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Third Circuit Casts New Uncertainty on "Deepening Insolvency" Claims

In a decision that will no doubt revive a dormant debate concerning "deepening insolvency," the United States Court of Appeals for the Third Circuit (the Third Circuit) recently found that, under Pennsylvania law, deepening insolvency is an independent cognizable cause of action when there is evidence of fraud. See *In re Lemington Home for the Aged,* Case No. 10-4456 (3d Cir. Sept. 21, 2011). By contrast, recent decisions in Delaware and New York bankruptcy courts have held that deepening insolvency is not an independent cause of action, even in instances when the failure of a fiduciary prolongs or further deepens a corporation's insolvency.

The case arose from the failure of a nonprofit elder care home, the Lemington Home for the Aged (the Home), which was established in Pittsburgh more than 100 years ago as a haven for elderly members of the African-American community.

Beginning in 1983, the Home began to experience financial difficulties as a result of the overwhelmingly large percentage of patients receiving Medicaid. In 1997, the Home's board of directors hired an administrator who apparently was not qualified for the position. By 1999, the Home was insolvent. The Home was given a grant to hire a new administrator, but instead used the funds for other purposes.

In December 2002, the board hired a new CFO, who failed to maintain a general ledger or to keep any books and records. In 2004, the board was informed that employee insurance premiums had not been paid although payroll deductions had been made for that purpose. From November 2003 to January 2005 there was no meaningful oversight by the board of the Home's financial operations.

In May 2004, the Home's administrator recommended that the Home file for bankruptcy, but the board choose to seek other options. For example, it tried to borrow US$1 million, but it needed a viability study to get the loan. The board, however, declined to approve the study. The Home's accounting firm quit in 2004 because of non-payment. By December 2004, the board was in disarray. No minutes were kept at board meetings. The board members relied on financial advice from the CFO, although they already knew he kept no records. At a board meeting on January 6, 2005, the board looked at options including bankruptcy and restructuring. At that meeting, the board voted to stop admissions and transfer the Home's primary charitable asset, the Lemington Home Fund, to Lemington Elder Care, with which it had an interlocking board of directors.

On April 13, 2005, the Home filed a voluntary Chapter 11 petition in the United States Bankruptcy Court for the Western District of Pennsylvania. A committee of unsecured creditors (the Committee) was appointed shortly thereafter. In May 2005, one of the Home's creditors hired a forensic accountant to investigate the Home's financial situation. He found that: (i) reliable bank and business records could not be obtained; (ii) the facility's accounting system had not been maintained for some time; and (iii) Medicaid claims had not been submitted since August 2004.

On June 9, 2005, the Bankruptcy Court directed the Home to obtain a viability study from Primus Care, which found that the Home could not continue to operate in its current condition because, *inter alia:* (i) the Home's department heads were unqualified; and (ii) basic internal controls were missing in areas such as census tracking, account receivable, accounts payable, payroll and resident trust accounts. The study recommended appointing board members with for-profit experience, along with a long-term care management company. In November 2005, the Committee commenced an adversary proceeding, alleging causes of action against the directors and officers for breach of fiduciary duties of care and loyalty and for deepening insolvency.

Despite the Committee's evidence, the District Court granted summary judgment in favor of the directors and officers and found that the business judgment rule as well as the doctrine of *in pari delicto* applied to shield the directors and officers from liability. The Committee appealed.

The Third Circuit agreed with the Committee, finding that there was enough evidence for a rational fact finder to conclude that the officers and directors did not exercise reasonable diligence, and thus application of the business judgment rule in this case could not be decided on a summary judgment motion.

With respect to deepening insolvency, the Third Circuit initially noted that under Pennsylvania state law "deepening insolvency" is defined as "an injury to [a debtor's] corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life." The Third Circuit, however, concluded that fraud must first be proven to support a claim of deepening insolvency and that "it is necessary to demonstrate that the director's action caused the deepening insolvency." Nevertheless, the Pennsylvania courts had never ruled on the issue of whether deepening insolvency was an independent cause of action. In a previous case, however, the Third Circuit had held that it believed the Pennsylvania Supreme Court would determine that deepening insolvency may give rise to a cognizable injury. See, e.g., *Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co.,* 267 F.3rd 340, 356 (3d Cir. 2001). In its decision, the Third Circuit acknowledged that other courts and commentators have rejected claims of deepening insolvency as an independent cause of action. This includes bankruptcy courts in New York and Delaware. Although recognizing that its decision may be erroneous, it was bound by its decision in *Flaherty* that deepening insolvency was an independent cause of action.

The Third Circuit's decision significantly alters the playing field for corporate directors and officers. Prior to this decision, officers and directors of companies seeking relief under the Bankruptcy Code were safe in the knowledge that whether their companies filed for relief in Delaware or New York, they were immune from a claim for deepening insolvency as an independent cause of action. The Third Circuit's decisions generally are binding on the Delaware bankruptcy courts. In the instant case, however, the Third Circuit was interpreting Pennsylvania law, so it is uncertain how it would rule in a case arising under Delaware law.

Corporate governance laws have become fraught with traps for the unwary, with the obligations of officers and directors changing from jurisdiction to jurisdiction. The choice of venue for filing may now become one of the most significant initial decisions. Thus, officers and directors of troubled companies need to retain counsel skilled in both bankruptcy and corporate governance to help guide them through these pitfalls.

If you would like to learn more about our corporate governance or restructuring and insolvency practices, please contact your principal Squire Sanders lawyer or one of the lawyers listed in this Alert.

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