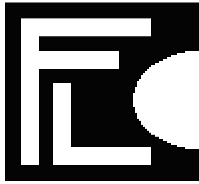

**Financial Lawyers Conference**

# Current Topics in Bankruptcy Litigation: Five Causes of Action, a Theory of Damages, and a Defense

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## I. OVERVIEW.

The financial collapse of 2008 has spurred a wave of bankruptcies across the country.[2] Unfortunately, due to the lack of available liquidity for insolvent companies the increased use of secured debt and changes to the bankruptcy code, the most of these bankruptcies have not been healthy restructurings, but liquidations.[3] As a result, the liquidation of litigation claims held by the estate has become a mainstay for bankruptcy practitioners looking to provide value to unsecured creditors. In the previous year and a half, trustees, debtors in possession and creditors' committees have sued banks, prior management, and former directors for, among other things, breach of contract (both oral and written), breach of the implied duty of good faith, fraud, misrepresentation, aiding and abetting fraud, breach of fiduciary duty, aiding and abetting breach of fiduciary duty, preferences, and fraudulent transfers.

To discuss any one of these sources of bankruptcy litigation fully would take more space than we have been allotted. Instead, these materials provide the basics and some cutting edge issues for five areas of bankruptcy litigation that have been rapidly developing recently: (i) equitable subordination, (ii) recharacterization, (iii) breach of fiduciary duty, (iv) aiding and abetting breach of fiduciary duty, and (v) deepening insolvency. We also discuss deepening insolvency as a measure of damages and the defense of *in pari delicto*, which have also been developing rapidly in the past years.

## II. EQUITABLE SUBORDINATION.

### A. Basics.

Bankruptcy Code section 510(c) permits a bankruptcy court to subordinate all or part of an allowed claim or interest or to transfer any lien securing a subordinated claim to the bankruptcy estate. It provides, in relevant part:

> after notice and a hearing, the court may–
>
> > (1) *under principles of equitable subordination*, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest; or

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[2] See, e.g., Michael Barbaro, Retailing Chains Caught in a Wave of Bankruptcies, N.Y. Times, Apr. 15, 2008, available at http://www.nytimes.com/2008/04/15/business/15retail.html; see generally, Quarterly U.S. Bankruptcy Statistics available at http://www.abiworld.org/am/template.cfm?section=Bankruptcy_Statistics1.

[3] See, e.g., Parija B. Kavilanz, Circuit City to shut down: Court approves bankrupt electronics retailer's motion to liquidate and close its remaining 567 stores, CNNMoney.com, available at http://money.cnn.com/2009/01/16/news/companies/circuit_city; Stephanie Rosenbloom, Struggling Mervyns to Close Its Doors, N.Y. Times, October 17, 2008, available at http://www.nytimes.com/2008/10/18/business/18shop.html; Retailer Steve & Barry's to liquidate stores, Seattle Times, Nov. 20, 2008.

(2) order that any lien securing such a subordinated claim be transferred to the estate.[4]

Equitable subordination is a powerful remedy, unique to bankruptcy, that allows the bankruptcy court to change the order in which creditors are paid from the bankruptcy estate's limited assets. In general, equitable subordination is limited to reordering distribution priorities and does not permit total disallowance of a claim.[5] In addition to altering the distribution priorities on account of a claim, where a subordinated claim is secured, Bankruptcy Code section 510(c)(2) permits a bankruptcy court to transfer any lien securing a subordinated claim to the estate to effectuate the intended priority.[6] Altering the payment priorities is a significant remedy as typically it will reduce the distribution to the creditor on the subordinated claim from payment in full as a secured creditor to payment of pennies on the dollar as an unsecured creditor, or from some payment as an unsecured creditor to no payment at all as a subordinated unsecured creditor.

Unless a creditor's claim is subordinated through a plan of reorganization, a claim for equitable subordination must be brought by an adversary proceeding.[7] Most decisions hold that only the trustee or debtor in possession have standing to bring a claim for equitable subordination unless the trustee or debtor in possession unjustly refuses to bring an action.[8] However, other opinions have held that a creditor has standing to seek equitable subordination in certain circumstances even absent a debtor in possession unjustly refusing to bring an action (e.g., when that creditor seeks to equitably subordinate another creditor's claim to just its own).[9]

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[4] 11 U.S.C. § 510(c)(1) (emphasis added).

[5] See In re Mobile Steel Co., 563 F.2d 692, 699 (5th Cir. 1977); In re 80 Nassau Assocs., 169 B.R. 834, 837 (Bankr. S.D.N.Y. 1994). However, if the conduct of the creditor is so egregious that it affects the validity of the claim under applicable principles of law, the bankruptcy court can disallow the claim as part of the claims allowance process, as was done in Pepper v. Litton. See 308 U.S. 295, 309 (1935). Section 502(j) preserves from the Chandler Act the same language used in Pepper to disallow the claim of an insider under principles of equitable subordination. Compare 11 U.S.C. § 502(j) to 308 U.S. at 305, n.12; see also In re Werth, 37 B.R. 979, 991 (Bankr. D. Colo. 1984) ("the claim will be disallowed to the extent [the debtor] establishes damages under Colorado law, resulting from the Bank's breach [of an oral contract to lend money].").

[6] Ford v. Feldman (In re Florida Bay Trading Co.), 177 B.R. 374, 386 (Bankr. D. Fla. 1994). Note that instead of allowing the trustee to avoid the security interest, which is preserved for the bankruptcy estate under Bankruptcy Code § 551, only if the court so orders will the security interest be transferred to the estate for the benefit of the creditors. Id.

[7] Fed R. Bankr. P. 7001(8).

[8] See, e.g., Official Comm. of Unsecured Creditors of AppliedTheory Corp. v. Halifax Fund, L.P. (In re AppliedTheory Corp.), 493 F.3d 82, 87 (2d Cir. 2007); In re Morpheus Lights, Inc., 228 B.R. 449, 454 (Bankr. N.D. Cal. 1998).

[9] In re Vitreous Steel Prods. Co., 911 F.2d 1223 (7th Cir. 1990) (the individual creditor seeking equitable subordination "is not acting in the interests of all the unsecured creditors" and "individual creditors have an interest in subordination separate and apart from the interests of the estate as a whole."); Algonquin Power Income Fund v. Ridgewood Heights, Inc. (In re Franklin Indus. Complex, Inc.), 2007 Bankr. LEXIS 3004 (Bankr. N.D.N.Y. Aug. 30, 2007). Accord In re Granite Partners, L.P., 210 B.R. 508, 514 (Bankr. S.D.N.Y. 1997) ("Although not technically a standing issue, the remedy of equitable subordination is not limited to a trustee, and one creditor may seek to equitably subordinate another creditor's claim to his own.").

### B. "Principles of Equitable Subordination"

Bankruptcy Code section 510(c) provides an amorphous standard for when the court may single out a creditor for harsh treatment. Courts may subordinate for purposes of distribution "under principles of equitable subordination." By articulating such a vague standard, Congress has simultaneously codified case law that was in existence at the time of the passage of the Bankruptcy Code[10] and allowed for further development of the principles.[11]

The majority of courts have held that the following conditions, which were first set forth in Benjamin v. Diamond (In re Mobile Steel Corp.)[12] (a case under the Chandler Act, the predecessor to the current Bankruptcy Code) must be satisfied before equitably subordinating a claim:

I. the claimant must have engaged in some kind of inequitable conduct;

II. the misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant; and

III. equitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy Code.[13]

Recent decisions have further specified the types of "inequitable conduct" that will suffice for the remedy of equitable subordination: "To satisfy the first prong of the test, a court must find (1) fraud, illegality, or breach of fiduciary duty, (2) undercapitalization, or (3) control or use of the debtor as an alter ego for the benefit of the claimant."[14] The Ninth Circuit Court of Appeals has not been this explicit, but has held that mere undercapitalization of debtor is an insufficient basis to equitably subordinate claims.[15]

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[10] H.R. Rep. No. 595, 95th Cong., 1st Sess. 359 (1977) (citing Pepper v. Linton, 308 U.S. 295 and Taylor v. Standard Gas & Elec. Co., 306 U.S. 307 (1938).

[11] Statement of Rep. Edwards, 124 Cong. Rec. H11,095 (daily ed. Sept. 28, 1978); Statement of Sen. De Concinin, 124 Cong. Rec. S17,413 (daily ed. Oct. 6, 1978).

[12] 563 F.2d 692 (5th Cir. 1977).

[13] Id. at 700; see also, Paulman v. Gateway Venture Partners III, L.P. (In re Filtercorp, Inc.), 163 F.3d 570, 583 (9th Cir. 1998); Citicorp Venture Capital v. Comm. of Creditors Holding Unsecured Claims, 160 F.3d 982, 986-87 (3d Cir. 1998); In re Lifschultz Fast Freight, 132 F.3d 339, 344 (7th Cir. 1997); Sure-Snap Corp. v. State Street Bank & Trust Co., 948 F.2d 869, 876 (2d Cir. 1991); cf. United States v. Noland, 517 U.S. 535, 116 S. Ct. 1524, 134 L. Ed. 2d 748 (1996). Some courts ignore this third prong as superfluous. Bala v. Kaler (In re Racing Servs.), 340 B.R. 73, 78 (8th Cir. B.A.P. 2006) ("When Congress passed the current Bankruptcy Code in 1978, it expressly authorized equitable subordination. Therefore, any exercise of authority under Section 510(c)(1) of the Bankruptcy Code is not inconsistent with the Code unless it ignores the Code's language.").

[14] Official Committee of Unsecured Creditors v. Bay Harbour Master Ltd. (In re BH S&B Holdings LLC), 2009 Bankr. LEXIS 3712 (Bankr. S.D.N.Y. Nov. 24, 2009). Accord O'Connell v. Arthur Andersen, LLP (In re AlphaStar Ins. Group, Ltd.), 383 B.R. 231, 276 (Bankr. S.D.N.Y. 2008).

[15] Paulman v. Gateway Venture Partners III, L.P. (In re Filtercorp, Inc.), 163 F.3d 570, 583 (9th Cir. Wash. 1998) ("the fact that Filtercorp was insolvent is insufficient to require subordination of claims").

If fraud is the basis for equitable subordination, it must be pled with particularity under the standard set forth in Fed. R. Civ. P. 9(b).[16] Even if fraud is *not* the basis, conclusory or vague allegations that the creditor engaged in some inequitable conduct will not survive summary judgment. In two recent cases, Ashcroft v. Iqbal[17] and Bell Atlantic Corp. v. Twombly[18] the U.S. Supreme Court has overruled the standard in Conley v. Gibson that a motion to dismiss under Fed. R. Civ. P. 12(b)(6) may only be granted if there is "no set of facts" that plaintiff could prove to state a claim.[19] Applying this standard on a motion to dismiss, courts accept all factual allegations in the complaint as true – discounting legal conclusions clothed in factual garb – and then determine whether these factual allegations "plausibl[y] suggest an entitlement to relief."[20]

A very recent decision shows that "inequitable conduct" standard may be a lot broader than previously articulated. In Credit Suisse v. Official Committee of Unsecured Creditors (In re Yellowstone Mt. Club LLC),[21] the Bankruptcy Court for the District of Montana subordinated a $375 million secured syndicated facility to all of the debtor's debt, both secured and unsecured. In that case, the debtor/borrower, Yellowstone Mountain Club, was a high-end golf and ski development that went bankrupt after it refinanced its development through Credit Suisse. At Credit Suisse's urging, the principals of Yellowstone Mountain Club borrowed $375 million; $24.2 million went to repay preexisting secured debt, approximation $9 million went toward fees and administrative costs and $209 million immediately went to Yellowstone Mountain Club's principal, Blixseth.[22] There was nothing to suggest that the loan from Credit Suisse was not at arm's length.[23] According to the Court:

> Credit Suisse had not a single care how Blixseth used a majority of the loan proceeds, and in fact authorized Blixseth to take $209 million and use it for any purpose unrelated to the Yellowstone Club. Blixseth, however, had a problem in this case because he was not the sole owner of the Yellowstone Club and he did not want to share the loan proceeds with the B shareholders. Thus, Blixseth booked the $209 proceeds that he took from the Yellowstone Club as a loan months after he actually took the proceeds. Blixseth claims he always intended to repay the $209 million BGI note, but Blixseth's former wife Edra testified to the contrary.

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[16] See In re Universal Foundry Co., 163 B.R. 528, 539-41 (E.D. Wis. 1993) (affirming bankruptcy court's conclusion that trustee failed to sufficiently plead "the circumstances constituting fraud in connection with its equitable subordination claim").

[17] 129 S. Ct. 1937, 1949 (2009)

[18] 550 U.S. 544 (2007),

[19] 355 U.S. 41, 45-46 (1957)

[20] 129 S. Ct. 1951.

[21] Case No. 08-61570-11, Adv. No. 09-00014 (Bankr. D. Mont. May 13, 2009); available at http://www.scribd.com/doc/15447269/Yellowstone-Mountian-Club-Interim-Order.

[22] Slip Opinion at 11-12.

[23] Id. at 8.

> Blixseth testified that he always intended to take the $209 loan proceeds as a loan rather than a distribution because booking the transaction as a distribution would have caused his owner's equity account to have a negative balance.[24]

The bankruptcy court found that Credit Suisse had acted recklessly in loaning against the project when due diligence would have uncovered that it was doomed for failure. Further, the court held that the fact that the project went into bankruptcy was, itself, a harm to the other creditors. Condition (I) of the *Mobile Steel* standard was satisfied by Credit Suisse's "predatory" lending, and condition (II) was satisfied by the resultant bankruptcy. Based on this, the court held:

> The only plausible explanation for Credit Suisse's actions is that it was simply driven by the fees it was extracting from the loans it was selling, and letting the chips fall where they may. Unfortunately for Credit Suisse, those chips fell in this Court with respect to the Yellowstone Club loan. The naked greed in this case combined with Credit Suisse's complete disregard for the Debtors or any other person or entity who was subordinated to Credit Suisse's first lien position, shocks the conscience of this Court. While Credit Suisse's new loan product resulted in enormous fees to Credit Suisse in 2005, it resulted in financial ruin for several residential resort communities. Credit Suisse lined its pockets on the backs of the unsecured creditors. The only equitable remedy to compensate for Credit Suisse's overreaching and predatory lending practices in this instance is to subordinate Credit Suisse's first lien position to that of CrossHarbor's superpriority debtor-in-possession financing and to subordinate such lien to that of the allowed claims of unsecured creditors.[25]

Some articles discussing the *Yellowstone* decision dismiss it as out-of-hand[26] because the case involves particularly bad facts.[27] It appears that the resort development was an enormous undertaking for the area, to the point where nearly every contractor within the region had invested its time and resources on the project and was awaiting payment. Because of Credit Suisse's large financing of the project and the downturn in the real estate market, if it remained in first position, virtually no contractor or other creditor would receive a dime and administrative claims may not have been paid.[28] The court used the doctrine of equitable subordination to ensure that all of the other contractors and various creditors of the project would receive some

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[24] Id. at 17.

[25] Id. at 19.

[26] Jo Ann J. Brighton and Felton E. Parrish, "Yellowstone: New Standards for Lender Liability in Today's Economic Climate," Am. Bankr. Inst. J., Vol. XXVIII, No. 7 (Sept. 2009) at 28.

