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DEEPENING INSOLVENCY: Will the U.S. theory be adopted in Canada?

Should Lenders be Concerned?

In the United States, claims for "deepening insolvency" have been advanced against lenders and investment bankers to insolvent companies as well as against the officers and directors of insolvent companies. Experience suggests that developments in U.S. commercial laws tend to be imported north of the border.[1] Accordingly, lenders should be aware of the existence of the theory of deepening insolvency and the risk of creditors attempting to use it in Canada.

What is Deepening Insolvency?

The term "deepening insolvency" refers to "an injury to [a debtor's] corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life".[2] As a legal concept, plaintiffs advancing claims of deepening insolvency seek to attribute liability to persons who cause or contribute to the alleged wrongful prolongation of the life of a company, when that has increased the indebtedness of the company and/or diminished the value of its business. One consequence of increased indebtedness or diminished value is that unsecured creditors ultimately recover less from restructuring or liquidation proceedings in respect of the subject company.

An example may illustrate the theory. It is common practice in Canada for unsecured lenders to ask for collateral security when asked to give more time to a financially challenged borrower. The legal analysis of the risks of such a transaction historically has focused on the question of whether the granting of the new security would be preferential. The preference risk is that if time is given but the borrower ultimately fails, the lenders may have their security set aside and be returned to unsecured status. The business issue for the lenders is whether to give the borrower time knowing that there is at least some legal risk that the grant of security may be set aside subsequently.

The deepening insolvency theory raises an additional potential risk. Suppose that lenders agree to give time and take security, but the borrower fails six months later. Suppose further (with the benefit of hindsight) it is determined that the unsecured creditors would have been better off if the lenders had refused to give time and the debtor had filed for creditor protection or bankruptcy six months earlier. The unsecured creditors could have been better off if either the debtor's business and/or assets were worth more six months earlier, or there had been less debt at the time. In those circumstances, simply setting aside the security granted to the lenders would not restore the other unsecured creditors to the same position they would have been in if the six month extension had not been granted.

The new risk for lenders in Canada could be that in addition to having their security set aside, a claim might be made that the lenders are also liable in damages for the diminution in recovery of the other creditors. In Canada, that claim could be based either on "deepening insolvency" being accepted as a new cause of action, or alternatively the theory being used to justify a damage remedy under the oppression provisions of the applicable corporate law.

U.S. Theory

There is a growing body of complicated and conflicting U.S. jurisprudence and the theory of deepening insolvency is by no means universally accepted by U.S. courts. U.S. courts appear to have adopted one of three separate views regarding claims of deepening insolvency. The first view recognizes deepening insolvency as a new separate cause of action in tort or based on a higher standard

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[1] Although, 67 years after the U.S. Supreme Court decision in *Pepper v. Litton,* 84 L.Ed. 281 (U.S.S.C. 1939), the status of the doctrine of equitable subordination as a recognized course of action in Canada is still uncertain.

[2] *Official Comm. of Unsecured Creditors v. R. F. Lafferty & Co., Inc.,* 267 F.3d 340 (3d Cir. 2001). We note that there currently is not a universally accepted definition of the theory of deepening insolvency.

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requiring fraudulent conduct. The second view is that deepening insolvency is only a theory by which to measure damages. Under this view, some courts have considered the deepening of a company's insolvency to be a form of injury to the company and its creditors, compensable under established causes of action (*e.g*. breach of fiduciary duty by the company's directors and in respect of the third parties such as lenders, actions against such persons for aiding and abetting or conspiring in the breach of the directors' fiduciary duties) and measured by the extent of the company's "deepened insolvency". Finally, some U.S. courts have chosen to reject arguments of deepening insolvency outright. Such courts have concluded that the theory of deepening insolvency is duplicative of existing causes of action and that the concept itself lacks a convincing legal and economic foundation.

Re Exide Tech, Inc.[3] is an example of a U.S. case where a deepening insolvency claim was advanced against a syndicate of lenders to the insolvent company by the official committee of unsecured creditors in circumstances that have some parallels to the example described above. In the *Re Exide* case, the lending syndicate established a $650 million credit facility for the company in 1997. In 2000 the company became insolvent and continued to be insolvent thereafter. The complaint of the creditors' committee was based on the following: (i) the lender group made an additional $250 million loan to the insolvent company to finance an acquisition of a business; (ii) the lenders received substantial additional collateral and guarantees at or shortly after the time of making the loan in 2000; (iii) the new financing significantly increased the lenders' leverage over the company, (iv) the company's financial situation continued to decline; and (v) the lenders caused the company to delay its bankruptcy filing until a certain date to prevent the security interests granted in the 2000 loan transaction from being voidable as preferences.

