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The Watchful Eye

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Sincerely,

Robert A. Modansky, CPA
 Martin Leventhal, CPA

Partners and Co-Champions of the Business Investigative and Insolvency Services Group

RSSM has instituted a program in which guest columnists may submit articles for publication in *The Watchful Eye*. Deborah J. Piazza and Jennifer L. Rando are the guest columnists for this issue.

Is Anyone Safe?

Deepening Insolvency

In these troubled times, attorneys, accountants and other professionals must be very careful in counseling clients that may be in the zone of insolvency. While an attorney may believe he is fulfilling his professional duty by assisting a corporate client in effectuating a financial transaction, if such transaction is ultimately found to be a fraudulent transfer or a breach of the fiduciary duties of one or more of the corporate

client's principals, the attorney who counseled the client on such transaction could find him- or herself liable for aiding and abetting a deepening insolvency.

In recent years, we have seen an emergence of case law involving "deepening insolvency" claims. While the theory itself can be traced back to 1896 in *Paterson v. Franklin*, 176 Pa. 612 (Pa. 1896) where the Pennsylvania Supreme Court analyzed the issue in the context of a corporation which raised funds through use of a false statement and was soon thereafter rendered insolvent, it was not until 2001 that the current case law started to emerge.

In that year, the Third Circuit Court of Appeals held that a creditors' committee had a valid cause of action for deepening insolvency under Pennsylvania law against the debtor's various professionals, including accountants, lawyers and independent underwriters. See *In re Lafferty*, 267 F.3d 340 (3d Cir. 2001). Then, in June 2007, the Delaware Supreme Court turned things around by affirming the Delaware Chancery Court's holding that there is no independent cause of action for deepening insolvency under Delaware law. See *Trenwick Am. Litigation Trust & Ernest & Young*, 931 A.2d 438 (Del. 2007) aff'g 906 A.2d 168 (Del. Ch. 2006). Parties to complex financial transactions thought they were safe again, until *Brown Schools*.

BROWN SCHOOLS

This year, the Bankruptcy Court for the District of Delaware made it clear that deepening insolvency is still alive in Delaware, and reaffirmed that a debtor's retained professionals can be liable for damages based on a deepening insolvency. *Miller v. McCown DeLeeuw & Co. (In re The Brown Schools)*, 386 B.R. 37 (Bankr. D. Del. 2008). In *Brown Schools*, the Chapter 7 trustee brought an adversary proceeding against the debtors' parent company, certain shareholders, and directors, and the debtors' prepetition attorneys. *Id.* at 42-43. The Chapter 7 trustee sought to recover damages based on various theories, including deepening insolvency, breach of fiduciary duty, fraudulent conveyance, conspiracy, and aiding and abetting. *Id.*

This case is noteworthy because although the bankruptcy court dismissed the deepening insolvency claims based on *Trenwick*, the court found deepening insolvency may still be used as a valid theory of damages for breach of fiduciary duty claims. *Id.* at 46.

However, restructuring and insolvency professionals should

find *Brown Schools* notable for other reasons. In *Brown Schools*, not only were the shareholders and directors subject to breach of fiduciary duty claims, but the bankruptcy court also sustained claims against the debtors' attorneys for breach of fiduciary duty, aiding and abetting breach of fiduciary duty, and fraudulent transfers and civil conspiracy relating to work performed on behalf of the debtors during their prepetition debt restructuring. The attorneys moved to dismiss the breach of fiduciary duty, aiding and abetting and conspiracy claims based on the fact that they were disguised deepening insolvency claims and should be dismissed. *Id.* However, the court found that while some breach of fiduciary duty claims may be disguised deepening insolvency claims, the claims in the *Brown Schools* case involved self-dealing and were therefore a violation of the duty of loyalty, which is different from deepening insolvency, and may be sustained. *Id.* at 46-47.

The court also sustained the fraudulent transfer claims against the debtors' attorneys. *Id.* at 56. The first claim was sustained on the grounds that the attorneys aided and abetted the other defendants in effectuating a prepetition debt restructuring in violation of their fiduciary duties. *Id.* at 57. The other fraudulent transfer claim involved the disgorgement of attorneys fees paid to the debtors' attorneys. *Id.* As for actual fraud, the court found the facts were sufficient to support a claim the attorneys received fees from the debtors knowingly and with the intent they were payment for helping the other defendants hinder the debtors' other creditors. *Id.* Accordingly, the payment of those fees could be avoided as a fraudulent conveyance (citing to *In re Interco Systems, Inc.*, 202 B.R. 188, 193 n.4 (Bankr. W.D.N.Y. 1996)). *Id.* at 58. As for constructive fraud, the court found there could be sufficient facts to conclude that the value of the services rendered by the attorneys was less than reasonably equivalent value as compared with the legal fees paid because the services rendered by the attorneys to the debtors in connection with the prepetition debt restructuring did not benefit the debtors but caused the other defendants to receive a preferred claim over the other unsecured creditors. *Id.* at 58.

THIRD-PARTY LIABILITY

The *Brown Schools* case is one of the most recent examples of a court sustaining deepening insolvency claims against an attorney in connection with performing services for a client who may be insolvent or in the zone of insolvency. It may seem obvious that if an attorney has aided and abetted a breach of fiduciary duty, there may be liability for such actions. However, uncertainty arises in situations where an attorney

cannot determine if a particular transaction is an exercise of a principal's good business judgment, whether the transaction is fraudulent, or whether the principal was negligent in its decision-making. Should attorneys be held to a higher standard because of their expected knowledge of insolvency laws? Should courts require some specific or imputed knowledge of the wrongdoing on the part of the attorney?

