

## **Third Circuit Reaffirms Viability of Deepening Insolvency Claim**

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Nancy Chu

In *Official Committee of Unsecured Creditors v. Baldwin (In re Lemington Home for the Aged)*, 659 F.3d 282 (3d Cir. 2011), the Third Circuit Court of Appeals held, among other things, that the “deepening insolvency” cause of action, which the Third Circuit previously recognized in *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340 (3d Cir. 2001), remains an independent cause of action under Pennsylvania law.

### **Background**

Lemington Home for the Aged, also known as Lemington Center (“Lemington Center” or the “Home”), was a nonprofit corporation founded in 1883 that provided care for elderly members of the African-American community in Pittsburgh. Lemington Center was affiliated with Lemington Elder Care Services (“Elder Care”), with which it had an interlocking board of directors.

Beginning in the 1980s, Lemington Center began to experience financial troubles. In 1998, the U.S. Department of Health and Human Services imposed a monthlong ban on the Home’s admissions of new patients. Sometime afterward, Lemington Center’s administrator began to work on a part-time basis despite a state law requirement that the center employ a full-time, licensed administrator. From November 2003 through January 2005, Lemington Center had no

treasurer, nor was there any meaningful oversight of the Home's financial operations. The Home's chief financial officer also failed to maintain a general ledger for several years.

In 2004, two residents died at the Home, one under circumstances suggesting neglect. The Pennsylvania Department of Health conducted an investigation and noted that an administrator or a designee had not been on the premises as required by law and that the Home's administrator lacked the necessary qualifications. In March 2005, Lemington Center's board discussed plans to transfer the Home's principal charitable asset, the Lemington Home Fund, to Elder Care. On April 13, 2005, Lemington Center filed for chapter 11 protection in Pennsylvania.

The bankruptcy court approved the closure of the Home and the transfer of its residents to other facilities after Lemington Center failed to find either funding or a purchaser. In November 2005, the court authorized the official committee of unsecured creditors appointed in the case to prosecute claims against the Home's officers and directors for breach of fiduciary duty and for deepening insolvency. The adversary proceeding filed by the committee was withdrawn to the district court, which granted summary judgment to the defendants, ruling, among other things, that the committee failed to show the existence of fraud necessary to support a claim of deepening insolvency:

Judging the facts in the light most favorable to plaintiff, as required, plaintiff has failed to create a material issue of fact regarding the claims of fraud. There are simply no facts by which a reasonable trier of fact could find that defendants committed or precipitated any type of fraud. At most, their actions amount to negligence, but in order to support a claim for deepening of insolvency, plaintiff must create a genuine issue of fact sufficient to establish the elements of fraud.

The committee appealed to the Third Circuit.

### **The Third Circuit's Ruling**

A cause of action for “deepening insolvency” has not been formally recognized by the Pennsylvania state courts. However, relying on “decisions interpreting the law of other jurisdictions and on the policy underlying Pennsylvania tort law,” the Third Circuit previously ruled in *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340 (3d Cir. 2001), that “the Pennsylvania Supreme Court would determine that ‘deepening insolvency’ may give rise to a cognizable injury.”

A Third Circuit panel further “clarified the mechanics” of the cause of action in *In re CitX Corp.*, 448 F.3d 672 (3d Cir. 2006), stating that “deepening insolvency” in Pennsylvania is defined as “an injury to [a debtor’s] corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life.” According to the *CitX* court, in order to prevail on such a claim, a plaintiff must demonstrate that the fiduciary’s actions caused the deepening of insolvency and that the defendant’s actions were fraudulent; negligence alone is insufficient.

In *Lemington*, the Third Circuit acknowledged that recent case law has called into question the viability of the deepening insolvency cause of action. Even so, the court noted that it was bound by its prior ruling in *Lafferty*, which could be overturned only by an en banc ruling. The Third Circuit accordingly vacated the district court’s grant of summary judgment on this claim. It remanded the case for trial, finding that there was a genuine issue of material fact as to whether the directors and officers fraudulently contributed to the deepening insolvency of the Home by, among other things: (i) failing to disclose to creditors and to the bankruptcy court the board’s decision to close the Home while delaying the bankruptcy filing for four months; (ii)

commingling the Home's funds with funds of related entities; (iii) continuing to do business with vendors although they knew that the debtor was insolvent; and (iv) failing to collect business receivables.

### **Outlook**

Courts and commentators have increasingly questioned the viability of "deepening insolvency" as an independent cause of action. The Delaware state courts, for example, have expressly held that deepening insolvency is not available as an independent cause of action or a ground for damages under Delaware law. *Lemington* indicates that, at least for now, deepening insolvency remains a viable cause of action under Pennsylvania law.