

IN PRACTICE

BANKRUPTCY LAW

District Court Refuses To Recognize Deepening Insolvency Cause of Action

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Giving the lending community some peace of mind in otherwise trying times, the U.S. District Court for the District of New Jersey has ruled that neither the New Jersey legislature nor the New Jersey state courts have recognized an independent cause of action known as “deepening insolvency.”

On March 26, in *Stanziale v. Sun National Bank, et al. (In re Dwek, et al.)*, Civ. No. 3:09-cv-5046, the U.S. District Court granted Sun National Bank’s appeal from an earlier decision by the U.S. Bankruptcy Court for the District of New Jersey denying Sun’s motion to dismiss a deepening insolvency claim. The claim was filed against Sun by Charles A. Stanziale Jr., the trustee appointed in the Chapter 11 bankruptcy cases of Solomon Dwek, a real estate investor, and his multiple businesses.

Sun’s interlocutory appeal taken by the district court arose out of one of the

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many adversary proceedings filed by the trustee. In the adversary complaint against Sun National Bank, Todd Holmes and Albert Rescinio, the trustee alleged that Solomon Dwek operated a “Ponzi” scheme in which he took money from numerous investors under the pretext of using it for buying and improving investment real estate but instead he used the money collected from the investors to pay back his earlier investors.

At the heart of the trustee’s allegations against Sun were several loans purportedly made by Community Bank, Sun’s predecessor by merger, to Solomon Dwek and two of his companies, Dwek Properties, LLC and SEM Realty, LLC, which loans were repaid either to Community Bank or to Sun Bank with interest. The trustee sought to recover the loan payments received by Community and Sun on the basis of three theories for recovery: (1) that the payments at issue constituted fraudulent transfers, (2) that Sun aided and abetted Solomon Dwek’s fraud, conversion, and breaches of fiduciary duty, and (3) that Community’s loans to Solomon Dwek and his businesses caused such debtors to incur additional liabilities at a time when they were already insolvent, thereby causing their “deepening insolvency.”

Deepening Insolvency, A Creature of State Law

“Deepening insolvency” refers to the “fraudulent prolongation of a corporation’s life beyond insolvency” resulting in damage to the corporation caused by increased debt. *Schacht v. Brown*, 711 F.2d 1343, 1350 (7th Cir.), cert denied, 464 U.S. 1002 (1983). Although frequently used by bankruptcy trustees and committees of unsecured creditors in bankruptcy cases, this theory is a creature of state law. *OHC Liquidation Trust v. Credit Suisse First Boston LLC (In re Oakwood Homes Corp.)*, 340 B.R. 510, 537 (Bankr. D. Del. 2006); see also, *Thabault v. Chait*, 541 F.3d 512, 521 (3d Cir. 2008).

Although “deepening insolvency” as a general theory enjoyed some early popularity in the 1990s, it was not recognized as a cause of action (as opposed to a standing doctrine, an exception to the *in pari delicto* defense, or as a theory of damages) until 2001 in *Official Comm. Of Unsec. Creditors v. R. F. Lafferty & Co.*, 267 F.3d 340 (3d Cir. 2001), applying Pennsylvania law. The trustee could bring a claim for “deepening insolvency” against Sun and the other defendants only if such claim existed under New Jersey law.

After Sun filed a motion to dismiss the trustee's original complaint, Judge Ferguson of the bankruptcy court found that the complaint lacked the specificity necessary to withstand a challenge under Rule 12(b)(6) and ordered the trustee to file an amended complaint. Notably, however, in ruling on Sun's motion to dismiss the original complaint on June 22, 2009, Judge Ferguson declined to dismiss the "deepening insolvency" count of the trustee's complaint, relying in part on the decision of Judge Gambardella, also of the Bankruptcy Court for the District of New Jersey, in *Forman v. Salzano, et al. (In re NorVergence, Inc.)*, 405 B.R. 709 (Bankr. D.N.J. 2009), in which Judge Gambardella allowed a claim of "deepening insolvency" brought by a bankruptcy trustee against the debtor's insiders, as well as several leasing and financing companies, to go forward. (Interestingly, certain defendants sought and were granted interlocutory appeal of Judge Gambardella's order as it related to deepening insolvency, and, instead of responding to such defendants' brief in support of appeal, the NorVergence trustee simply withdrew the claim.)