At its core, the complaint by the unsecured creditors' committee alleged that the lenders controlled the company and forced the company to fraudulently continue its business at ever-increasing levels of insolvency for the benefit of the lenders. It was further alleged that the conduct of the lenders caused the company to suffer significant losses and become more deeply insolvent, costing the creditors substantial value.[4]

The lenders brought a motion to summarily dismiss the proceeding on a number of grounds, including that deepening insolvency is not recognized under the laws of Delaware. The Delaware Court refused to summarily dismiss the claim for deepening insolvency when there has been damage to corporate property.[5]

Is There a Place for the "Deepening Insolvency" Theory in Canada?

The U.S. packaging of the underlying theory as "deepening insolvency" is likely to appeal to creditors as an additional basis for a claim or to support a claim under existing statutory provisions. However, it is unclear whether a Canadian court will accept the theory of deepening insolvency as a new cause of action against arm's-length lenders (*i.e*. non-corporate actors) or for that matter against officers and directors of the company. The Supreme Court of Canada's decision in *Peoples Department Stores Inc. v. Wise*, [2004] 3 S.C.R. 461 established that directors owe their fiduciary duty only to the company and, specifically, not to the creditors of the company. This does not change when a corporation is in the "nebulous 'vicinity of insolvency'". The Supreme Court of Canada also reaffirmed the business judgment rule and stated that any honest and good faith attempt to remedy the corporation's financial problems will, if unsuccessful, not qualify as a breach of a statutory fiduciary duty. As a result, given the uncertainties in the U.S. about deepening insolvency liability theories, we are skeptical about the likelihood of "deepening insolvency" being recognized in Canada ultimately as a separate cause of action, as opposed to a theory of damages.

An alternative is to make deepening insolvency claims under the oppression remedy contained in many Canadian corporate statutes. One difficulty is that the oppression remedy is intended to be a remedy against corporate actors. As long as the degree of control exercised by a lender over a debtor company remains within the realm of a conventional borrower-lender relationship, it seems unlikely that a lender would be liable for any oppressive conduct of the corporation. To date claims brought under the oppression remedy against an arm's-length commercial lender to a corporation have generally been unsuccessful.[6]

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[3] In *Re Exide Tech., Inc.* 299 B.R. 732 (Bankr. D.Del. 2003) [hereinafter "*Re Exide*"], the lender allegedly delayed the corporation's bankruptcy filings in order to prevent the grant of new security from being voidable as a preference.

[4] *Ibid* at 596.

[5] Two recent decisions in the Third Circuit may have the effect of significantly watering down the Delaware Supreme Court's decision in *Re Exide*.

[6] See, for example, *Thomson v. Quality Mechanical Services Inc*. (2001), 18 B.L.R. (3d) 99 (Ont. S.C.J.) and *Levy-Russell Ltd. v. Shieldings Inc*. (2004), 48 B.L.R. (3d) 28 (Ont. S.C.J.), in which the courts rejected claims under the oppression remedy against a bank or other lender.

On the other hand, in circumstances in which a lender exercises *de facto* control over management of the debtor, then it is not outside the realm of possibility that liability may follow.[7] For example, if the lender exercises its control and influence over the directors and officers to force or, acquiesce to, management adopting a strategy to delay the payment of trade payables and order substantial amounts of new inventory to improve its security position in advance of a pre-planned filing, a court might consider this a form of joint conduct by management and the lenders that deepened the insolvency of the debtor to the detriment of other creditors.[8]

When dealing with a borrower in the "vicinity of insolvency", one of the best protections for any lender against claims by other creditors is to strictly maintain the borrower-lender relationship and to avoid exercising undue control over the management of the business. Another is to avoid supporting a scheme that clearly benefits management or the owners at the expense of unknowing creditors.

Conclusion

Enterprising plaintiffs and their counsel will likely continue to try their luck with the latest legal theories from the U.S. As a result, Canada may very well see claims made using "deepening insolvency" nomenclature. However, absent the kind of egregious conduct that would already attract liability under established causes of action, it is not likely that the theory of deepening insolvency will create any new liabilities or sources of recovery in Canada.

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[7] Even here, however, it was held, in *Wheeliker v. R.* [1999] 2 C.T.C. 395 (Fed. C.A.) that a person acting as a *de facto* director without the requisite qualifications cannot have the status of a "director". Two qualifications are that only individuals (not corporations) can be directors and directors must be elected or appointed by shareholders.

[8] Interestingly, in *Peoples*, the court stated that "[t]he fact that creditors' interests increase in relevancy as a corporation's finances deteriorate is apt to be relevant to, *inter alia*, the exercise of discretion by a court in granting standing to a party as a "complainant" under s. 238(d) of the CBCA as a "proper person" to bring a derivative action in the name of the corporation under ss. 239 and 240 of the CBCA, or to bring an oppression remedy claim under s. 241 of the CBCA".

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