

The Deepening Insolvency Risk.

Introduction

The past few years have seen an ever increasing number of reported lawsuits asserting the theory of “deepening insolvency”. From only 4 or 5 in the year 2000 to well over 55 in the years 2004 and 2005. Anecdotal evidence suggests that far more have been filed and not reported. The theory is that a lender has participated in the deepening of the insolvency of a borrower. As such, the lender becomes liable to a trustee or creditors committee in a bankruptcy case or even shareholders in the case of a failed work out. Since the theory attaches to what may be seen as everyday conduct in the restructuring of a troubled loan, caution is warranted.

The History of Deepening Insolvency

The theory first appeared 1980 in a securities litigation case where the court rejected the notion that automatically extending a corporations existence conferred a benefit to the corporation. The court said “A corporation is not a biological entity for which it can be presumed that any act which extends its existence is beneficial to it”, *Investors Funding Corp. of New Your Sec. Litig. V. Dansker*, 523 F.Supp. 533541 (S.D.N.Y. 1980).

A number of reported cases followed this approach. There were (and are) differing opinions as to whether this is a new theory of liability or a measure of damages from existing theories of corporate responsibility. The weight of authority seems to side with this becoming a new theory of liability and one that must be considered when dealing with a troubled loan.

Elements of Deepening Insolvency

If one thinks of this theory as “deepening the insolvency of a borrower” the concept becomes clearer. This is the foundation upon which the elements are based. Some courts will require the fraudulent prolonging of a corporations existence beyond insolvency, or the fraudulent expansion of a corporations debt to extend its life. Of more concern are the courts that allow the theory to go forward where there was negligence in relying on a financial advisor opinion, or on negligently prepared financial statements.

The best definition of the elements of deepening insolvency can be summarized as follows:

1. The fraudulent prolongation of an insolvent corporation’s life by hiding its true financial condition;
2. causing the corporation to become more insolvent by incurring additional liabilities or the dissipation of assets’

3. so that the value that could have been realized if the corporations business activity had not been improperly prolonged, and
4. the corporations suffers harm distinct from the harm suffered by its creditors.

The real risk is a court determines that an element is only required to be held to a negligence standard as some courts have now ruled. Whether it is the fraud of management or simple incompetence the natural reaction by management to any troubled loan is to buy time for a solution to appear. This is usually brought about by using false or misleading financial information. If the lender discovers this fact and continues on with a work out or forbearance agreement they may well have crossed over the bridge into a risk of a deepening insolvency claim.

Incurring additional debt is likewise an often used treatment for a troubled loan. A refinance or an over advance will almost always deepen the indebtedness of the company. Depending upon its true financial situation this new loan or over advance can easily drive the company into deepening insolvency. The result of this deepening insolvency is to reduce the possible recovery to creditors had the company closed its doors at that point and engaged in an orderly liquidation.¹

This risk is as one court found is being considered an “aider and abettor” of deepening insolvency conduct. This presents itself in the work out stage where the natural reaction by the lender and the borrower is to shore up the borrower’s financial ability to service bank debt. If the lender has knowledge that the elements of deepening insolvency are occurring and negligently overlooks them, there may well be a claim asserted after an unsuccessful work out or bankruptcy that the lender was an active participant in deepening the insolvency of the borrower. This is the classic risk of being the last “solvent bystander” left at the scene of a failed company.

The best example of the lender risk can be found in the reported decision *In re Exide Tech., Inc.* 299 B.R. 732 (Bankr. D. Del. 2003) wherein the lenders continued to loan money to a debtor while the debtor was insolvent on a balance-sheet basis. Nevertheless new loans were made and new collateral taken that in part refinanced old debt. Exide was kept afloat long enough for the preference risk to go away and then allowed to file chapter 11. The court’s decision can be interpreted as holding the lender liable under deepening insolvency by: (1) extending credit to an insolvent company; and (2) causing the borrower to remain in business all at the expense of the creditors.

Damages

¹ In Germany there is a statutory obligation to file bankruptcy if a corporation is insolvent.

Measuring damages in a deepening insolvency situation can be difficult. Obvious examples include situations where there is a measurable value at the outset of a work out. The lender and the borrower engage in what are perceived as normal work out transaction but the effect is to increase debt, or as a result deepen the insolvency of the borrower. This requires that a valuation is made early on using perhaps all three methods of valuing a company. Where it is balance-sheet, cash flow, or adequate capital it will be useful to have a benchmark to work from. If the deepening insolvency conduct drives that value down from positive to negative the measure of damages is pretty simple.

Measuring damages when a company is already at or near insolvency is more difficult. At or into insolvency the company is actually owned by its creditors. The owners are no longer “in the money” and the directors owe a fiduciary duty to the creditors to insure the remaining value is protected for them. The measure of damages can be the loss of value before the alleged bad acts and after. Even if the difference is differing degrees of insolvency. The difference to creditors may be a difference of 30% or 50% of their claim but for the conduct giving rise to deepening insolvency. Therefore, just because a company may be insolvent does not lessen the risk of deepening insolvency. Its’ insolvency can “deepen”.

Warning Signs

1. Understand the borrower’s solvency position under all three solvency tests – balance sheet, cash flow, and adequate capital;
2. Make and memorialize decisions in light of the protections that exist under the business judgment defense²;
3. Consider the industry and economic context of your decisions;
4. Resist financing losses with further debt;
5. Monitor key financial ratios and indicators, including trade payables;
6. Consider obtaining the consent or support of major creditors before implementing strategies that may pose a risk to major assets or increase debt levels; and
7. Always assure fairness in related party transactions.

Conclusion

The changes to chapter 11 of the bankruptcy code will only further muddle this issue. Now that a debtor has a considerably shorter period of time to confirm a plan, the result will likely be more effort put into pre-bankruptcy restructurings and inevitably forbearance agreements during this stage. The risk of engaging in conduct that is later alleged to have deepened the insolvency of the debtor is real. One option will be to require an earlier filing to allow for court approved

² The business judgment defense can be used by directors to defend their conduct if based upon their business judgment they did not act with fraudulent intent or bad faith.

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lending and avoid the risk altogether. The alternative is to work within your normal lending parameters. This can be done so long as you carefully monitor the debtor's financial situation.

Should you have further questions on this theory please don't hesitate to contact me. I can be reached at:

Jack Cullen
Foster Pepper PLLC
1111 3rd Ave. Suite 3400
Seattle, WA 98101
Direct dial: 206.234.4689
Email: jc@foster.com