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Third Circuit Addresses "Deepening Insolvency" Claims: In re Lemington Home

In a decision issued on September 21, 2011, Official Comm. Of Unsecured Creditors v. Baldwin (In re Lemington Home for the Aged), No. 10-4456, 2011 WL 4375676 (3d Cir. Sept. 21, 2011) ("Lemington Home"), the U.S. Court of Appeals for the Third Circuit reversed a grant of summary judgment in favor of defendant directors and officers and held that the "deepening insolvency" cause of action, which the Third Circuit previously recognized in Official Comm. Of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340 (3d Cir. 2001) ("Lafferty"), remains an independent cause of action under Pennsylvania law. The District Court for the Western District of Pennsylvania had granted summary judgment in favor of the defendants on the deepening insolvency claim on the ground that the plaintiff was unable to show the requisite element of fraud on the part of the directors and officers. On appeal, the Third Circuit reversed and held that there was a genuine issue of material fact as to whether the directors and officers fraudulently contributed to the deepening insolvency of the debtor. The Third Circuit also reinstated related breach of fiduciary duty claims against the officers and directors.

While the Third Circuit acknowledged in its decision that recent case law has called into question the viability of the deepening insolvency cause of action, it specifically noted in a footnote that it was bound in its decision to follow its prior decision in Lafferty recognizing the claim, which only could be overturned by the Third Circuit *en banc*. Thus, for now, deepening insolvency remains a viable cause of action under Pennsylvania law.

I. **Background**

The debtor Lemington Home, a non-profit personal care facility in Pittsburgh, Pennsylvania, filed for chapter 11 protection in April 2005, after several years of mismanagement and financial struggles, including among other things: its failure to maintain financial records, its failure to appoint a treasurer, "going concern" warnings in its last several audits, repeated citations by the housing department, the death of two residents on account of alleged negligence by the facility, a downgrade of its license to provisional status, the failure of the board to maintain minutes, and a failure to submit Medicare billings. The board also maintained the same nursing home administrator in the several years prior to the bankruptcy filing, even though she held only a part time position in violation of state law and an outside group had recommended she be replaced with a more seasoned administrator. Prior to the bankruptcy filing, the board also decided to stop new patient admissions at the facilities, and considered transferring the facility's principal charitable assets to an affiliated entity where some of the board members also held positions.

After the chapter 11 filing, the Official Committee of Unsecured Creditors (the "Committee") appointed in the case sought and obtained derivative standing to assert on behalf of the estate various causes of actions against the debtor's former directors and officers, including claims for breach of fiduciary duties of care and loyalty and for deepening insolvency. The defendants moved for summary judgment, which was granted by the District Court. The District Court held that the breach of fiduciary duty claims were precluded by virtue of the business judgment rule and the doctrine of *in pari delicto*, and the Committee failed to show the requisite fraud on the part of the directors and officers to support a deepening insolvency claim. The Committee appealed the ruling to the Court of Appeals for the Third Circuit.

II. The Third Circuit's Decision

On appeal, the Third Circuit reversed the dismissal of both claims. First, the Third Circuit found that summary judgment on the breach of fiduciary duty claims was not appropriate because a genuine issue of material fact existed as to whether the directors exercised reasonable diligence in their duties prior to the bankruptcy. The court noted that the business judgment rule would only apply if no breach of fiduciary duty had occurred, and the defendants' evidence of various board meetings, consideration of operational alternatives and reliance on assistance of counsel did not dispositively warrant application of the business judgment rule where numerous red flags were raised about the competence of the debtor's administrator and chief financial officer over time. The Third Circuit further concluded that the Committee had presented sufficient evidence to raise a genuine issue of material fact as to whether the "adverse interest" exception to the *in pari delicto* defense applied, given the alleged self-dealing by the board members in considering moving certain assets to an affiliate they also were associated with prior to the bankruptcy.[1]

Second, the Third Circuit found that summary judgment could not be granted in favor of the defendants on the deepening insolvency claim given a genuine issue of material fact as to whether the directors and officers fraudulently contributed to the deepening insolvency of Lemington Home. Importantly, the Third Circuit relied on its prior ruling in Lafferty, where it had concluded that "the Pennsylvania Supreme Court would determine that 'deepening insolvency' may give rise to a cognizeable injury." Lafferty, 267 F.3d at 349. The court restated the principle that deepening insolvency is "an injury to [a debtor's]

[1] Under the "adverse interest" exception, the actions of the directors and officers are not imputed to the corporation--and *in pari delicto* is no defense--where the alleged breaches of fiduciary duty did not benefit the corporation but instead benefited the directors' and officers' own self-interest.