[27] See, e.g., J. Thomas Beckett, "A Rogue Loan Not a Rogue Decision: a Response to a Recent Analysis of Yellowstone," Am. Bankr. Inst. J., Vol. XXVII, No. 8 (Nov. 2009) at 22; Ken Rathburn, Kreisler or Yellowstone? The Reach of the Equitable Subordination Doctrine, Banking and Finance Law Report, available at http://www.bankingandfinancelawreport.com/tags/Yellowstone.

[28] Rathburn, *supra* note 27.

payment. However, the fact that a bankruptcy court could impose equitable subordination based on "predatory lending" to multi-million dollar developer seems unusual based on any facts. This case may have been appropriate for fraudulent transfer law, but seems inappropriate for equitable subordination.

### C. Subordination of Claims of Insiders.

Where the claimant is a fiduciary of the debtor or the functional equivalent of an insider, the dealings between the debtor and the claimant are subjected to heightened scrutiny and, if the transaction between them is sufficiently challenged (by a *prima facie* showing), the burden shifts to the claimant to prove both the good faith of the transaction and its inherent fairness, rather than requiring the plaintiff to prove inequitable conduct.[29] The equitable subordination doctrine has been used to address inequitable conduct by insiders trading in a bankrupt debtor's claims as well as inequitable pre-petition conduct.[30] Outside the context of insiders, applying equitable subordination is much more difficult. As a result, a key battle in equitable subordination claims is whether the creditor counts as an "insider." While this is easy enough to prove in litigation against the former directors and officers of a corporation, it can also apply to lenders: "If the lending institution usurps the power to make business decisions from the customer's board of directors and officers, then it must also undertake the fiduciary obligation that the officers and directors owe the corporation (and its creditors)."[31] Bankruptcy courts can equitably subordinate a lender when the lender steps beyond the traditional role of a lender and participates in the debtor's business or engages in other egregious conduct that justifies the use of the court's equitable powers.[32]

Shubert v. Lucent Technologies Inc. (In re Winstar Communications, Inc.)[33] is a recent case defining the limits of when a lender can be an insider. In that case, the Third Circuit Court of Appeals upheld a bankruptcy court's ruling that (i) Lucent Technologies ("Lucent") was an insider of Winstar Communications ("Winstar"), (ii) Lucent's claim would be equitably

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[29] In re Herby's Foods, Inc., 2 F.3d 128, 141 (5th Cir. 1993); In re Mr. R's Prepared Foods, Inc., 251 B.R. 24, 29 (Bankr. D. Conn. 2000); cf. Capitol Bank. & Trust Co. v. 604 Columbus Avenue Realty Trust (In re 604 Columbus Avenue Realty Trust), 968 F.2d 1332, 1360 (1st Cir. 1992) ("Whether the creditor is an insider or fiduciary of the debtor is fundamentally important to the level of scrutiny that courts apply to allegations of misconduct against a creditor"); In re Fabricators, Inc., 926 F.2d 1458, 1465 (5th Cir. 1991) (ruling that if the claimant is not an insider, "then evidence of more egregious misconduct . . . is necessary"); In re Missionary Baptist Church Foundation of America, Inc., 818 F.2d 1135, 1144 n.8 (5th Cir. 1987); In re N&D Properties, Inc., 799 F.2d 726, 731 (11th Cir. 1986).

[30] See Citicorp Venture Capital, Ltd. v. Comm. of Creditors Holding Unsecured Claims (In re Papercraft Corp.), 324 F.3d 197 (3d Cir. 2003) (holding that claimant's covert purchase of claims at discounted amount while acting as fiduciary to debtor was sufficiently egregious to warrant subordination of amount paid for claims and damage inflicted on non-selling creditors – including litigation expenses); In re UVAS Farming Corp., 91 B.R. 575 (Bankr. D.N.M. 1988).

[31] In re Badger Freightways, Inc., 106 B.R. 971, 977 (Bankr. N.D. Ill. 1989); see also Boyd v. Sachs (In re Auto Specialties Manufacturing Co.), 153 B.R. 457, 478 (Bankr. W.D. Mich. 1993).

[32] In re U.S. Abatement Corp., 39 F.3d 556, 561 (5th Cir. 1994).

[33] 554 F.3d 382 (3d Cir. 2008).

subordinated, and (iii) a $188.2 million loan payment Lucent received in 2000 was an avoidable preference.[34]

Winstar was a publically traded provider of local and long-distance telecommunications services that filed for bankruptcy.[35] The company was working on building a global broadband network when it collapsed. In 1998, it entered into a "strategic partnership" with Lucent, under which Lucent would finance Winstar's network construction efforts with credit lines. In return, Winstar entered into a supply agreement obligating it to purchase certain products and services exclusively from Lucent. In November 2000, Winstar borrowed an additional $200 million from another creditor. However, after Lucent threatened to cut-off any further credit, Winstar paid it $188.2 million in December 2000, less than 90 days before Winstar's bankruptcy.[36]

The Third Circuit began its analysis with the text of the definition of "insider." The Bankruptcy Code defines insiders as follows:

> The term "insider" *includes*–
> * * *
> (B) if the debtor is a corporation–
> (i) director of the debtor;
> (ii) officer of the debtor;
> (iii) person in control of the debtor;
> (iv) partnership in which the debtor is a general partner;
> (v) general partner of the debtor; or
> (vi) relative of a general partner, director, officer, or person in control of the debtor;
> * * *
> (E) affiliate, or insider of an affiliate as if such affiliate were the debtor; and
>
> (F) managing agent of the debtor.[37]

Several courts have noted that, because the Code uses the work "includes," the category of insiders called "non-statutory insiders" falls within the definition but outside the enumerated categories.[38]

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34 Id. at 392.

35 Id. at 391.

36 Id. at 394.

37 11 U.S.C. § 101(31) (emphasis added).

38 In re Carrozzella & Richardson, 302 B.R. 415 (Bankr. D. Conn. 2003); In re A. Tarricone, Inc., 286 B.R. 256 (Bankr. S.D.N.Y. 2002); Matter of Krehl, 86 F.3d 737 (7th Cir. 1996); In re Kong, 196 B.R. 167 (N.D. Cal. 1996).

In Winstar, Lucent argued that in order for a creditor to constitute an "insider" as either a "person in control" or a non-statutory insider, that creditor must exercise "actual managerial control over the debtor's day-to-day operations."[39] The court rejected this argument:

> We agree with Lucent that actual control (or its close equivalent) is necessary for a person or entity to constitute an insider under § 101(31)'s "person in control" language. However, a finding of such control is not necessary for an entity to be a non-statutory insider . . . to hold otherwise would render meaningless Congress's decision to provide a non-exhaustive list of insiders in 11 U.S.C. § 101(31)(B) because the "person in control" category would function as a determinative test . ... [¶] ... In light of these enumerated categories, we hold that it is not necessary that a non-statutory insider have actual control; rather, the question is whether there is a close relationship [between debtor and creditor] and . . . anything other than closeness to suggest that any transactions were not conducted at arm's length.[40]

Applying this definition, the court of appeals held that the bankruptcy court's finding that Lucent was an insider was well supported by its other findings that Lucent had the ability to coerce Winstar into transactions not in Winstar's interest. These actions included making Winstar a captive buyer and forcing the smaller company into transactions that only benefited Lucent. Specifically, it repeatedly forced Winstar to make massive purchases of unneeded equipment for the sole purpose of inflating Lucent's revenue.

### D. Equitable Subordination Only Appropriate to Offset Specific Harm to Creditors

Because equitable subordination is remedial, not penal, the claim generally will be subordinated only to the extent necessary to offset the specific harm that the debtor and its creditors suffered on account of the alleged inequitable conduct.[41] However, the misconduct need not be related to the creation of the claim for the claim to be subordinated.[42] Two recent decisions have further elaborated the remedial nature of the equitable subordination remedy.

In re Kreisler[43] involved debtors that owned two properties in Chicago encumbered by several mortgages, including a junior mortgage held by Ravenswood Community Bank. The debtors purchased the junior mortgage through a special purpose vehicle and hid their ownership

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[39] 554 F.3d 382, 395; see also Butler v. David Shaw, Inc., 72 F.3d 437, 443 (4th Cir. 1996).

[40] 554 F.3d 382, 396-97(internal citations and quotation marks omitted).

[41] Id.; Benjamin v. Diamond (In re Mobile Steel Corp.), 563 F.2d 692, 701 (5th Cir. 1977); Carter-Waters Okla., Inc. v. Bank One Trust Co., N.A. (In re Eufala Indus. Auth.), 266 B.R. 483 (10th Cir. B.A.P. 2001).

[42] Machinery Rental Inc. v. Herpel (In re Multiponics, Inc.), 622 F.2d 709 (5th Cir. 1980); Enron Corp. v. Avenue Special Situations Fund II, LP (In re Enron Corp.), 333 B.R. 205 (Bankr. S.D.N.Y. 2005) ("Fundamentally, the analysis focuses on the alleged inequitable conduct, and any associated harm therefrom, not on any particular claim or group of claims."); In re Reed, 11 B.R. 258 (Bankr. D. Utah 1981).

[43] 546 F.3d 863 (7th Cir. 2008).

interest in the SPV.[44] When the SPV sought to have its claim paid out of the bankruptcy estate, the bankruptcy court was outraged by the debtor duplicity and ruled that the SPV's claim should be equitably subordinated.[45]

On appeal, the Seventh Circuit Court of Appeals reversed, ruling that, even secretly acquiring the Ravenswood claim through the SPV constituted inequitable conduct, equitable subordination of the SPV's claim was not appropriate because there was no evidence that the debtors' conduct harmed any of their creditors.[46] The only creditor affected by what the debtors had done was Ravenswood, which sold its claim at a deep discount, but the bank was not complaining.[47]

Henry v. Lehman Commercial Paper, Inc. (In re First Alliance Mortgage Co.)[48] highlights the fact that inequitable conduct must cause harm to the other creditors that is related to the bankruptcy or the claim. In that case, the debtor, First Alliance Mortgage Company ("FAMCo"), was a predatory sub-prime mortgage lender. FAMCo used Lehman Commercial Paper, Inc. ("Lehman") to underwrite its mortgage products.[49] In the late 1990s, FAMCo came under scrutiny for its coercive and misrepresentative lending practices; seven states and the Department of Justice launched an official investigation into FAMCo and, in April 2000, it filed for bankruptcy.[50]

Two lawsuits were filed against Lehman based on its role as the primary underwriter for FAMCo, both asserting that Lehman lent knowing assistance to FAMCo's fraudulent lending practices.[51] The first was a class action filed by FAMCo's borrowers for damages for abetting the fraud in violation of California law. The second suit was an adversary complaint filed by the liquidating trustee to equitably subordinate Lehman's $77 million secured claim in FAMCo's bankruptcy case.[52]

The lawsuits were tried concurrently in the District Court for the Central District of California. In the borrowers' lawsuit, the jury found Lehman liable for 10 percent of the total fraud damages suffered by the class, equal to roughly $5 million. However, the district court held that equitable subordination was *not* an appropriate remedy in this case, reasoning that

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[44] Id. at 864-65.

[45] Id. at 865.

[46] Id. at 866. Accord In re SI Restructuring, Inc., 532 F.3d at 362 ("Because the loan proceeds were used to pay current unsecured creditors, unsecured creditors, as a class, were not harmed when the Wooleys' [sic] obtained security for the November loan.").

[47] Id. at 867.

[48] 471 F.3d 977 (9th Cir. 2006).

[49] Id. at 986.

[50] Id. at 985.

[51] Id. at 983.

[52] Id. at 987.

Lehman's conduct was not "sufficiently egregious to justify equitable subordination of a non-insider, non-fiduciary creditor."[53]

On appeal, the Ninth Circuit affirmed the district court's ruling in relevant parts.[54] The court focused on the first Mobile Steel requirement—whether Lehman engaged in inequitable conduct. The court acknowledged that "[a]t first blush, the Trustee's argument has a certain allure, because there is surely something 'inequitable' in an abstract sense about aiding and abetting fraud."[55] However, the Ninth Circuit held that the district court was correct to deny the remedy of equitable subordination:

> Lehman's activities were not carried out in contemplation of the later-filed First Alliance bankruptcy, and Lehman's conduct was not a contributing factor to bring about the bankruptcy or determining the ordering of creditors to the bankruptcy estate. . . . Instead, the impact of Lehman's conduct on First Alliance borrower creditors is only tangentially related to the First Alliance bankruptcy in that both Lehman and the borrowers are creditors of the First Alliance estate.[56]

As a result of the ruling, Lehman's $77 million secured claim was allowed despite Lehman's alleged involvement in aiding and abetting FAMCo's fraudulent lending practices.

### E. Transferee Liability for Bad Act of Transferor.

Another issue that has cropped up (and is likely to crop up again) is the question whether a bad actor may transfer a claim that would otherwise be subordinated, free and clear of potential subordination. Bankruptcy Code § 550(b) protects good faith transferees of transfers avoidable pursuant to Bankruptcy Code sections 547(b) (relating to preferential transfers) and 548 (relating to fraudulent transfers).[57] Although the language of § 510(c) does not specifically provide for a "good faith" defense for purchasers of claims, it has been argued that the "good faith" defense under § 550(b) of the Bankruptcy Code should be extended to claims purchasers in the claims transfer process.

In Enron Corp. v. Avenue Special Situations Fund II, LP (In re Enron Corp.),[58] the Bankruptcy Court for the Southern District of New York confronted this issue. Prior to filing bankruptcy, Enron entered into a $1.75 billion revolving credit agreement with certain lenders. After Enron filed for bankruptcy, those lenders transferred some of their claims. Enron commenced adversary proceedings against various lenders, alleging, *inter alia*, equitable

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[53] Austin v. Chisick (In re First Alliance Mortgage Co.), 298 B.R. 652, 668 (C.D. Cal. 2003).

[54] In re First Alliance Mortgage Co., 471 F.3d at 1006-07.

[55] Id. at 1007.

[56] Id.

[57] 11 U.S.C. § 550(b).

[58] 333 B.R. 205 (Bankr. S.D.N.Y. 2005).

subordination and against the other transferees seeking to equitably subordinate and disallow the transferred claims.[59] The transferee defendants moved to dismiss the complaint arguing that (1) the claims should not be subject to subordination because section 510(c) requires that the party asserting the claims to have engaged in inequitable conduct causing injury;[60] and (2) subjecting transferees of claims to equitable subordination would both introduce multiple layers of litigation to innocent transferees and seriously affect liquidity in the distressed debt market.

In opposition to the motions, Enron argued that the transferred claims should be subject to subordination on the grounds that (1) the banks cannot transfer greater rights than they had (especially given that their rights are fixed on the petition date); (2) to the extent the purchasers of the claims are not indemnified, they should have protected themselves by demanding indemnification, which is in the standardized claims trading contract, rather than by seeking to limit the debtor's rights; and (3) a holding that transferred claims could not be subordinated based on the transferor's conduct would dramatically undermine the congressional purpose behind section 510(c) and enable "claims washing."[61]

The bankruptcy court found that the transferred claims were still subject to equitable subordination under § 510(c) of the Bankruptcy Code. According to the bankruptcy court, the remedy of equitable subordination remains with the claims and the transfer of those claims does not immunize them from subordination in the hands of the transferee. It further held that the "good faith" defense is not available to the transferee. The bankruptcy court's opinion strongly supported Enron's policy argument that shielding transferred claims from subordination would encourage creditors who have engaged in inequitable conduct to "wash" their claims free of the possibility of subordination merely by transferring them.[62]

On appeal, the District Court for the Southern District of New York reversed.[63] It began with a discussion of the legislative history of Bankruptcy Code § 510(c) and concluded that the potential for equitable subordination is a personal disability of a particular claimant not the claim. Therefore, it does not automatically travel with the claim, (notwithstanding the text of the statute, which grants courts authority to "subordinate all or part of a claim to all or part of another allowed claim.")[64] The district court pointed to the application of equitable subordination to unrelated claims based solely on the fact that they are held by a bad actor and subordination of claims after the petition date as evidence that the proper focus is on the claimant personally and not the claim.[65]

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[59] Id. at 211-12.