After, at the bankruptcy court's direction, the trustee filed an amended complaint also containing a "deepening insolvency" count, Sun moved for dismissal of the amended complaint, arguing, among other things, that the "deepening insolvency" count failed to state a cause of action because neither the New Jersey legislature nor the New Jersey courts has recognized an independent cause of action for "deepening insolvency." The bankruptcy court denied Sun's motion to dismiss in full in a ruling from the bench on September 15, 2009, after which Sun filed a motion for leave to appeal Judge Ferguson's ruling on the "deepening insolvency" count with the district court.

The district court granted Sun's request for leave to appeal, finding that the issue of whether New Jersey would recognize an independent tort of deepening

insolvency was a "controlling question of law," with respect to which there was a substantial difference of opinion, and which, if resolved in favor of Sun, could "materially advance the ultimate termination of the litigation."

Trend Against Deepening Insolvency as an Independent Tort

On appeal, Sun argued, in reliance on the earlier decisions of the Law Division of the New Jersey Superior Court and the New Jersey Supreme Court in *Bondi v. Citigroup* and the United States Court of Appeals for the Third Circuit in *Thabault v. Chait*, 541 F.3d 512 (3d Cir. 2008), that neither the New Jersey legislature nor the New Jersey Supreme Court had authorized a "deepening insolvency" cause of action. Sun further stressed that the cases decided in other jurisdictions also indicated a trend against recognizing "deepening insolvency" as an independent tort. Particularly, Sun pointed to Delaware's state courts refusal to recognize a cause of action for "deepening insolvency" in *Trenwick Am. Litig. Trust v. Ernst & Young LLP*, 906 A.2d 168 (Del. Ch. 2006). Finally, Sun contended that policy consideration strongly favored the preservation and use of existing causes of action for recovery for actual harm to troubled entities instead of the creation of a new, vaguely defined tort of "deepening insolvency."

In his brief in opposition to Sun's appeal, the Trustee understandably disagreed with Sun's arguments regarding whether New Jersey would recognize a cause of action for deepening insolvency, generally relying on dicta in the *Thabault v. Chait* decision.

The district court, through Judge Thompson, granted Sun's appeal and overturned the bankruptcy court's denial of Sun's motion to dismiss. In a concise yet well reasoned opinion, Judge

Thompson specifically pronounced that "No New Jersey court has recognized deepening insolvency as a cause of action, and in fact, the law division of the superior court explicitly refused to do so when given the opportunity." The district court also noted that "the vast majority of recent cases on the subject from other jurisdictions have disapproved of deepening insolvency as an independent cause of action, noting that such a claim is either inconsistent with or duplicative of already-established law." Echoing the concerns raised in Sun's appellate brief, the District Court also observed that the premise of deepening insolvency conflicts with some of the central doctrines of corporate law as well as principles of debt financing supporting the use of additional financing in certain situations for the purpose of avoiding a bankruptcy filing by an insolvent company.

The district court was not persuaded by the trustee's arguments that New Jersey courts would be willing to expand tort liability by recognizing the theory of "deepening insolvency," instead stating that the existing legal scheme was sufficient to deal with "persons who dishonestly pile additional debt onto an insolvent corporation."

The district court's decision continues the recent trend among state and federal courts rejecting "deepening insolvency" as an independent cause of action that has been used quite aggressively by trustees and creditor committees against officers, directors and lenders, as well as the professionals who advise them, in the aftermath of an unsuccessful workout. While, as an unpublished decision, Judge Thompson's opinion may not make many legal headlines, this decision nevertheless deals a meaningful blow to this poorly defined doctrine and allows lenders and professionals, as well as directors and officers of troubled companies, to make their business decisions in a more established legal environment. ■