Case law demonstrates that the standard may vary depending on the circumstances of the case. In the recent case *In re Senior Cottages*, 482 F.3d 997 (8th Cir. 2007), the court held a cause of action against attorneys for aiding and abetting a breach of fiduciary duty was established. *Id.* at 1007. In its decision, the court found that an attorney can be liable for legal malpractice based on negligence; however, with respect to aiding and abetting a tort, there must be knowledge that the primary tortfeasor's conduct was a breach of duty. *Id.* In *Lafferty*, the court held that a creditors' committee had a valid cause of action for deepening insolvency against the debtor's attorney where the attorney knowingly utilized his law firm to perpetrate a Ponzi scheme. *Lafferty*, 267 F.3d at 344-45. Further, in *Alberts v. Tuft (In re Greater Southeast Community Hospital Corp.)*, 353 B.R. 324 (Bankr. D.C. 2006) aff'd 333 B.R. 506 (D.D.C. 2006), the court found that deepening insolvency is a visible theory of damages regardless of whether the injury occurred as a result of negligence or fraud, leaving the door open to the possibility of attorney liability for deepening insolvency based upon either negligence or fraud. *Id.* at 338.

Because the case law is not clear as to the standard of liability for deepening insolvency damage claims, professionals need to be aware that such liability can arise in almost any context. Counseling and advising clients as to the risks involved can be an attorney's best way to minimize the threat of such liability.

RED ALERT: POSSIBLE NEGLIGENCE STANDARD OF LIABILITY

Insolvency professionals may believe deepening insolvency claims based on negligence cannot be sustained based on the recent Third Circuit case *Seitz v. Detweiler, Hershey and Associates, P.C.; Robert Schoen, C.P.A. (In re Citrix Corp.)*, 448 F.3d 672, 681 (3d. Cir. 2007). In *Seitz*, the Third Circuit rejected a deepening insolvency claim against accounting based on its finding that the allegations of negligence were insufficient to sustain a deepening insolvency cause of action. However, while some cases seem to establish there must be a knowledge component (whether actual or constructive) prior to finding a professional liable for deepening insolvency, other

cases imply no knowledge is necessary. In *Nisselson v. Ford Motor Co. (In re Monahan Ford Corp.)*, 340 B.R. 1, 31 (Bankr. E.D.N.Y. 2006), the court dismissed a cause of action against accountants, but held that "allegations of an egregious refusal to see the obvious or investigate the doubtful can reasonably support an inference that the accountant acted with intent" implying that fraudulent intent can be inferred from negligence. Arguably, under *Monahan Ford*, a professional can be liable for deepening insolvency damages where they failed to notice or investigate something they should have. That sounds like a negligence standard!

Further, in the *Alberts v. Tuft* case, the court expressed its refusal to restrict recoveries for deepening insolvency to actions involving fraud and stated that "[u]nless and until this court is told differently by a higher court in its own circuit, deepening insolvency will remain a viable theory of damages in this jurisdiction regardless of whether the injury occurred as a result of negligence or fraud". *Id.* at 337-338.

Other cases where courts have left open the possibility of professional liability for deepening insolvency damages based on negligence include: *Official Comm. of Unsecured Creditors of VarTec Telecom, Inc. v. Rural Tel. Fin. Coop (In re VarTec Telecom, Inc.)*, 335 B.R. 631, 646 (Bankr. N.D. Tex. 2005) (Court left open the possibility that a negligent lender could be found liable for deepening insolvency); *Tabas v. Greenleaf Ventures, Inc. (In re Flagship Healthcare, Inc.)* 269 B.R. 721, 726 (Bankr. S.D. Fla. 2001) (Court found that financial advisers were not liable under a theory of deepening insolvency but left open the possibility that a professional could be held liable under the theory of deepening insolvency but left open the possibility that a professional could be held liable under the theory of deepening insolvency); *Fehribach v. Ernst & Young, LLP*, 493 F.3d 905, 910 (7th Cir. 2007) (Court assessed auditor liability under a deepening insolvency theory based on possible negligence).

While no negligence claims are asserted in the *Brown Schools* case, the court leaves open the possibility for deepening insolvency damages based on negligence. Notably, should the attorney in *Brown Schools* have known its representation could constitute a breach of fiduciary duty or that his client's principals' actions were a breach of their fiduciary duty? Perhaps more guidance will be forthcoming as the trustee pursues its damage claims in the case.

CONCLUSION

Courts must look to the facts and circumstances of each case to

determine whether or not an action can be upheld against an attorney or other professional for deepening insolvency damages. Regardless of the nature of the cause of action, the professional insolvency community needs to be aware of the risk of deepening insolvency damages when assisting an insolvent or near insolvent client in effectuating a transaction that could benefit and possibly save the company from failure.

While the wide scope of liability in *Brown Schools* may cause some concern, professionals must remember that "[e]ven when the company is insolvent, the board can, in good faith, pursue whatever strategies it would like to maximize the value of the firm." *Trenwick*, 906, A. 2d at 204. Professionals should be given the same deference in representing such clients. If officers and directors could escape liability by arguing they were trying to do what was best for the company, why should professionals held to a higher standard? Unless a professional's actions amount to gross negligence or an intent to defraud, they should be protected from liability for the deepening insolvency of a client. Otherwise, liability for the deepening insolvency of a client based on negligence will have a chilling effect on restructuring professionals throughout the industry.

Insolvency professionals can attempt to limit the risks by explaining the deepening insolvency concerns to clients, promptly directing a company towards a bankruptcy filing, reviewing all financial information provided by the company, and keeping copious notes of all efforts made in attempt to improve a company's financial position and maintain a going concern. Although, in the end, deepening insolvency damage claims may be a risk restructuring professionals will face in effectively representing their claims.

About the Authors:

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