[60] Id. at 216.

[61] Id. at 215.

[62] Id. at 230.

[63] Enron Corp. v. Springfield Assocs., L.L.C. (In re Enron Corp.), 379 B.R. 425 (S.D.N.Y. 2007).

[64] 11 U.S.C. § 510(c).

[65] 379 B.R. at 441.

Notwithstanding the court's finding that equitable subordination was a disability of a claimant and not a claim, the court created a system whereby some claims could be subordinated based on the transferor's conduct and some would not. The court distinguished acquisitions of claims by *sale* and acquisitions by *assignment*: "A personal disability that has attached to a creditor who transfers its claim will travel to the transferee if the claim is assigned, but will not travel to the transferee if the claim is sold."[66] Unlike assignees, purchasers in good faith are generally protected from the personal disabilities of their sellers since such transferees do not stand in the shoes of their sellers. According to the court, this distinction is

> particularly imperative in the distressed debt market context, where sellers are often anonymous and purchasers have no way of ascertaining whether the seller (or a prior transferee) has acted inequitably or received a preference. No amount of due diligence on their part will reveal that information, and it is unclear how the market would price such unknowable risk. Parties to pure assignments, by contrast, can easily contract around the risk of equitable subordination or disallowance by entering into indemnity agreements to protect the assignee.[67]

The District Court in Enron did not attempt to answer the question of how a court should distinguish between an assignment and a sale. In a footnote of the opinion, the court provided an example of a sale (purchase on the open market) and of an assignment (acquisition by operation of law, such as subrogation), but did not identify factors that would guide the bankruptcy court.[68] Although further appeal was requested, it was denied.[69] Because the case settled, the bankruptcy court did not have an opportunity to apply the framework and, to date, no reported case has applied the district court's distinction.

## III. RECHARACTERIZATION.

"Recharacterization" refers to an equitable power exercised by bankruptcy courts to treat a purported claim or transaction according to its true economic nature and substance, notwithstanding its form or name. The Bankruptcy Code does not expressly grant any such power, but many courts have nonetheless found an implied power to recharacterize based on their general powers as courts of equity.[70]

The following scenario helps illustrate the recharacterization of a loan as an equity contribution:

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[66] Id. at 436.

[67] Id. at 442.

[68] Id. at 446, n. 104.

[69] Enron Corp. v. Springfield Assocs., L.L.C. (In re Enron Corp.), 2007 U.S. Dist. LEXIS 70731, Bankr. L. Rep. (CCH) P81029 (S.D.N.Y. Sept. 24, 2007).

[70] In the context of bankruptcy, there are two major types of recharacterization: recharacterization of loans as equity contributions and recharacterization of sales as secured loans. Because there has not been much development in the law regarding recharacterization of sales as secured loans, we omit discussion of that here.

> Corporation is grossly undercapitalized. It must raise $6 million in order to meet payroll and other immediate and critical working capital needs. Unfortunately, Corporation cannot locate any lender willing to extend financing. Among other things, Corporation can barely service its current debt, it has no unencumbered assets to offer as security for an additional loan, and it does not have sufficient cash flow to service interest or principal on any additional loan. Two Investors sit on Corporation's board of directors, each of whom has already invested millions of dollars in equity in Corporation at its inception and in subsequent financing rounds. Investors agree that they will each loan $3 million to Corporation in exchange for notes bearing interest at 10 percent. The notes are negatively amortized: they do not require any payment of principal or interest during their term but must be satisfied in their entirety by a balloon payment at maturity after three years. The loan proceeds are used immediately to fund Corporation's working capital needs. However, Corporation's financial condition continues to deteriorate; it cannot service its other debt; and it eventually files for bankruptcy relief. Investors file proofs of claim on account of their notes. At this point, Corporation's other unsecured creditors request that the bankruptcy court recharacterize the purported financing notes as equity contributions. They argue that the amounts advanced by Investors, although cast in the form of loans, were actually equity infusions.

Presented with such a request, under the majority view, the bankruptcy court is "not required to accept the label of 'debt' or 'equity' placed by the debtor upon a particular transaction, but must inquire into the actual nature of the transaction to determine how best to characterize it."[71] In other words, the court is required to scrutinize the transaction "according to an objective test of economic reality to determine its true economic nature."[72] If the transaction, although "cast in the form of a loan[,]"nevertheless has the "substance and character of an equity contribution[,]" then the court may recharacterize the transaction as an equity contribution.[73] This is the case even where an equity investment may require regulatory approval.[74]

As a threshold proposition, jurisdictions do not agree uniformly whether bankruptcy courts have the power to recharacterize debt into equity. The vast majority of jurisdictions have held that bankruptcy courts may recharacterize debt as equity:

> Bankruptcy courts that have applied a recharacterization analysis have stated that their power to do so stems from the authority vested in the

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[71] In re Cold Harbor Assocs., 204 B.R. 904, 915 (Bankr. E.D. Va. 1997). Accord Adelphia Communs. Corp. v. Bank of Am., N.A. (In re Adelphia Communs. Corp.), 365 B.R. 24, 74 (Bankr. S.D.N.Y. 2007) ("recharacterization and equitable subordination analyses differ from each other in that recharacterization analyses focus on the substance of the transaction, whereas equitable subordination analyses focus on the creditor's behavior.").

[72] Cohen v. KB Mezzanine Fund II, L.P. (In re Submicron Sys. Corp.), 291 B.R. 314, 323 (Bankr. D. Del. 2003) (citations omitted).

[73] Aquino v. Black (In re Atlantic Rancher, Inc.), 279 B.R. 411, 437 (Bankr. D. Mass. 2002).

[74] Menotte v. NLC Holding Corp. (In re First NLC Fin. Servs., LLC), 396 B.R. 562, 567-68 (Bankr. S.D. Fla. 2008).

> bankruptcy courts to use their equitable powers to test the validity of debts. The source of the court's general equitable powers is § 105 of the Code, which states that bankruptcy judges have the authority to "issue any order, process or judgment that is necessary or appropriate to carry out the provisions" of the Code.[75]

At least five Circuit Courts of Appeal recognize the power of bankruptcy courts to recharacterize debt as equity.[76]

On the other hand, a minority of courts have taken the position that the Bankruptcy Code does not permit the recharacterization of debt to equity.[77] In In re Pacific Express, Inc., the Bankruptcy Appellate Panel for the Ninth Circuit reasoned that Bankruptcy Code § 502 authorizes a court to determine the "amount" of a claim, and § 157(b)(2)(B) of the Judicial Code[78] authorizes a court to determine the "allowance or disallowance" of a claim, but that no provision authorizes a court to decide the character of a claim.[79] The panel next examined Bankruptcy Code § 510(c), which authorizes the equitable subordination of claims under certain circumstances. It is well-settled that, although bankruptcy courts have broad authority to work equity under § 105(a), they may not do so in a manner inconsistent with the Bankruptcy Code.[80] Stated another way, § 105(a) "supplements the courts' specifically enumerated bankruptcy powers by authorizing orders necessary or appropriate to carry out provisions of the Bankruptcy Code. However, § 105(a) has a limited scope. It does not create rights that would otherwise be unavailable under the Bankruptcy Code."[81] The panel found that recharacterization was

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75 In re Autostyle Plastics, Inc., 269 F.3d at 749.

76 Estes v. N&D Prop., Inc., 799 F.2d 726, 733 (11th Cir. 1986) ("Shareholder loans may be deemed capital contributions in one of two circumstances: where the trustee proves initial undercapitalization or where the trustee proves that the loans were made when no other disinterested lender would have extended credit."); In re Autostyle Plastics, Inc., 269 F.3d 726, 748 (6th Cir. 2001) (holding that bankruptcy courts "can consider whether to recharacterize a claim of debt as equity"); In re Hedged Inv. Assoc., Inc., 380 F.3d 1292 (10th Cir. 2004); In re Submicron Sys. Corp., 432 F.3d 448 (3d Cir. 2006); In re Official Comm. of Unsecured Creditors for Dornier Aviation, Inc., 453 F.3d 225, 231 (4th Cir. 2006) ("recharacterization is well within the broad powers afforded a bankruptcy court in § 105(a) and facilitates the application of the priority scheme laid out in § 726.").

77 Pacific Express Holding, Inc. v. Pioneer Commercial Funding Corp. (In re Pacific Express, Inc.), 69 B.R. 112, 115 (B.A.P. 9th Cir. 1986); In re Airadigm Communications Inc., 376 B.R. 903, 916 (Bankr. W.D. Wis. 2007) ("There is – or should be – no such cause of action as recharacterization in bankruptcy."); Pinetree Partners, Ltd. v. Retirement Sys. (In re Pinetree Partners, Ltd.), 87 B.R. 481, 491 (Bankr. N.D. Ohio 1988) (following In re Pacific Express, Inc.).

78 See 28 U.S.C. § 157(b)(2)(B).

79 In re Pacific Express, Inc., 69 B.R. at 115 ("While the Code supports the court's ability to determine the amount and the allowance or disallowance of claims, those provisions do not provide for the characterization of claims as equity or debt.").

80 Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 206 (1988) ("whatever equitable powers remain in the bankruptcy courts must and can only be exercised within the confines of the Bankruptcy Code."); Gouveia v. Tazbir, 37 F.3d 295, 300 (7th Cir. 1994).

81 In re WCI Cable, Inc., 282 B.R. 457, 468 (Bankr. D. Or. 2002) (quoting United States v. Pepperman, 976 F.2d 123, 131 (3d Cir. 1992)).

inconsistent with the Bankruptcy Code. It therefore concluded that recharacterization was not a permissible exercise of a bankruptcy court's equitable power.[82]

The Supreme Court's 1999 decision in Grupo Mexicano De Desarrollo v. Alliance Bond Fund[83] may affect the debate over the authority of bankruptcy courts to recharacterize debt as equity. In Grupo Mexicano, the Supreme Court held that a preliminary injunction may not issue to preserve assets to which a party did not yet have a legal claim. The Supreme Court recognized that "equity is flexible; but in the federal system, at least, that flexibility is confined within the broad boundaries of traditional equitable relief. To accord a type of relief that has never been available before ... is to invoke a default rule ... not of flexibility but of omnipotence."[84] Grupo Mexicano may lend support to the minority position that recharacterization is not a legitimate exercise of a bankruptcy court's general equitable powers under Bankruptcy Code § 105(a).[85] Recharacterization is neither authorized by statute nor a traditional equitable power. As stated in Grupo Mexicano, it may be that to permit bankruptcy courts to recharacterize claims under § 105 would be to adopt a rule not of flexibility, but of omnipotence.

On the other hand, several relatively recent opinions have held that Grupo Mexicano may not be as comprehensive as it first appeared. In Rubin v. Pringle (In re Focus Media, Inc.),[86] the Ninth Circuit Court of Appeals held that Grupo Mexicano appeared to except from its general rule the following two situations: where the plaintiff pleads for (i) equitable relief, and not just legal damages, in instances where a preliminary injunction is a reasonable measure to preserve the status quo; and (ii) avoidance of preference or fraudulent transfer claims, which are designed to prevent such conduct as "debtors' trying to avoid paying their debts, or seeking to favor some creditors over others."[87]

Jurisdictions that have allowed bankruptcy courts to recharacterize debt as equity have adopted similar, although varying, multi-factor tests.[88] These factors are "not exclusive, and no one factor is predominant, nor are the factors to be given rigidly equal weight."[89]

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[82] In re Pacific Express, Inc., 69 B.R. at 115 ("Where there is a specific provision governing these determinations, it is inconsistent with the interpretation of the Bankruptcy Code to allow such determinations to be made under different standards through the use of the court's equitable powers.").

[83] 527 U.S. 308 (1999).

[84] Id. at 322.

[85] See In re Pacific Express, Inc., 69 B.R. at 115.

[86] 387 F.3d 1077 (9th Cir. 2004).

[87] Grupo Mexicano, 527 U.S. at 322; see also, e.g., United States ex rel. Rahman v. Oncology Assocs., P.C., 198 F.3d 489 (4th Cir. 1999) (explaining that the Supreme Court in Grupo Mexicano "was not presented with, nor did it choose to address, a situation in which equitable remedies were claims."); CSC Holdings, Inc. v. Redisi, 309 F.3d 988 (7th Cir. 2002) (upholding preliminary injunction where equitable relief sought).

[88] These established criteria may act as a guideline for those seeking to advise an insider investing money in a troubled company to minimize the risk of recharacterization.

[89] In re Cold Harbor Assocs., 204 B.R. at 915; see also In re Autostyle Plastics, Inc., 269 F.3d at 750 ("No one factor is controlling or decisive. The factors must be considered within the particular circumstances of each case.").

The overriding principle governing this determination is "whether the transaction bears the earmarks of an arm's length negotiation. The more such an exchange appears to reflect the characteristics of an arm's length negotiation, the more likely such a transaction is to be treated as debt."[90] A second key factor is whether the corporation is undercapitalized at the time the funds are advanced. "When a corporation is undercapitalized, a court is more skeptical of purported loans made to it because they may in reality be infusions of capital."[91] On the other hand, recharacterization may not be appropriate where a party is "acting as a lender of last resort and not as an investor."[92]

Courts have adopted three sets of factors to be used in determining whether to recharacterize debt as equity. The Sixth Circuit Court of Appeals and lower courts in the First, Third, and Eighth Circuits have adopted the so-called "Roth Steel"[93] set of 11 factors, as follows:

1. the names given to the instruments, if any.
2. the presence or absence of a fixed maturity date and schedule of payments.
3. the presence or absence of a fixed rate of interest and interest payments.
4. the source of repayments.
5. the adequacy or inadequacy of capitalization.
6. the identity of interest between the creditor and the stockholder.
7. the security, if any, for the advances.
8. the corporation's ability to obtain financing from outside lending institutions.
9. the extent to which the advances were subordinated to the claims of outside creditors.
10. the extent to which the advances were used to acquire capital assets.
11. the presence or absence of a sinking fund to provide repayments.[94]

The Fifth, Tenth, and Eleventh Circuits, as well as lower courts in the Second Circuit, have adopted the following 13 factor test, largely identical to the Roth Steel factors:

1. the names given to the certificates evidencing indebtedness.
2. the presence or absence of a fixed maturity date.
3. the source of payments.
4. the right to enforce payment of principal and interest.

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90 In re Cold Harbor Assocs., 204 B.R. at 915 (citing Pepper v. Litton, 308 U.S. 295 (1939)).

91 In re Submicron Sys. Corp., 291 B.R. at 325 (quoting In re Autostyle Plastics, Inc., 269 F.3d at 746-47) (noting that "undercapitalization alone is insufficient to justify the subordination of insider claims; there must be evidence of other inequitable conduct.").