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corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life," noting however that a deepening insolvency cause of action requires a showing of fraud; negligence is not sufficient. Lemington Home, 2011 WL 4375676 at *10 (quoting In re Citx Corp., 448 F.3d 672, 677 (3d Cir. 2006)). While deeming itself bound to its prior precedent recognizing the cause of action, the Third Circuit acknowledged that "courts and commentators have increasingly called into question the viability of 'deepening insolvency' as an independent cause of action." Id. at *10 n.6.

As for the specific examples of fraud alleged by the Committee, the Third Circuit highlighted, among other things:

- the board's decision to close the facility and cease admitting new patients while delaying the bankruptcy filing for four additional months, which decision was not disclosed to the bankruptcy court or creditors;

- the payment of substantial fees paid post-petition to attorneys, accountants, and other consultants to transition the debtors' resources to a related entity, which similarly were not disclosed in relevant bankruptcy court filings;

- the officers' commingling of the debtors' funds with those of related entities, failure to collect on the Medicare receivable, directing the post-petition transfer of the debtor's equipment to related entities and other similar missteps.

The Third Circuit concluded that this evidence, when considered in the light most favorable to the Committee as the non-moving party, raised a genuine issue of material fact as to whether the directors and officers fraudulently contributed to the deepening insolvency of Lemington Home. Accordingly, it reversed the ruling by the District Court and remanded the case for trial.

III. Implications

On one level, the Lemington Home decision is somewhat unsurprising in that the Third Circuit allowed the statutory creditors' committee appointed in the bankruptcy case to pursue claims against the debtor's directors and officers based on a litany of specific allegations of mismanagement and lack of care (i.e., ignoring various red flags) in the years prior to the debtor's bankruptcy filing. However, putting aside the strength of the particular claims, the Third Circuit's decision is an important reminder that courts in some jurisdictions continue to recognize (or have not reversed prior decisions recognizing) the potential viability of deepening insolvency as an independent cause of action – here under Pennsylvania law. Over the last several years, other courts have rejected the viability of deepening insolvency as a tort and it remains to be seen whether such claims will have continued viability over time, or whether such claims ever could be proven absent the occurrence of fraud or a breach of fiduciary duty based on the same underlying facts.

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If you have any questions, please feel free to contact any of your regular contacts at the firm or any of our partners and counsel listed under “Bankruptcy and Restructuring” in the “Practices” section of our website (www.clearygottlieb.com).

CLEARY GOTTLIEB STEEN & HAMILTON LLP

Office Locations

NEW YORK
One Liberty Plaza
New York, NY 10006-1470
T: +1 212 225 2000
F: +1 212 225 3999

WASHINGTON
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
T: +1 202 974 1500
F: +1 202 974 1999

PARIS
12, rue de Tilsitt
75008 Paris, France
T: +33 1 40 74 68 00
F: +33 1 40 74 68 88

BRUSSELS
Rue de la Loi 57
1040 Brussels, Belgium
T: +32 2 287 2000
F: +32 2 231 1661

LONDON
City Place House
55 Basinghall Street
London EC2V 5EH, England
T: +44 20 7614 2200
F: +44 20 7600 1698

MOSCOW
Cleary Gottlieb Steen & Hamilton LLC
Paveletskaya Square 2/3
Moscow, Russia 115054
T: +7 495 660 8500
F: +7 495 660 8505

FRANKFURT
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
T: +49 69 97103 0
F: +49 69 97103 199

COLOGNE
Theodor-Heuss-Ring 9
50688 Cologne, Germany
T: +49 221 80040 0
F: +49 221 80040 199

ROME
Piazza di Spagna 15
00187 Rome, Italy
T: +39 06 69 52 21
F: +39 06 69 20 06 65

MILAN
Via San Paolo 7
20121 Milan, Italy
T: +39 02 72 60 81
F: +39 02 86 98 44 40

HONG KONG
Bank of China Tower
One Garden Road
Hong Kong
T: +852 2521 4122
F: +852 2845 9026

BEIJING
Twin Towers – West (23rd Floor)
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
T: +86 10 5920 1000
F: +86 10 5879 3902

BUENOS AIRES
CGSH International Legal
Services, LLP-
Sucursal Argentina
Avda. Quintana 529, 4to piso
1129 Ciudad Autonoma de Buenos Aires
Argentina
T: +54 11 5556 8900
F: +54 11 5556 8999

SÃO PAULO
Cleary Gottlieb Steen & Hamilton
Consultores em Direito Estrangeiro
Rua Funchal, 418, 13 Andar
São Paulo, SP Brazil 04551-060
T: +55 11 2196 7200
F: +55 11 2196 7299