92 In re AtlanticRancher, Inc., 279 B.R. at 438.

93 These factors were adopted from the tax court case Roth Steel Tube Co. v. Comm'r of Internal Revenue, 800 F.2d 625, 630 (6th Cir. 1986).

94 In re Autostyle Plastics, Inc., 269 F.3d 726; In re Micro-Precision Techs., Inc., 303 B.R. 238, 246-48 (Bankr. D.N.H. 2003); In re Exide Techs., Inc., 299 B.R. 732, 740-42 (Bankr. D. Del. 2003); U.S. Bank, N.A. v. Stalnaker (In re Rosen Auto Leasing, Inc.), No. BK02-81781, 2004 Bankr. LEXIS 1399, at *8-9 (Bankr. D. Neb. Sept. 17, 2004); In re Vanguard Airlines, Inc., 302 B.R. 292, 300 (Bankr. W.D. Mo. 2003). Accord Official Committee of Unsecured Creditors v. Bay Harbour Ltd. (In re BH S&B Holdings LLC, et al.), 2009 Bankr. LEXIS 3712 (Banrk. S.D.N.Y. Nov. 24, 2009).

5. participation in management flowing as a result.
6. the status of the contribution in relation to regular corporate creditors.
7. the intent of the parties.
8. "thin" or inadequate capitalization.
9. identity of interest between creditor and stockholder.
10. the source of interest payments.
11. the ability of the corporation to obtain loans from outside lending institutions.
12. the extent to which the advance was used to acquire capital assets.
13. failure of the debtor to repay on the due date or seek postponement.[95]

Finally, lower courts in the Third Circuit also have adopted the following seven factor test, which incorporates various factors from the preceding tests:

1) the name given to the instrument.
2) the intent of the parties.
3) the presence of a fixed maturity date.
4) the right to enforce payment of principal and interest.
5) the presence or absence of voting rights.
6) the status of the contribution in relation to regular corporate contributors.
7) the certainty of payment in the event of the corporation's insolvency or liquidation.[96]

As a result of these recharacterization decisions, lenders and investors should clearly specify whether their transactions are intended to give rise to debt or equity. In a recent decision out of the Bankruptcy Court for the District of Delaware, the court, while using established factors set forth above, ultimately determined that any analysis should focus primarily on the parties' intent at the time of the transaction.[97]

## IV. BREACH OF FIDUCIARY DUTY

The fiduciary duties of well capitalized corporations are well known. Directors and officers "have a triad of primary fiduciary duties: due care, loyalty, and good faith."[98] "The obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty. Only the later two duties, where violated, may directly result in liability ..."[99] In a well capitalized corporation, the board of directors and senior

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[95] Estate of Mixon v. United States, 464 F.2d 394 (5th Cir. 1972) (Fifth Circuit tax case); In re Hedged-Investments Assocs., Inc., 380 F.3d at 1298 (Tenth Circuit bankruptcy case); In re Lane, 742 F.2d 1311, 1314-15 (11th Cir. Ala. 1984) (Eleventh Circuit bankruptcy case)); In re Cold Harbor Assocs., 204 B.R. at 915 (lower court within Second Circuit).

[96] See In re Submicron Sys. Corp., 291 B.R. at 323.

[97] Official Committee of Unsecured Creditors of Radnor Holdings Corp. v. Tenenbaum Capital Partners LLC (In re Radnor Holdings Corp.), 353 B.R. 820 (Bankr. D. Del. 2006).

[98] Emerald Partners v. Berlin, 787 A.2d 85, 90 (Del. 2001). Directors of a corporate general partner likewise may owe fiduciary duties to the partnership and the limited partners. See Wallace v. Wood, 752 A.2d 1175, 1180 (Del. Ch. 1999).

[99] Stone v. Ritter, 991 A.2d 362, 370 (Del. 2006).

management owe fiduciary duties exclusively to the corporation and its shareholders; they owe no duties to creditors. The rights of creditors are against the corporation directly or are contractual in nature.[100]

In the late 1980s and early 1990s, the case law shifted. Courts recognized that creditors' rights are not limited to their contracts where the corporation is insolvent.[101] Perhaps the most dramatic developments affecting bankruptcy litigation affect causes of action for breach of fiduciary duties of board members and senior management in the "zone of insolvency."

The phrase "zone of insolvency" was first used in a 1991 decision by Chancellor Allen of the Delaware Chancery Court, Credit Lyonnaise Bank Nederland, N.V. v. Pathe Comms. Corp.[102] The "zone of insolvency" was not defined in the decision and was only mentioned in a footnote. In the footnote, the Chancery Court said:

> where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise. ... [I]n managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act."[103]

Many courts and commentators subsequently interpreted the opinion as meaning that boards and management of companies owed some fiduciary duties to creditors and that creditors could sue board members for breaches of their fiduciary duties.[104]

Recent cases have discredited the zone of insolvency doctrine. First, in Production Recourses Group L.L.C. v. NCT Group, Inc.,[105] the Delaware Chancery Court suggested that, while directors and officers of corporations in the zone of insolvency owe a fiduciary duty to creditors, they may satisfy that duty by acting in a manner that benefits the corporate enterprise.

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[100] Revlon Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).

[101] Simons v. Cogan, 542 A.2d 785, 788 (Del. Ch. 1987), aff'd, 549 A.2d 300 (Del. 1988); Geyer v. Ingersol Pub'ns Co., 621 A.2d 748, 789-90 (Del. Ch. 1992).

[102] Credit Lyonnais Bank Nederland, N.V. v. Pathe Communs. Corp., 1991 Del. Ch. LEXIS 215 (Del. Ch. Dec. 30, 1991).

[103] Id. at *108, n. 55.

[104] See, e.g., Royce de R. Barondes, "Fiduciary Duties of Officers and Directors of Distressed Corporations," 7 Geo. Mason L. Rev. 45, 66-71 (1998) (arguing that Credit Lyonnais should be read to create rights that are "affirmatively enforceable by creditors" against directors of companies in the vicinity of insolvency). Accord, Official Comm. Of Unsecured Creditors of Buckhead Am. Corp. v. Reliance Capital Group, Inc. (In re Buckhead Am. Corp), 178 B.R. 956, 968-69 (D. Del. 1994); Weaver v. Kellogg, 216 B.R. 563, 582-84 (S.D. Tex. 1997).

[105] 863 A.2d 772 (Del. Ch. Dec. 30, 1991).

It noted that Credit Lyonnais was not intended to provide additional rights to creditors of a corporation in the zone of insolvency, but "a shield to directors from stockholders who claimed that the directors have a duty to undertake extreme risk, so long as the corporation would not technically breach any legal obligations."[106]

Then, in September 2006, the Delaware Court of Chancery issued its decision in North American Catholic Education Programming Foundation, Inc. v. Gheewalla,[107] holding that creditors could not bring a direct action for breach of fiduciary duty against directors of a corporation in the zone of insolvency. In May 2007, the Delaware Supreme Court affirmed the Chancery Court's decision and made three key rulings:

- Even when a company is within the zone of insolvency, its "directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of shareholders."[108]

- Although directors of an insolvent corporation (as opposed to in the zone of insolvency) owe fiduciary duties to creditors, creditors have no right to assert direct claims for breach of fiduciary duty against the directors.

- When the corporation is in fact insolvent, creditors only have standing to maintain derivative claims against directors on behalf of the corporation for breaches of fiduciary duties.[109]

Finally, in 2007, the Delaware Supreme Court issued its decision affirming a Chancery Courts decision in Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.[110] That decision adopted the reasoning of the Chancery Court, which held, *inter alia*, that a board had no duty to wind up the affairs of an insolvent corporation if the board has adopted a business strategy to preserve or increase the value of the corporation in accordance with its fiduciary duties. The fact that the strategy ultimately fails and creditors consequently recover less (*i.e.*, the corporation's insolvency is "deepened"), does not itself constitute a breach of duty under Delaware law.

In so doing, the court noted that Delaware courts traditionally had been reluctant to expand existing fiduciary duties owed by directors to creditors.

> [C]reditors are afforded protection through contractual agreements, fraud and fraudulent conveyance law, implied covenants of good faith and fair dealing,

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106 Id. at 788, n. 52.

107 2006 Del. Ch. LEXIS 164 (Del. Ch., Sept. 1, 2006).

108 N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101.

109 See Gheewalla, 930 A.2d 92, 94 (Del. 2007).

110 906 A.2d 168, 205 (Del Ch. 2006), aff'd sub nom. Trenwick Am. Litig. Trust v. Billet, 931 A.2d 438 (Del. 2007).

> bankruptcy law, general commercial law and other sources of creditors' rights… Accordingly, the general rule is that directors do not owe creditors duties beyond the relevant contractual terms.[111]

According to the court, when a solvent corporation is navigating in the zone of insolvency, the focus of Delaware directors should not change. "[D]irectors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners." [112] However, where it is alleged that a director has conflict of interest and that the conflict of interest motivated the director to continue a business enterprise that has no realistic probability of making money, then an adequate claim for director breach of fiduciary duty is stated.[113]

Courts have reacted differently to the recent decisions.[114] Of particular note is Berg & Berg Ents., LLC v. Boyle.[115] In that case, the largest creditor ("Berg") of an insolvent California corporation ("Pluris") filed an initial complaint against the directors of Pluris after Pluris had experienced financial difficulties and entered into an assignment for the benefit of its creditors. Berg alleged that the Pluris directors had breached their fiduciary duty to act for the benefit of Pluris' creditors given that Pluris had entered the "zone of insolvency."[116]

Berg alleged that, in February 2002, Pluris, which was experiencing financial distress, informed Berg that it was attempting to secure outside financing to continue operations. At this time, Berg informed Pluris that if its financing efforts failed, Berg wanted to explore ways in which Berg could derive value from approximately $50 million in net operating losses ("NOLs") that Pluris had accumulated through a chapter 11 reorganization. Pluris was unable to secure sufficient outside financing and made an assignment for the benefit of its creditors. Berg claimed that not preserving the NOLs through a chapter 11 reorganization destroyed potential value for Berg and Pluris's other secured creditors and, due to the insolvent or near-insolvent state of Pluris, constituted a breach of their fiduciary duties. The trial court dismissed Berg's complaint without leave to amend, reasoning that the complaint failed to state a viable claim for

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[111] Id. at 99 (internal quotations omitted).

[112] Id. at 101. Note, however, that Delaware law gives an unlawful dividend claim to a corporation and its creditors in the event of the corporation's dissolution or insolvency. See In re Musicland Holding Corp.), 398 B.R. at 783-84. The business judgment rule does not provide a defense to an unlawful dividend claim.

[113] But see Joseph v. Frank (In re Troll Comm'ns) 385 B.R. 110, 119-20 (Bankr. D. Del. 2009); In re Musicland Holding Corp., 398 B.R. at 786 (Bankr. S.D.N.Y. 2008).

[114] Curiously, two recent New York bankruptcy cases purporting to apply Delaware law have referenced the "zone of insolvency" as a basis for triggering fiduciary duties to creditors. In re Magnesium Corp. of Am., 399 B.R. 722 (Bankr. S.D.N.Y. 2009); Responsible Person of Musicland Holding Corp. v. Best Buy Co. (In re Musicland Holding Corp.), 398 B.R. 761 (Bankr. S.D.N.Y. 2008).

[115] Case No. H031591 (Cal. Ct. App. Oct. 29, 2009). Available at http://www.courtinfo.ca.gov/opinions/documents/H031591.PDF

[116] Slip Opinion at 2.

breach of fiduciary duty against the directors. After appeal, the California Court of Appeal upheld the trial court's dismissal:

> We accordingly hold that the scope of any extra-contractual duty owed by corporate directors to the insolvent corporation's creditors is limited in California, consistently with the trust-fund doctrine, to the avoidance of actions that divert, dissipate, or unduly risk corporate assets that might otherwise be used to pay creditors claims. This would include acts that involve self-dealing or the preferential treatment of creditors. Further, because all the California cases applying the trust-fund doctrine appear to have dealt with actually insolvent entities, and because the existence of a zone or vicinity of insolvency is even less objectively determinable than actual insolvency, we hold that there is no fiduciary duty prescribed under California law that is owed to creditors by directors of a corporation solely by virtue of its operating in the "zone" or "vicinity" of insolvency.[117]

## V. AIDING AND ABETTING BREACH OF FIDUCIARY DUTY.

A claim for aiding and abetting the breach of a fiduciary duty generally requires that the plaintiff show:

(1) the plaintiff was in a fiduciary relationship with a third party;
(2) there was a breach of the fiduciary's duty by the third party;
(3) there was a knowing participation in the breach by a defendant who is not a fiduciary and
(4) there are damages proximately caused by the breach.[118]

While officers and directors are most often pursued by trustees, debtors in possession, and creditors' committee for breach of fiduciary duty, financial institutions and professionals are among those entities most frequently sued for aiding and abetting breach of fiduciary duty:

> Because modern banks provide an array of valuable, and frequently innovative, financing services, banks often are regarded as having been a "partner in crime" with a company the bank may have considered merely a "borrower" or "customer." The factual elements frequently recurring in bank fraud cases include, most notably: (i) financing, through a series of transactions, of a fraudulent enterprise over an extended duration; (ii) the bank's use of actual or alleged "atypical" banking practices, and; (iii) an ultimate bankruptcy (or absconding with funds) by a borrower or client of the bank.[119]

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[117] *Id.* at slip pages 24-25 (footnotes omitted) (emphasis in original).

[118] See S & K Sales Co. v. Nike, Inc., 816 F.2d 843, 851 (2d Cir. 1987); cf. Restatement (Second) Torts § 876(b).

[119] Richard C. Mason, "Civil Liability for Aiding and Abetting," 61 Bus. Law. 1135, 1166 (May 2006).

One of the most significant issues in the area of aiding and abetting breach of fiduciary duty is whether the cause of action exists in all states and, if not, determining where it does not exist. More than eighteen states have recognized a cause of action for aiding and abetting breach of fiduciary duty.[120] At least one case indicates federal common law provides a cause of action aiding and abetting breach of a fiduciary duty.[121] On the other hand, Georgia does not recognize a claim for aiding and abetting a breach of fiduciary duty[122] and there are conflicting federal decisions concerning Pennsylvania law.[123]

### A. The Existence of a Fiduciary Duty and Breach of the Duty.

Proving aiding and abetting breach of fiduciary duty requires proving that there existed a fiduciary duty of a third party to the plaintiff. Typically, the plaintiff does not need to prove that the defendant had an independent fiduciary duty to the plaintiff, [124] though (as noted below) if the defendant owes plaintiff a fiduciary duty, this will change the analysis.

The case of Bondi v. Bank of America Corp. (In re Parmalat Securities Litigation) is typical of suits against lenders. In that case, the plaintiff, suing on behalf of Parmalat (the

[120] Id. at 1159 (citing Casey v. U.S. Bank Assoc., 26 Cal. Rptr. 3d 401. 405-06 (Cal. Ct. App. 2005); Holmes v. Young, 885 P.2d 305, 308 (Colo. Ct. App. 1994); Malpiede v. Townson, 780 A.2d 1075, 1097 (Del. 2001); Nerbonne, N.V v. Lake Bryant Int'l Properties, 689 So. 2d 322, 325 (Fla. Dist. Ct. App. 1997); Thornwood, Inc. v. Jenner & Block, 799 N.E.2d 7.56, 768-69 (Ill. App. Ct. 2003), appeal denied, 807 N.E.2d 982 (Ill. 2004); Kuhlman Elec Corp. v. Chappell, No. 2003-CA-001232-MR, 2005 WL 3243498, at *8 (Ky. Ct. App. Dec. 2, 2005); Cacciola v. Nellhaus, 733 N.E.2d 133, 139 (Mass. Ct. App. 2000); Carson Fischer, PLC v. Standard Fed. Bank., No. 248125, 2005 WL 292343, at *6 (Mich. Ct. App. Feb. 8, 2005), rev'd in part, 2006 WL 1303137 (Mich. May 12, 2006); Witzman v. Lehrman, Lehrman & Flom, 601 N.W2d 179, 186-87 (Minn. 1999); Branch Banking & Trust Co. v. Lighthouse Fin., No. 04 CVS 1523, 2005 WL 1995410, at *7 (N.C. Super. Ct. July 13, 2005); Bondi v. Citigroup, Inc., No. BER-L-10902-04, 2005 WL 975856, at *18 (N.J. Super. Ct. Law Div. Feb. 28, 2005); Fate v. Owens, 27 P.3d 990, 997-98 (N.M. Ct. App. 2001), cert. denied, 27 P.3d 476 (N.M. 2001); Shearson Lehman Bros. Inc. v. Bagley, 614 N.Y.S.2d 5 (N.Y. App. Div. 1994); Future Group II v. Nationsbank, 478 S.E.2d 45, 50 (S.C. 1996); Chem-Age Indus., Inc. v. Glover, 652 N.W.2d 756, 773-76 (S.D. 2002); Toles v. Toles, 113 S.W.3d 899, 917 (Tx. Ct. App. 2003); Halifax Corp. v. Wachovia Bank, 604 S.E.2d 403, 412-14 (Va. 2004); and Lenticular Europe, LLC ex rel Van Leeuwen v. Cunnally, 693 N.W.2d 302, 309 (Wis. Ct. App. 2005)).

[121] K & S Partnership v. Continental Bank, N.A., 952 F.2d 971, 980 (8th Cir. 1991) ("Knowing participation in a breach of fiduciary duty 'is analogous to a cause of action . . . for aiding and abetting a securities fraud,' where the primary violation involves a breach of fiduciary duty.") cf. Whitney v. Citibank, N.A., 782 F.2d 1106, 1115 (2d Cir. 1986)).

[122] Monroe v. Board of Regents, 602 S.E.2d 219, 224 (Ga. Ct. App. 2004).

[123] Compare Adena, Inc. v. Cohn, 162 F. Supp. 2d 351, 357 (E.D. Pa. 2001) (predicting Pennsylvania would recognize a claim for aiding-abetting breach of fiduciary duty) and Stone St. Servs. v. Daniels, Civ. A. No. 00-1904, 2000 U.S. Dist. LEXIS 18904, 2000 WL 1909373, at *3 (E.D. Pa. Dec. 29, 2000) with Daniel Boone Area School Dist. v. Lehman Bros., Inc., 187 F Supp. 2d 400, 413 (W.D. Pa. 2002) and Flood v. Makowski, 2004 U.S. Dist. LEXIS 16957, No. 03-1803, 2004 WL 1908221 at *36 (M.D. Pa. 2004).

[124] Neilson v. Union Bank of Cal., N.A., 290 F. Supp. 2d 1101, 1133 (C.D. Cal. 2003); Casey v. U.S. Bank Nat. Assn., 127 Cal. App. 4th 1138, 1145 (2005) ("we reject the banks' attempt to overlay the civil conspiracy 'independent duty' requirement onto an aiding and abetting claim."). But see In re County of Orange, 203 B.R. 983 (Bankr. C.D. Cal. 1996), aff'd in part, rev'd in part on other grounds sub nom, County of Orange v. McGraw-Hill Co. (In re County of Orange), 245 B.R. 138 (C.D. Cal. 1997).

debtor), alleged that Bank of America assisted Parmalat managers in "structuring and executing a series of complex, mostly off-balance sheet, financial transactions that were deliberately designed to conceal Parmalat's insolvency."[125] These complex transactions allegedly included loans with undisclosed side-letter agreements, use of special purpose entities to hide the use of debt as equity, and swaps that had "no currency or interest rate exchanges and offered the counterparties no ability to hedge."[126] Bank of America characterized the claim as one of aiding and abetting a breach of duty owed to Parmalat's shareholders – to whom the Bank argued it owed no duty. The court held that this argument was entirely irrelevant because the complaint adequately alleged the banks aided insiders in breaching duties the insiders owed to Parmalat itself.[127]

The recent decision in ASARCO LLC v. Americas Mining Corp.,[128] is also interesting in this regard. In that case, it was alleged ASARCO owed fiduciary duties to its creditors because it was insolvent, and breached those fiduciary duties by engaging in an intentional fraudulent transfer of its shares of Southern Peru Copper Company to Americas Mining Corporation ("AMC").[129] In addition to avoiding the transfer, the court found AMC liable for aiding and abetting this breach of the fiduciary duty because AMC knew that ASARCO's directors' conduct constituted a breach of duty gave substantial assistance or encouragement to ASARCO's directors so to conduct themselves.[130] As a result, the ASARCO was awarded damages in additions to avoidance of the transfer.

### B. Knowing Participation in the Breach of the Fiduciary Duty.

Substantial assistance requires a plaintiff to allege that the action of the aider and abettor "proximately caused the harm on which the primary liability is predicated."[131] The substantial assistance prong is met where a defendant "affirmatively assists, helps conceal, or by virtue of failing to act when required to do so enables the fraud to proceed."[132]

While summary allegations of participation or aiding in the wrongdoing will not make it past the pleading stage,[133] courts have generally not required significant amounts of aid to hold banks liable for aiding and abetting breach of fiduciary duty. One court has held "common sense tells us that even 'ordinary business transactions' a bank performs for a customer can satisfy the substantial assistance element of an aiding and abetting claim if the bank actually knew those transactions were assisting the customer in committing a specific tort. Knowledge is the crucial

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125 383 F. Supp. 2d 587, 590 (S.D.N.Y. 2005).

126 Id. at 592.

127 Id. at 599.

128 396 B.R. 278, 416 (S.D. Tex. 2008).

129 Id. at 297.

130 Id. at 41.

131 Filler v. Hanvit Bank, 339 F. Supp. 2d 553, 557 (S.D.N.Y. 2004) (citation omitted).

132 OSRecovery, Inc. v. One Groupe Int'l, Inc., 354 F. Supp. 2d 357, 378 (S.D.N.Y. 2005) (citation omitted).

133 Scognamillo v. Credit Suisse First Boston LLC, No. C03-2061 (TEH), 2005 U.S. Dist. LEXIS 20221, at *14-15 (N.D. Cal. Aug. 25, 2005).

element."[134] Attorneys advising a company president on how he might "warehouse premiums" so he could purchase illicit off-shore insurance policies were found to be aiding and abetting breaches of fiduciary duty.[135] Similarly, where a bank lent sums to the fiduciary (a trust) knowing the loan was made for purposes of misleading a plaintiff creditor, the lender was liable to the plaintiff.[136] However, mere silence or inaction can only constitute substantial assistance if the alleged aider/abettor has a fiduciary duty to the injured party.[137]

The Third Circuit Court of Appeals, in applying Pennsylvania law, has noted that Restatement (Second) of Torts § 876 suggests that the following six factors determine whether a defendant rendered substantial assistance for purposes of accomplice liability:

a. the nature of the act encouraged;

b. the amount of assistance given by the defendant;

c. the defendant's presence or absence at the time of the tort;

d. the defendant's relation to the other tortfeasor;

e. the defendant's state of mind; and

f. the foreseeability of the harm that occurred.[138]

Knowledge of the fiduciary's breach of duty is required for liability for aiding and abetting that breach.[139] The knowledge of wrongdoing requirement generally means the aider/abettor must have known the act was a breach of fiduciary duty.

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[134] Casey v. U.S. Bank Nat. Assn., 127 Cal. App. 4th 1138, 1145 (Cal. Ct. App. 2005).

[135] Anstine v. Alexander, 128 P.3d 249, 265 (Colo. Ct. App. 2005).

[136] Rabobank Nederland v. Nat'l. Westminster Bank, No. A104604, 2005 WL 1840108, at *9-11 (Cal. Ct. App. Aug. 4, 2005).

[137] Strong v. France, 474 F.2d 747, 752 (9th Cir. 1973).

[138] Fassett v. Delta Kappa Epsilon, 807 F.2d 1150, 1163 (3d Cir. 1986) (quoting Restatement (Second) of Torts, § 876(b), comment d).

[139] Chance World Trading v. Heritage Bank of Commerce, 438 F. Supp. 2d 1081, 1086-1087 (N.D. Cal. 2005) ("the inference that Heritage Bank knew of Ms. Yadav-Ranjan's fraud cannot be drawn from evidence that Heritage Bank did not follow its own internal rules, and the only other evidence Chance World has produced that could show knowledge by Heritage Bank is an e-mail, which, according to uncontradicted testimony, was not sent to a valid address for the bank."); Neilson, 290 F. Supp. 2d at 1120 (C.D. Cal. 2003) ("The complaint asserts that the Banks knew Slatkin was committing fraud and was breaching his fiduciary duties to class members. It also alleges that each bank actively participated in Slatkin's Ponzi scheme with knowledge of his crimes. . . . It alleges, in particular, that the Banks utilized atypical banking procedures to service Slatkin's accounts, raising an inference that they knew of the Ponzi scheme and sought to accommodate it by altering their normal ways of doing business. This supports the general allegations of knowledge."); Kolbeck v. Lit America, Inc., 939 F.Supp. 240, 247 (S.D.N.Y. 1996), aff'd, 152 F.3d 918 (2d Cir. 1998) ("Inaction, or a failure to investigate, constitutes actionable participation only when a defendant owes a fiduciary duty directly to the plaintiff; that the primary violator owes a fiduciary duty to the plaintiff is not enough."); King v. George Schonberg & Company, 233 A.D.2d 242, 243, 650 N.Y.S.2d 107 (1st Dep't 1996).

In Hashimoto v. Clark the court found that plaintiff had not adequately alleged knowledge where:

> As far as these officers were concerned, the disposal of the metals presented no cause for alarm. Sheffield was a metals dealer who, Safrabank assumed, regularly traded metals. Furthermore, Safrabank had no reason to believe that Sheffield had not otherwise covered its positions. These officers deny that Safrabank had any knowledge of Sheffield's overall metals positions or of its futures trading.[140]

Generally, knowledge is hard to prove. However, in bank fraud cases, defendant's use of atypical banking procedures is a judicially recognized basis for an inference of "knowledge" the bank is aiding another's misconduct.[141] Familiarity over an extended period with the course of conduct relating to the scheme at issue also may support an inference of "knowledge."[142]

Most courts have even gone beyond the "actual knowledge" standard. Where facts are known to the defendant from which the conclusion objectively follows that a fraud is being perpetrated (and assisted by defendant), aider-abettor liability may exist even if the defendant lacked "actual knowledge."[143] Those courts have held that, unlike a cause of action for conspiracy, the knowledge requirement for aiding and abetting liability may be satisfied by proof that a defendant acted with reckless disregard.[144] "Reckless disregard" is not, however, evidenced by "mere suspicion," but rather requires proof the aider-abettor ignored obvious "danger signals"[145] or was deliberatively indifferent to the propagation of the fraud scheme.[146]

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[140] Hashimoto v. Clark, 264 B.R. 585, 598-99 (D. Ariz. 2001).

[141] Aetna Casualty & Surety Co. v. Leahey Construction Co., 219 F.3d 519, 536 (6th Cir. 2000); Camp v. Dema, 948 F.2d 455, 459 (8th Cir. 1991); Woodward v. Metro Bank, 522 F.2d 84, 97 (5th Cir. 1975).

[142] Jaguar Cars, Inc. v. Royal Oaks Motor Car Co., 46 F.3d 258, 270 (3d Cir. 1995) (holding that "experience and active participation in the . . . dealership, combined with the extent of the fraud" presented a sufficient basis for imposition of aiding-abetting liability). In that case, the evidence of the father's control over the dealership, included his having (1) spent significant time there, (2) reviewed the financial statements, and (3) discussed the dealership's operations on a daily basis with his son, "the architect" of the fraudulent scheme "combined with evidence of the pervasive nature of the fraudulent scheme." Id. at 271.

[143] Filler, 339 F. Supp. 2d at 560; Javitch v. First Montauk Fin. Corp., 279 F. Supp. 2d 931, 941 (N.D. Ohio 2003); Williams v. Bank Leumi Trust Co., No. 96 Civ. 6695 (LMM), 1997 U.S. Dist. LEXIS 7538 (S.D.N.Y. May 30, 1997). But see In re Citigroup, Inc. Secs. Litig., 330 F. Supp. 2d 367 (S.D.N.Y. 2004).

[144] Levine v. Diamanthusel, Inc., 950 F.2d 1478, 1483 (9th Cir. 1991); FDIC v. First Interstate Bank of Des Moines, N.A., 885 F.2d 423, 432-33 (8th Cir. 1989).

[145] Abbott v. Equity Group, Inc., 2 F.3d 613, 623 n.33 & 626 (5th Cir. 1993).

[146] Commodity Futures Trading Corp. v. Sidoti, 178 F.3d 1132, 1136 (11th Cir. 1999) (aiding and abetting occurred through decision to hire sales personnel exclusively from various companies with histories of sales practice fraud coupled with absence of training or attempt to restrain practices); see generally, In re IKON Office Solutions, Inc., 277 F.3d 658, 673 (3d Cir. 2002); Lehman Bros. Commer. Corp. v. Minmetals Int'l Non-Ferrous Metals Trading Co., 179 F. Supp. 2d 118, 153 (S.D.N.Y. 2000) ("[A] third party can become obligated to investigate an agent's actions where there are indications that the agent's actions are suspicious in nature. A failure to investigate under such circumstances may result in the third party's liability for aiding and abetting the agent's breach of his fiduciary duty. See Whitney v. Citibank, N.A., 782 F.2d 1106, 1115-16 (2d Cir. 1986)").

### C. Causation and Damages.

A plaintiff must also show that the defendant's conduct (that otherwise meets the requirements for aiding and abetting liability) was the proximate cause of the plaintiff's damages.[147] The assistance must have been "a substantial factor in causing the harm suffered."[148] Ortho-Med is instructive because the court found that plaintiff Micro-Aire had established each of the requisite elements for aiding and abetting a breach of fiduciary duty, but the court concluded that plaintiff had no claim for damages against defendant Ortho-Med:

> The Court does not intend to condone the private commission arrangement [which breached a fiduciary duty]. There is little doubt that it would have been ample grounds for terminating the Agreement if Micro-Aire had not already done so when it learned of the arrangement. But it cannot be grounds for a separate claim unless it results in provable damages. Its argument that a proper comparison would show such damages is not only logically flawed, but is unsupported by the evidence. In the place of evidence is the parties' speculation: Ortho-Med speculates that both parties benefited from the arrangement because the customers were served more efficiently and more products were sold; Micro-Aire speculates that it lost sales because a "loyal" distributor would have performed better. There is no evidence to support either position.[149]

## VI. DEEPENING INSOLVENCY.

Although the term "deepening insolvency" was coined over 20 years ago, courts still exhibit divergent understandings of the concept. Some courts recognize deepening insolvency as an intentional tort, some recognize it as a form of negligence, some recognize it as a theory of damages and some just see it as a mistake. Recent decisions have begun to narrow the scope of this confusing body of law; however, many cases still provide significant uncertainty.

Generally, deepening insolvency describes a claim that a defendant acted (or failed to act) in a manner that wrongfully prolonged the life of the corporation outside of bankruptcy and that such action (or inaction) damaged the corporation (or its creditors) through a decline in the

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[147] See, e.g., Filler v. Hanvit Bank, No. 01 Civ. 9510 (MGC), 2003 U.S. Dist. LEXIS 15950, at *2 (S.D.N.Y. Sept. 12, 2003); Neilson, 290 F. Supp. 2d at 1135 (holding that substantial assistance "requires the plaintiff to allege that the actions of the aider/abettor proximately cause the harm on which the primary liability is predicated.").

[148] Cohen v. Adventist Health Sys./West (In re Diamond Benefits Life Ins. Co.), No. MDL 93-0972-PHX-RGS, 2006 U.S. Dist. LEXIS 10074, at *14-15 (D. Ariz. March 10, 2006) ("Had DBLIC not been looted of the $18 million in cash by Defendants, and those they aided and abetted, and deprived of another $11 million owed to it by LACOP, DBLIC would now be in the position to pay all of its creditor claims. The losses are clear. The causal link to Defendants is irrefutable."); Neilson, 290 F. Supp. 2d at 1135; Ortho-Med, Inc. v. Micro-Aire Surgical Instruments, Inc., No. CV 93-7621(JGD), 1995 U.S. Dist. LEXIS 22217, at *32 (C.D. Cal. April 10, 1995) ("It is clear in California that a party must suffer detriment to have a claim for damages"); Kolbeck, 939 F. Supp. at 246; DePinto v. Ashley Scott, Inc., 222 A.D.2d 288, 290, 635 N.Y.S.2d 215, 217 (1st Dep't 1995).

[149] Ortho-Med, 1995 U.S. Dist. LEXIS, at *31-32; compare Meyers v. Moody, 475 F. Supp. 232, 237 (N.D. Tex. 1979) (holding that damages were measurable "in terms of loss of value or physical damage to corporate assets, restraints upon the marketability of corporate assets, and interference with the development of corporate properties."), aff'd, 693 F.2d 1196, 1214 (5th Cir. 1982).

corporation's net value or an increase in its debt. Two cases are generally cited as genesis for "deepening insolvency" as a separate tort: Schact v. Brown[150] and Official Committee of Unsecured Creditors v. R.F. Lafferty & Co.[151]

In Schact, the Illinois Director of Insurance was acting as liquidator of the Reserve Insurance Company. The Director pursued claims against the insolvent insurance company's officers, directors, and parent corporation, alleging that they continued the insurance company in business past the point of insolvency and looted the company of its most profitable assets. In affirming the district court's denial of a motion to dismiss, the Seventh Circuit Court of Appeals held "the corporate body is ineluctably damaged by the deepening of its insolvency through increased exposure to creditor liability . . . in most cases, it would be crucial that the insolvency of the corporation be disclosed so that shareholders may exercise the right to dissolve the corporation in order to cut their losses."[152]

In Lafferty, a creditors' committee brought a claim on behalf of the debtors' estate alleging that the defendants, including the debtors' officers, directors, and outside professionals, induced the debtors into issuing debt securities, thereby deepening the debtors' insolvency and forcing them into bankruptcy.[153] According the committee, the outsider professionals conspired with the debtors' management, who were also the debtors' sole shareholders, in engineering a Ponzi scheme to the detriment of the debtor corporation's general unsecured creditors. The district court found that a claim based on deepening insolvency could give rise to a cognizable injury under Pennsylvania law. In affirming, the Third Circuit Court of Appeals held, "even when a corporation is insolvent, its corporate property may have value. The fraudulent and concealed incurrence of debt can damage that value in several ways."[154]

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[150] 711 F.2d 1343 (7th Cir. 1983).

[151] 267 F.3d 340 (3d Cir. 2001).

[152] 711 F.2d at 1350 (citing In re Investors Funding Corp. of N.Y. Sec. Litig., 523 F. Supp. 533, 536 (S.D.N.Y. 1980). In In re Investors Funding Corp., plaintiffs alleged that the debtor's insiders (the Danskers) embarked on a scheme to loot the debtor using its professionals. The insiders induced creditors and shareholders to invest more funds in the debtor based on a false picture of the debtor's financial well-being and misappropriated a portion of the funds that were raised. Peat, Marwick, Mitchell & Co. ("PMM"), the debtor's outside auditor, was sued for enabling the Danskers to paint a false financial picture. Id. at 537. PMM moved to dismiss the complaint on the ground that the corporation was in *pari delicto* because the Danskers were its officers and they were not acting adversely to the corporation in trying to keep it afloat. In denying PMM's motion to dismiss, the court held:

> Even to the extent one focuses upon the artificial financial picture of IFC [the debtor] created by the Danskers which prolonged IFC's existence several years beyond its actual insolvency, PMM's position is not persuasive. A corporation is not a biological entity for which it can be presumed that any act which extends its existence is beneficial to it. The complaint plainly alleges that, as a result of the Danskers' practices, IFC's financial situation was caused to deteriorate even further after 1971. Accepting the allegations of the complaint as true, it is manifest that the prolonged artificial solvency of IFC benefited only the Danskers and their confederates, not IFC.

523 F. Supp. at 541.

[153] 267 F.3d 340, 345 (3d Cir. 2001).

[154] Id. at 349. The Court went on to cite Schacht v. Brown, 711 F.2d at 1350; Hannover Corp. of Am. v. Beckner, 211 B.R. 849, 854-55 (M.D. La. 1997); Allard v. Arthur Andersen & Co., 924 F. Supp. 488, 494 (S.D.N.Y.

*Footnote contined on next page.*

### A. The Development of an Independent Cause of Action.

Several courts have interpreted Schact and Lafferty as broadly recognizing deepening insolvency as an independent cause of action.[155] One such example is Official Committee of Unsecured Creditors v. Credit Suisse First Boston (In re Exide Technologies).[156] In that case, a creditors' committee alleged that the agent bank and other lenders controlled and dominated the debtor by, for example, initiating an acquisition that proved disastrous to the debtor. According to the complaint, the lenders caused the debtors to make the acquisition "so that they could obtain the control necessary to force the Debtors fraudulently to continue its business for nearly two years at ever increasing levels of insolvency."[157] Following Lafferty and Schact, the Delaware bankruptcy court held that Delaware would recognize a claim for deepening insolvency if the lender controlled the debtor and caused the debtor to continue its business at ever increasing levels of insolvency.[158]

Whether and to what extent there is a separate tort for deepening insolvency is not firmly established in all courts. The Exide decision suggest that there is, indeed, a separate tort for which lenders could be held liable for increasing the insolvency of the borrower by continuing to lend. However, there has been growing resistance to deepening insolvency as an independent cause of action. Many courts have held that lending to an insolvent borrower *in and of itself* cannot create a lender liability. Those courts that have disputed deepening insolvency as an independent cause of action usually invoke one or more of the following concerns:

- To label the prolongation of an insolvent corporation a tort ignores the possibility that the directors and officers of the corporation are using the funds provided post-insolvency to save the corporation. Identifying the theory of deepening insolvency as a tort would be contrary to the business judgment rule, which protects the decisions of directors and officers to make business decisions that are in the best interests of the corporation and its constituents.

- The theory of deepening insolvency as an independent cause of action, to the extent it punishes bad conduct is subsumed by other tort causes of action, such as common law fraud, breach of fiduciary duty, aiding and abetting breach of fiduciary duty, professional malpractice, or negligence.

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1996); In re Gouiran Holdings, Inc., 165 B.R. 104, 107 (E.D.N.Y. 1994); Feltman v. Prudential Bache Sec., 122 B.R. 466, 473 (S.D. Fla. 1990); Herbert H. Post & Co. v. Sidney Bitterman, Inc., 219 A.D.2d 214, 639 N.Y.S.2d 329 (N.Y. App. Div. 1st Dep't 1996); and Corcoran v. Frank B. Hall & Co., 149 A.D.2d 165, 175, 545 N.Y.S.2d 278 (N.Y. App. Div. 1st Dep't 1989) for the proposition that deepening insolvency had attained a growing acceptance as a cause of action.

[155] See, e.g., Limor v. Buerger (In re Del-Met Corp.), 322 B.R. 781(Bankr. M.D. Tenn. 2005); In re LTV Steel Co., 333 B.R. 397, 422 (Bankr. D. Ohio 2005); Collins v. Kohlberg & Co. (In re Southwest Supermarkets, L.L.C.), 315 B.R. 565 (Bankr. D. Ariz. 2004); Schnelling v. Thomas (In re AgriBiotech, Inc.), 319 B.R. 216 (D. Nev. 2004); In re Exide Techs., Inc., 299 B.R. at 736; Lichtenstein v. Stockton Bates, LLP (In re Computer Personalities Sys., Inc.), No. 01-14231, 2003 Bankr. LEXIS 1572, (Bankr. E.D. Pa. Nov. 18, 2003).

[156] 299 B.R. 732 (Bankr. D. Del. 2003).

[157] Id. 750-51.

[158] Id. at 752.

Two cases in the Bankruptcy Court for the Southern District of New York have illustrated these problems.

In Kittay v. Atlantic Bank (In re Global Service Group LLC),[159] the chapter 7 trustee of Global Service Group sued Atlantic Bank of New York, alleging that Global Service Group was in the zone of insolvency from its formation and that Atlantic Bank of New York knew or should have known that Global would be unable to repay its loans. Notwithstanding its knowledge of Global Service Group's insolvency, Atlantic Bank made a secured loan to Global Service Group and obtained a security interest in the personal assets of Global Service Group's principals, thereby prolonging its life outside of bankruptcy. Other creditors allegedly extended credit (including trade credit) based on Atlantic Bank's loan. The bankruptcy court determined that the trustee stated no cause of action:

> The distinction between "deepening insolvency" as a tort or damage theory may be one unnecessary to make. Prolonging an insolvent corporation's life, without more, will not result in liability under either approach. Instead, one seeking to recover for "deepening insolvency" must show that the defendant prolonged the company's life in breach of a separate duty, or committed an actionable tort that contributed to the continued operation of a corporation and its increased debt.
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> * * *
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> The Complaint alleges, in substance, that Atlantic Bank should be liable for Global's "deepening insolvency" because the bank made a loan that it knew or should have known Global could never repay. This may be bad banking, but it isn't a tort. A third party is not prohibited from extending credit to an insolvent entity; if it was, most companies in financial distress would be forced to liquidate. And while the Complaint alleges that Atlantic Bank made the loan on the strength of its relationship with the Goldmans and their personal assets, this is neither surprising nor improper. Banks prefer to lend to those they know, and have the right to insist on guaranties and pledges of personal assets from the corporate principals. Notably, the Complaint does not allege or imply that Atlantic Bank extended the loans to enable the Goldmans to siphon off the funds or commit some other wrong.
>
> This leads to the second problem with the First Cause of Action, and for that matter, with much of the Complaint. The unspoken premise of the trustee's "deepening insolvency" theory is that the managers of an insolvent limited liability company are under an absolute duty to liquidate the company, and anyone who knowingly extends credit to the insolvent company breaches an independent duty in the nature of aiding and abetting the managers' wrongdoing. The assumption is a faulty one.
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[159] 316 B.R. 451, 456 (Bankr. S.D.N.Y. 2004).

> [I]n contrast to the laws of some foreign jurisdictions, including the United Kingdom, there is no absolute duty under American law to shut down and liquidate an insolvent corporation. The fiduciaries may, consistent with the business judgment rule, continue to operate the corporation's business.[160]

The Court went on to rule that the complaint filed by the trustee did not contain specific allegations to overcome the business judgment rule (e.g., that the directors and officers acted in bad faith or with fraudulent intent), and dismissed the trustee's counts for deepening insolvency and aiding and abetting breach of fiduciary duty.

As described above, in the Gheewalla decision, the Delaware Supreme Court recently rejected the idea that a fiduciary duty to creditors arises when a corporation is in the "zone of insolvency."[161] Instead, the court held that creditors could assert a derivative claim on behalf of the corporation once the company is actually insolvent.[162] The Delaware law, while obviously influential, will not apply in all situations, and decisions still exist applying the law of other states to hold that a fiduciary duty does exist when a corporation is in the "zone of insolvency."[163]

Similarly, in In re Verestar, Inc., the court affirmatively held that deepening insolvency was not an independent cause of action because it added nothing to the causes of action under breach of fiduciary duty and aiding and abetting breach of fiduciary duty.[164]

Some courts in other jurisdictions have followed the reasoning of Verestar, rejecting deepening insolvency as a cause of action.[165] Trenwick America Litigation Trust v. Ernst & Young, LLP[166] is likely one of the most influential of these because it comes out of the Delaware Court of Chancery and was affirmed by the Delaware Supreme Court. In that case, a publicly traded insurance holding company had acquired three unaffiliated insurance companies in arm's length transactions. The acquisitions were approved by the holding company's shareholders and there was no evidence that the directors of the holding company acted fraudulently in connection with the acquisitions. However, the acquisitions proved improvident when the amount of insurance claims against the holding company and its subsidiaries exceeded estimates and

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160 Id. at 458-60. See also RSL COM Primecall, Inc. v. Beckoff (In re RSL COM Primecall, Inc.), Adv. No. 03-2176, 2003 Bankr. LEXIS 1635, at *8 (Bankr. S.D.N.Y. Dec. 11, 2003) ("There is no authority that supports [the] position that there is a blanket duty to liquidate upon insolvency, untempered by the business judgment rule. . . . It has never been the law in the United States that directors are not afforded significant discretion as to whether an insolvent company can 'work out' its problems or should file a bankruptcy petition.").

161 N. Am. Catholic Educational Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 103 (Del. 2007).

162 Id.

163 See In re James River Coal Co., 360 B.R. 139, 170 (Bankr. E.D. Va. 2007) ("Once a corporation enters the zone of insolvency, the fiduciary duties owed by the Directors extend also to the corporation's creditors.").

164 343 B.R. 444, 477 n.18 (Bankr. S.D.N.Y. 2006).

165 See, e.g., In re Magnesium Corp. of Am., 2009 Bankr. LEXIS 54; In re Envid, Inc., 345 B.R. 426, 453 (Bankr. D. Mass. 2006); In re SW Fla. Heart Group, 346 B.R. 897, 898 (Bankr. M.D. Fla. 2006); Bookland v. Baker, Newman & Noyes, LLC, 271 F. Supp. 2d 324 (D. Me. 2003).

166 906 A.2d 168 (Del. Ch. 2006), aff'd sub nom., Trenwick Am. Litig. Trust v. Billett, 931 A.2d 438, 2007 Del. LEXIS 357 (Del. 2007); see also North American Catholic Educational Programming Foundation Inc. v. Gheewalla, 930 A.2d 92 (Del. 2007).

prevented the holding company from being able to timely pay its debts.[167] The holding company and its top subsidiary filed for bankruptcy and a trustee for the top subsidiary initiated a lawsuit against the holding company's banks, alleging deepening insolvency.

The Court dismissed the lawsuit, holding that there was no cause of action for deepening insolvency. Under Delaware law, there is no obligation for a corporation to cease business and liquidate upon reaching the state of insolvency. The board of directors may, in good faith, continue to pursue strategies to maximize the value of the firm. The Court observed:

> the fact of insolvency does not render the concept of "deepening insolvency" a more logical one than the concept of "shallowing profitability." That is, 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.[168]

Thus, a failed but good faith attempt to turn things around for a corporation is still subject to the business judgment rule.[169] Courts in other jurisdictions have also rejected deepening insolvency as an independent cause of action.[170] While it acknowledged the growing trend toward recognizing deepening insolvency as a cause of action, the Fifth Circuit has declined to speculate on whether the Texas Supreme Court would recognize deepening insolvency as a viable, independent legal theory.[171]

Other courts have declined to go as far, indicating that there was a tort of deepening insolvency, but requiring that there be some showing of fraud.[172] These rulings suggest that a

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[167] Id. at 272.

[168] Id. at 205.

[169] Id.; see also Gheewalla, 930 A.2d 92, 103

[170] See, e.g., Kaye v. Dupree (In re Avado Brands, Inc.), No. 05-3823, 2006 Bankr. LEXIS (Bankr. N.D. Tex. Dec. 28, 2006) (determining that no cause of action for deepening insolvency existed under Georgia law); Official Comm. of Unsecured Creditors VarTec Telecom, Inc. v. Rural Tel. Fin. Coop. (In re VarTec Telecom, Inc.), 335 B.R. 631 (Bankr. N.D. Tex. 2005) (determining that no cause of action for deepening insolvency existed under Texas law).

[171] Fla. Dep't of Ins. v. Chase Bank of Tex. Nat'l Ass'n, 274 F.3d 924 (5th Cir. 2001) ("Ultimately, the Court need not decide whether the Texas Supreme Court would recognize this theory as an independent cause of action. Even if it would, Florida has made no attempt, either in its summary judgment briefing and evidence in the district court, or in its brief on appeal, to quantify how much additional debt, if any, Western Star incurred after Chase assisted in establishing the empty trust. To the extent that Florida has adequately briefed deepening insolvency as a viable legal theory, there is no evidence of damages measured from the 'deepening insolvency' perspective that would justify allowing Florida to proceed to trial on this claim."); see also Smith v. Arthur Anderson LLP (In re Boston Chicken), 421 F.3d 995, 1003 (9th Cir. 2005) ("although we hold that the dissipation of assets constitutes an injury to Boston Chicken, we express no opinion on whether the complaint states a valid claim for relief based on that injury").

[172] Seitz v. Detweiler, Hershey & Assocs. P.C. (In re CitX Corp.), 448 F.3d 672, 677 (3d Cir. 2006); In re Oakwook Homes Corp., 340 B.R. 510, 531-33 (Bankr. D. Del. 2006) (citing to Lafferty to hold that Delaware, New York and North Carolina would recognize a cause of action for deepening insolvency); In re Monahan Ford Corp., 340 B.R. 1, 40 (Bankr. E.D.N.Y. 2006) (holding that New York recognized a cause of action for deepening insolvency).

lender should not be at risk simply because it loans funds to an insolvent entity that subsequently becomes more insolvent.

### B. Deepening Insolvency as a Theory of Damages.

Even courts that have rejected deepening insolvency as a cause of action wholesale have recognized that it is a useful theory of damages. The damage theory is founded in general principles of corporate finance:

> Even when a corporation is insolvent, its corporate property may have value. The fraudulent and concealed incurrence of debt can damage that value in several ways. For example, to the extent that bankruptcy is not already a certainty, the incurrence of debt can force an insolvent corporation into bankruptcy, thus inflicting legal and administrative costs on the corporation.[173]

In certain jurisdictions, negligence may be sufficient to establish damages for deepening insolvency.[174] In other jurisdictions, proof of fraud is required.[175]

Courts have taken inconsistent approaches in how they measure the damages of deepening insolvency. Some courts seem to hold that the amount of debt incurred is the measure of the deepening insolvency.[176] Other courts have held that the damages for deepening insolvency are the amount of trade obligations incurred.[177] Still other courts hold that the loss of enterprise value is the appropriate measure of damages.[178]

A growing number of courts have held that deepening insolvency is not an appropriate measure of damages at all.[179] The leading case holding that deepening insolvency is not an appropriate measure of damages is Seitz v. Detweiler, Hershey and Associates (In re CitX Corp.), 448 F.3d 672 (3d Cir. 2006). In that case, the chapter 7 trustee sued the corporation's accountant on the grounds that the accountant missed many "red flags" when he prepared the corporation's financial statements. The Trustee sought damages based on deepening insolvency.

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[173] Richard A. Brealey & Stewart C. Myers, Principles of Corporate Finance 487 (5th ed. 1996).

[174] See, e.g., Hannover, 211 B.R. at 851; NCP Litig. Trust v. KPMG LLP, 901 A.2d 871, 888 (N.J. 2006) (". we find that inflating a corporation's revenues and enabling a corporation to continue in business "past the point of insolvency" cannot be considered a benefit to the corporation.").

[175] See, e.g., In re Student Fin. Corp., 335 B.R. 539, 548 (D. Del. 2005), In re CitX, 448 F.3d at 677.

[176] See, e.g., In re Flagship Healthcare, 269 B.R. 721, 728 (Bankr. S.D. Fla. 2001).

[177] Allard, 924 F. Supp. at 494.

[178] Bookland, 271 F. Supp. 2d at 331 (D. Me. 2003).

[179] See, e.g., SI Restructuring, Inc. v. Faulkner (In re SI Restructuring, Inc.), 532 F.3d 355, 362 (5th Cir. 2008) ("A deepening insolvency theory of damages has been criticized and rejected by many courts. We agree with the Third Circuit Court of Appeals, which recently concluded that deepening insolvency is not a valid theory of damages. The court recognized that deepening insolvency as a measure of harm depends on how the company uses the proceeds of the loan in question and 'looks at the issue through hindsight bias.'"); In re CitX Corp., 448 F.3d at 678; Comm'l Fin. Servs., Inc. v. J.P. Morgan Secs., Inc., No. 103,053 (Ok. Ct. Civil Appeals Sept. 28, 2006); Coroles v. Sabey, 79 P.3d 974, 983 (Utah Ct. App. 2003).

On appeal, the Third Circuit first addressed the malpractice action. See id. at *3 - *6. As an element of a malpractice claim is actual damages, the trustee had asserted that the accountant had harmed the corporation by, among other things, deepening the insolvency of that entity and expanding its debt "by virtue of its compilation statements prepared and relied on by third parties." In short order, the Third Circuit found that its earlier decision in *Lafferty* was in the context of a deepening insolvency cause of action and ruled that the decision should not be interpreted to create a novel theory of damages as an element in a malpractice cause of action. Accordingly, the dismissal of that cause of action was affirmed. See In re CitX Corp. at *6.

Recently the Third Circuit has tempered that decision somewhat. In Thabault v. Chait,[180] the accountant, PriceWaterhouseCoopers, was sued for professional negligence for failing to detect the insolvency of Ambasador, an insurance company. Thaubault, a receiver, for Ambasador sought damages for "deepening insolvencs as a measure of damages for PWC's negligence. Citing *Citx*, PWC "asked the court to hold that whenever a plaintiff seeks damages for the 'deepening insolvency' or 'an injury to the Debtor's corporate property from the fraudulent expansion of corporate debt and prolongation of its corporate life,' as part of its explanation of damages in a negligence action, recovery is not permissible."[181] The court of appeals disagreed:

> When a plaintiff brings an action for professional negligence and proves that the defendant's negligent conduct was the proximate cause of a corporation's increased liabilities, decreased fair market value, or lost profits, the plaintiff may recover damages in accordance with state law.[182]

## VII. *IN PARI DELICTO* DEFENSE.

*In pari delicto*[183] is recognized by several courts as a defense to deepening insolvency and aiding and abetting breach of fiduciary duty.[184] Indeed, no discussion of deepening insolvency and aiding and abetting breach of fiduciary duty would be complete without a discussion of the defense of *in pari delicto* because, where it applies, it bars a plaintiff from asserting claims where he, she or it participated in the wrongdoing underlying the claims.[185] According to the Supreme Court, *in pari delicto* is based on two premises: "first, that courts should not lend their good offices to mediating disputes among wrongdoers; and second, that denying judicial relief to an admitted wrongdoer is an effective means of deterring illegality."[186]

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[180] 541 F.3d 512, 520 (3d Cir. N.J. 2008

[181] *Id.* at 520.

[182] *Id.*

[183] Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 306, 105 S. Ct. 2622, 86 L. Ed. 2d 215 (1985) (citations omitted) "*In pari delicto*" is an abbreviation of the Latin phrase "*in pari delicto potior est conditio defendentis*" (meaning, where the wrong of both parties is equal, the position of the defendant is the stronger).

[184] See, e.g., Lafferty, 267 F.3d at 358; In re Del-Met Corp., 322 B.R. at 813-15.

[185] See Shearson, Lehman, Hutton, Inc. v. Wagoner, 944 F.2d 114, 120 (2d Cir. 1991) and cases cited therein.

[186] Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 306 (1985) (citations omitted).

Many courts have held that, because a bankruptcy trustee stands in the shoes of the debtor, *in pari delicto* applies to bar a trustee in bankruptcy or other successor from asserting claims against third parties that arise out of misconduct in which the debtor participated.[187] This position has been highly criticized by academics for creating inequitable results not contemplated by the Bankruptcy Code and some courts have held that a trustee, as successor of the debtor, is not subject to the *in pari delicto* defense.

State law governs whether an agent's actions or knowledge may be imputed to a corporation for state law claims.[188] Although, generally, the actions and knowledge of a corporation's directors and officers bind the corporation, every jurisdiction has exceptions to this, and the exceptions very from state to state. The most important development in this area recently has been a New Jersey Supreme Court Case rejecting the argument – accepted by many other courts – that the "imputation doctrine" prevents claims against professionals who failed to detect a fraud because the wrongdoing of the officers and directors is imputed to the corporation and the trust suing as its successor.

In NCP Litigation Trust v. KPMG LLP, the CFO and COO of Physician Computer Network, Inc. ("PCN") allegedly engaged in "fraudulent transactions to inflate PCN's reported revenues and reduce its reported expenses."[189] KPMG, PCN's independent auditor, allegedly failed to detect the fraud for several years. PCN later filed for bankruptcy, and the NCP Litigation Trust was created to enforce any causes of action PCN had for the benefit of PCN's shareholders. The Trust sued KPMG for negligence in the performance of its audits. The lower court dimissed the complaint based on imputation of the bad acts of the CFO and COO to PCN. The New Jersey Supreme Court disagreed, holding "the imputation doctrine does not bar corporate shareholders from recovering through a litigation trust against an auditor who was negligent within the scope of its engagement by failing to uncover or report the fraud of corporate officers and directors."[190] As a result of NCP, several federal courts have rejected application of *in pari delicto* where New Jersey law applies,[191] or where the law of a state is unclear as to the rules for imputation.[192]

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[187] Granite Partners, L.P. v. Bear, Stearns & Co., 17 F. Supp. 2d 275, 310 (S.D.N.Y. 1998).

[188] O'Melveny & Myers v. FDIC, 512 U.S. 79, 84, 85 & 87-89, 114 S. Ct. 2048, 129 L. Ed. 2d 67 (1994).

[189] 901 A.2d 871, 874 (N.J. 2006).

[190] Id. at 873.

[191] See, e.g., Thabault v. Chait, 541 F.3d 512 527-28 (3d Cir. 2008); Forman v. Salzano (In re Novergence, Inc.), 405 B.R. 709 (Bankr. D.N.J. 2009).

[192] See, e.g., Official Committee of Unsecured Creditors of Allegheny Health, Education and Research Foundation v. PriceWaterhouseCoopers, LLP, 2008 WL 3895559 (3d Cir. July 1, 2008) (certifying questions to Pennsylvania Supreme Court). But see, American International Group v. Greenberg, 2009 WL 1684808 (Del Ch. June 17, 2009) (holding that in pari delicto does not apply in suit against the corporations directors but does apply in a suit against third-party conspirators)

Very often, whether the *in pari delicto* defense can be asserted depends on whether an exception to the basic rules of corporate agency applies.[193] We summarize the exceptions below:

### A. The Adverse Interest Exception.

Almost all courts recognize the adverse interest exception to *in pari delicto*. It provides that "management misconduct will not be imputed to the corporation if the insiders acted entirely in their own interests and adverse to the interests of the corporation."[194] However, under the law of some states, "to come within the exception, the agent must have totally abandoned his principal's interests and be acting entirely for his own or another's purposes. It cannot be invoked merely because he has a conflict of interest or because he is not acting primarily for his principal."[195] Moreover, many courts hold that, where the agent acts with a mixed motive, seeking to gain both personal and corporate benefits, the exception will not apply, even if "the primary motivation for the acts is inimical to the principal."[196]

To determine whether the agent totally abandoned the corporation's interests to pursue his own agenda, courts generally examine whether the agent was stealing from, or stealing for, the corporation:

> Fraud on behalf of a corporation is not the same as fraud against it. Fraud against the corporation usually hurts just the corporation; the stockholders are the principal if not only victims; their equities vis-a-vis a careless or reckless auditor are therefore strong. But the stockholders of a corporation whose officers commit

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[193] One very significant variation among the states is New York's recognition of *in pari delicto*, also known in the Second Circuit as "the Wagoner rule," as one relating to standing (an element the plaintiff must generally prove), whereas *in pari delicto* is generally a defense with the burden on the defendant to prove. Shearson Lehman Hutton, Inc. v. Wagoner, 944 F.2d 114, 118 (2d Cir. 1991) ("In our analysis of the question [of standing], the 'case or controversy' requirement coincides with the scope of the powers the Bankruptcy Code gives a trustee, that is, if a trustee has no power to assert a claim because it is not one belonging to the bankrupt estate, then he also fails to meet the prudential limitation that the legal rights asserted must be his own." (internal citations omitted)).

[194] Wight v. Bankamerica Corp., 219 F.3d 79, 87 (2d Cir. 2000).

[195] Center v. Hampton Affiliates, Inc., 66 N.Y. 2d 782, 784-85 (N.Y. 1985). See also, Gray v. Evercore Restructuring L.L.C., 544 F.3d 320, 327 (1st Cir. 2008)("The bare fact that management received bonuses upon confirmation is not sufficient to establish the exception"); Bankruptcy Services, Inc. v. Ernst & Yong (In re CBI Holding Co., Inc.), 529 F.3d 432, 438 (2d Cir. 2008); Official Comm. of Unsecured Creditors of Allegheny Health & Res. Found. v. Price WaterhouseCoopers, LLP, 1007 U.S. Dist. LEXIS 3331 (W.D. Pa. Jan. 17, 2007).

[196] See, e.g., Sec. Investor Prot. Corp. v. BDO Seidman, LLP, 49 F. Supp. 2d 644, 650 (S.D.N.Y. 1999). Smith v. Anderson, 175 F. Supp. 2d 1199 (D. Ariz. 2001) (complaint alleged "a far reaching scheme to continue a company in business past its point of insolvency and systematically looting it"); In re Phar-Mor Securities Litigation, 900 F. Supp. 784, 787 (W.D. Pa. 1995) ("the true motive of the wrongdoers was the preservation of their employment, salaries, employments and reputations, as well as their liberty, at the expense of [the debtor's] corporate well-being"); FDIC v. Nathan, 804 F. Supp. 888, 894 (S.D. Tex. 1992) (bank officers "allegedly filled their own pockets while fraudulently extending the life of the thrift they continued to milk and intensifying the deficiencies which would push the institution into insolvency"); In re Investors Funding Corp., 523 F. Supp. at 541 (S.D.N.Y 1980) ("the thrust of the complaint is that [insiders] created the false appearance of fiscal salubrity to conceal their past acts of mismanagement and to raise capital for their future plundering.").

> fraud for the benefit of the corporation are beneficiaries of the fraud. Maybe not net beneficiaries, after the fraud is unmasked and the corporation is sued – that is a question of damages, and is not before us.[197]

Many states also recognize an exception to this exception, known as the "sole actor" rule. Under the sole actor rule, where the alleged wrongdoer who comes within the adverse interest exception is "one and the same" with the corporation, then the adverse interest exception is inapplicable, *in pari delicto* applies, and the corporation is barred from asserting its claims.[198] This rule applies only, however, where the wrongdoer exerts "domination" sufficient to affect corporate action "with respect to the particular transaction."[199]

### B. The "Innocent Decision Maker" Exception.

Some courts have held that *in pari delicto* applies only where "all relevant shareholders and/or decision-makers are involved in the fraud."[200] In Wechsler v. Squadron, Ellenoff, Plesent & Sheinfeld, L.L.P., the debtor's bankruptcy trustee sued its former law firm for "legal malpractice in failing to stop the fraud personally overseen and directed by [the debtor's] CEO Steven Hoffenberg and his cohorts."[201] The court dismissed the case under the *in pari delicto* rule because the trustee had no standing to sue for misconduct that was perpetrated principally by the corporation's own directors. The court noted, however, that *in pari delicto* does not apply where there were innocent decision-makers who were "ignorant of the ongoing fraud and could and would if advised of facts . . . have taken steps to bring the fraudulent conduct to an end."[202]

The court in Breeden v. Kirkpatrick & Lockhart clarified that this "innocent decision-maker" exception set forth in Wechsler requires the existence of relevant innocent decision-makers. The court there explained:

> Wechsler does not stand for the proposition, as the trustee would have it, that the presence of any innocent officer, director, or shareholder avoids the imputation of fraudulent acts by management to the corporation. Indeed, to the extent the *Wechsler* Court refers to "all relevant shareholders and/or decision-makers" it concedes the well-accepted proposition that some members of management are irrelevant for the purposes of applying the Wagoner rule. Only management that exercises total control over the corporation—or that exercises total control over

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[197] Cenco Inc. v. Seidman & Seidman, 686 F.2d 449, 456 (7th Cir. 1982).

[198] Mediators, Inc. v. Manney (In re Mediators Inc.), 105 F.3d 822, 827 (2d Cir. 1997).

[199] Munroe v. Harriman, 85 F.2d 493, 496 (2d Cir. 1936).

[200] Secs. Investor Protection Corp. v. BDO Seidman, LLP, 49 F. Supp. 2d 644, 650 (S.D.N.Y. 1999) (quoting Wechsler v. Squadron, Ellenoff, Plesent & Sheinfeld, L.L.P., 212 B.R. 34, 36 (S.D.N.Y. 1997)).

[201] Id. at 35.

[202] Id. at 36.

> the type of transactions involved in the particular fraudulent activity at issue—are relevant.[203]

Stated another way, the Wechsler innocent decision-maker exception exists—and the trustee therefore has standing to assert claims—where there are relevant, outside decision-makers who: (1) had no knowledge of any wrongdoing; (2) could have taken affirmative action to stop the wrongdoing; and (3) would have taken such action if they had been aware of the wrongdoing.[204]

On the other hand, the court in Lippe v. Bairnco Corp. held that, notwithstanding the existence of relevant, innocent decision-makers, the innocent decision-maker exception did not apply and *in pari delicto* barred the plaintiff from asserting claims where there was "sufficient unity" between the corporate plaintiff (Keene) and the management wrongdoers. [205]

The court there explained:

> Even accepting as true all the factual allegations[, the] complaint still alleges that it was Keene and its officers that masterminded, orchestrated, and engaged in the alleged misconduct. Indeed, Keene's decision makers—the individual director and officer defendants named in this action as well as Bairnco and its subsidiaries—are charged in the amended complaint with causing Keene to wrongfully divest as well as divert its assets for inadequate consideration in breach of their fiduciary duties to the corporation. Hence, even if the clarification noted in Wechsler is valid, it does not apply here, for there is a sufficient "unity" between Keene and defendants to implicate Keene in the alleged wrongdoing.[206]

In In re CBI Holding Co.,[207] the Southern District of New York vacated a judgment of $70 million on its fraud, breach of contract and negligence claims against the debtor's pre-petition accounting firm. In determining that, under New York law, the fault imputed to the debtor as a result of management's fraud deprived the plaintiff of any ability to recover, the

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[203] 268 B.R. 704, 710 (S.D.N.Y. 2001).

[204] See id.; see also Smith v. Andersen L.L.P., 175 F. Supp. 2d 1180, 1199 (D. Ariz. 2001) ("In cases involving more than one corporate actor, the plaintiff may avoid dismissal for lack of standing by alleging the existence of an innocent member of management who would have been able to prevent the fraud had he known about it."); Bankruptcy Servs. v. Ernst & Young (In re CBI Holding Co.), 247 B.R. 341, 364-65 (Bankr. S.D.N.Y. 2000) ("corporation whose management was involved in an accounting fraud is not barred from asserting claims for professional malpractice in not detecting the fraud, provided the corporation had at least one decision-maker in management or among its stockholders who was innocent of the fraud and could have stopped it."); Secs. Investor Protection Corp., 49 F. Supp. 2d at 649-51 (permitting malpractice complaint against auditor to stand provided trustee re-pleads to assert the existence of an innocent member of management who could have prevented the fraud).

[205] 218 B.R. 294, 302 (Bankr. S.D.N.Y. 1998)

[206] Id.; see also Akro Investicni Spolecnost v. A.B. Watley, 2003 U.S. Dist. LEXIS 3478 at *19-20 (S.D.N.Y. Mar. 12, 2003) ("These pleaded facts strongly suggest the existence of 'sufficient unity' between Tejkal and Private Investors' management to deprive the Receiver of standing, as the Court found in Lippe.").

[207] 311 B.R. 350 (S.D.N.Y. 2004).

Court rejected the application of the innocent insider exception and declined to adopt any innocent insider exception to *in pari delicto*. The Court reasoned that, "where a publicly traded company has delegated to a board of directors the owners' role of hiring and supervising managers, and where that board has failed to prevent managers from committing fraud, the managers' misconduct should be imputed to the company, so as not to disincentivize the innocent managers, board members, and owners from policing the conduct of the guilty."[208] The court concluded that "misconduct by those given authority to make decisions on behalf of a company should be imputed to the company even if innocent members of management could and would have prevented the fraud had they been aware of it."[209]

### C. The Successor in Interest Exception.

A final exception to the *in pari delicto* defense has been recognized by several courts for certain innocent successors to corporations that have been harmed by fraud and malfeasance. In the receivership context, several courts have declined to apply *in pari delicto* to bar the receiver from asserting the claims of an insolvent corporation on the ground that application of the doctrine to innocent creditors would be inequitable. These courts have noted that "defenses based on a party's unclean hands or inequitable conduct do not generally apply against that party's receiver."[210]

While the majority of circuit-level courts have not ruled on whether the *in pari delicto* defense applies to successors, two have. In F.D.I.C. v. O'Melveny & Myers, the Ninth Circuit held that under federal and state law equitable defenses good against the bank could not be asserted against the receiver:[211]

> A receiver, like a bankruptcy trustee and unlike a normal successor in interest, does not voluntarily step into the shoes of the bank; it is thrust into those shoes. It

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208 Id. at 372.

209 Id. (citing Cenco Inc. v. Seidman & Seidman, 686 F.2d 449 (7th Cir. 1982)). Accord Nisselson v. Lernout, 469 F.3d 143, 153 (1st Cir. 2006) ("[T]here is no 'innocent successor' exception available to a bankruptcy trustee in a case in which the defendant successfully could have mounted an in pari delicto defense against the debtor.").

210 FDIC v. O'Melveny & Myers, 61 F.3d 17, 19 (9th Cir. 1995), 61 F.3d at 19 (citing Camerer v. California Sav. & Comm'l Bank, 4 Cal. 2d 159, 170-71, 48 P.2d 39 (1935)). See also, Scholes v. Lehmann, 56 F.3d 750, 754 (7th Cir. 1995) ("the defense of *in pari delicto* loses its sting when the person who is *in pari delicto* is eliminated."); Putnam v. Chase, 106 Ore. 440, 444-45 (1923) ("creditors or depositors who are not *in pari delicto* with the original wrongdoers have a right to say that he who executed his note for the express purpose of perpetrating a fraud should not be heard to assert that fact in order to evade the consequences which his unlawful act has brought upon him.").

211 In F.D.I.C. v. O'Melveny & Myers, 969 F.2d 744, 751 (9th Cir. 1992), rev'd and remanded, 512 U.S. 79 (1994), the Ninth Circuit held that federal, not state, law governed the applicability of equitable defenses to a claim asserted by an FDIC receiver against the bank's law firm. It then determined that, under federal law, equitable defenses good against the bank could not be asserted against the receiver. The Supreme Court reversed as to the applicability of federal law, and remanded for a determination of whether California state law would apply equitable defenses available against the bank to the receiver. 512 U.S. at 89. On remand, the Ninth Circuit found that California would not do so, reiterating the above quoted language from O'Melveny I. F.D.I.C. v. O'Melveny & Myers, 61 F.3d 17, 19 (9th Cir. 1995).

> was neither a party to the original inequitable conduct nor is it in a position to take action prior to assuming the bank's assets to cure any associated defects or force the bank to pay for incurable defects ….[212]

Similarly in Scholes v. Lehmann, the Seventh Circuit held that "the defense of in pari delicto loses its sting when the person who is in pari delicto is eliminated."[213]

The language of these cases appears to support the proposition that a bankruptcy trustee, like a receiver, is not bound by the inequitable conduct of a debtor. Indeed a few courts have cited O'Melveny and Scholes for that proposition. In Blackwell v. Deloitte & Touche (In re IG Servs., Ltd.), the bankruptcy court found:

> The logic of the equitable [*in pari delicto*] doctrine fades quickly, however, when an innocent successor in interest, such as a bankruptcy trustee, brings the action. . . . After all, the "push" behind the doctrine is that the wrongdoer should not benefit from his wrongdoing. Once the wrongdoer has been displaced in bankruptcy by a third party trustee, who is acting for the benefit of innocent creditors, applying the doctrine against the trustee would be positively perverse, effectively punishing creditors for the sins of prior management, while allowing the wrongdoer to go free, sheltered behind, of all things, the wrongdoing of prior management.[214]

The Fourth Circuit Court of Appeals has ruled that where the trustee takes an absolute assignment of creditors' causes of action, the *in pari delicto* defense will not apply to a cause of action asserted by the trustee.[215] Moreover, at least one court has found that a Debtor can avoid application of *in pari delicto* through the use of Bankruptcy Code § 544's strong arm powers.[216]

Notwithstanding these cases and scholarship, authority now points against applying such a defense outside the context of receivership.[217] According to these circuits, section 541(a)'s

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[212] Id.

[213] 56 F.3d 750, 754 (7th Cir. 1995).

[214] Blackwell v. Deloitte & Touche (In re IG Servs., Ltd.), No. 02-5061-C at 20-21 (Bankr. W.D. Tex. Feb. 5, 2003) (Report and Recommendation to District Court) (citations omitted), report accepted, (W.D. Tex. July 30, 2003). See also McNamara v. PFS (In re Personal & Bus. Ins. Agency), 334 F.3d 239, 247 (3d Cir. 2003) ("nothing in the language of § 548 precludes us from considering the replacement of Kesselring by the Trustee and the concomitant removal of the taint of Kesselring's fraud from PBI, and we hold that Kesselring's conduct will not be imputed to the Trustee.").

[215] Logan v. JKV Real Estate (In re Bogdan), 414 F.3d 507, 514-15 (4th Cir. 2005). Cf. Waslow v. Grant Thornton LLP (In re Jack Greenberg, Inc.), 240 B.R. 486, 506 (Bankr. E.D. Pa. 1999) ("I conclude that Pennsylvania's Supreme Court would reject the notion that equitable defenses can never be raised against a trustee plaintiff but rather would allow a court applying Pennsylvania law discretion to bar use of the defense when under the circumstances presented, it concludes that its invocation would produce an inequitable result.")

[216] PM Denver, Inc. v. Porter (In re Porter McLeod, Inc.), 231 B.R. 786, 793-94 (D. Colo. 1999).

[217] Nisselson v. Lernout, 469 F.3d 143, 153 (1st Cir. 2006) ("[T]here is no 'innocent successor' exception available to a bankruptcy trustee in a case in which the defendant successfully could have mounted an in pari delicto

*Footnote contined on next page.*

language defining estate property as the debtor's interests "as of the commencement of the case" limits the estate's rights to those actually held by the debtor on the petition dated. These courts cite legislative history to note congressional intent that the trustee "take no greater rights than the debtor himself had." It has drawn criticism from judges[218] and academics for deviating from "good sense and fidelity to bankruptcy policy."[219] Going forward, we can reasonably expect to see more litigation on this subject.

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defense against the debtor."); Official Comm. of Unsecured Creditors v. Edwards, 437 F.3d 1145, 1151 (11th Cir. 2006) ("Both the text and purposes of the Bankruptcy Code support the conclusion of the district court that [the Trustee]'s complaint is subject to the same defenses that were available against a complaint filed by the debtor at the commencement of the bankruptcy."); Grassmueck v. Am. Shorthorn Ass'n, 402 F.3d 833, 836-837 (8th Cir. 2005) (same); Breeden v. Kirpatrick & Lockhart LLP (In re Brennett Funding Group, Inc.), 336 F.3d 94 (2d Cir. 2003); Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340 (3d Cir. 2001); In re Dublin Secs., Inc., 133 F.3d 377 (6th Cir. 1997); In re Hedged Investments Assocs., Inc., 84 F.3d 1281 (10th Cir. 1996); see also, Peregrine Funding, Inc. v. Sheppard Mullin Richter & Hampton LLP, 133 Cal. App. 4th 658, 678 (2005).

[218] Lafferty, 267 F.3d at 360 (Cohen, J., dissenting) ("the majority's reasoning rests on a mistaken interpretation of the bankruptcy code, needlessly thwarts recovery for innocent creditors, and insulates from civil liability those who help perpetrate fraud.").

[219] Jeffrey Davis, "Ending the Nonsense: The *In Pari Delicto* Doctrine Has Nothing to Do with What Is § 541 Property of the Estate," 21 Emory Bankr. Dev. J. 519 (2005); see also Jordan A. Kroop, A Ponzi Scheme and a 'Pointless Technicality,'" 21 Am. Bankr. Inst. J. 26 (2002); see also Tanvir Alam, "Fraudulent Advisors Exploit Confusion in the Bankruptcy Code: How *In Pari Delicto* Has Been Perverted to Prevent Recovery for Innocent Creditors," 77 Am. Bankr. L.J. 305, 322-23 (Summer 2003).