STATE OF RHODE ISLAND AND PROVIDENCE PLANTATIONS

NEWPORT, SC. **SUPERIOR COURT**

(FILED: March 30, 2017)

RICHARD J. LAND, in his capacity as Receiver of LINX, LTD.	:	
v.	:	**C.A. No. NC-2016-0371**
CHARLES W. ROCHE, LEONEL E. CHAMPAGNE, NAPAC, INC, DAVID P. MARTLAND (nominal stakeholder defendant), and LEICESTER ASSOCIATES, LLC	:	

DECISION

STERN, J. The instant matter comes before the Court on Napac, Inc.'s (Napac) Motion to Dismiss. Napac, Charles W. Roche (Roche) and Leonel E. Champagne (Champagne) (collectively, Defendants) move to dismiss Plaintiff's claim for deepening insolvency, as it is not currently a cognizable cause of action under the laws of the State of Rhode Island. In opposing Defendants' Motion to Dismiss, Linx, Ltd. (Linx)—through Richard J. Land, the Receiver for Linx (the Receiver)—urges this Court to recognize deepening insolvency as an independent cause of action. Jurisdiction is pursuant to Super. R. Civ. P. 12.

I

Facts and Travel

The instant action was brought by the Receiver of Linx, who was appointed by the Court on August 31, 2015. First Am. Ver. Compl. ¶ 1. Roche and Champagne were shareholders and, respectively, the president and vice president of Linx prior to it entering receivership. Id. at ¶¶ 2, 4.

Prior to 2014, Linx operated either a division or product line known as United Water Products (UWP), for which David Belezarian, Maria Tscholl, Sharon Gray, Sharon Molleur, Madison Poulin, Ashley Potvin (collectively, UWP Employees), and David P. Martland, Esq. provided services. Id. at ¶¶ 23-25. UWP sold products to customers in the fire protection and waterworks industries. Id. at ¶ 24. In the course of its business, UWP inventory was stored in two facilities: one in Middletown, Rhode Island and the other in Jacksonville, Florida. See Roche Aff. ¶ 2. Napac, a Massachusetts corporation, was one of UWP's major customers. See First Am. Ver. Compl. ¶ 6; Roche Aff. ¶ 2. Roche is a minority shareholder of Napac and, prior to June 2014, was also a director for Napac. See First Am. Ver. Compl. ¶ 28.

In June 2014, Linx caused the transfer of UWP to Napac for roughly $750,000, "the cost-value of UWP's then-current inventory." First Am. Ver. Compl. ¶¶ 26-27; Roche Aff. ¶ 3. Through his affidavit, Roche claims that this transfer was in response to the institution of various product liability lawsuits against Linx and done so that Linx could use these funds to assist in the defense of this litigation. Roche Aff. ¶ 3. Before the transfer of UWP to Napac, Roche claims that Linx had generally sold UWP inventory to Napac at a 25% mark-up. Id. UWP was a profitable division/product line of Linx prior to the transfer; afterwards, however, Linx's annual net sales reduced from approximately $14 million to $5.5 million. First Am. Ver. Compl. ¶¶ 27, 31-32. Linx ultimately became insolvent. Id. at ¶ 42.

Linx, via the Receiver, contends that after the completion of the transfer of UWP from Linx to Napac, the UWP Employees continued to provide services to UWP only to be compensated by Linx. Id. at ¶¶ 46-47. Further, "UWP maintained a phone line at the Linx office without paying Linx[, and] . . . received the benefit of using Linx's office facility, office

equipment and office utilities" as well as "UWP's goodwill, customers and customer relationships" without paying Linx for such benefits. Id. at ¶¶ 50-54.

In addition, Roche and Champagne are the sole members of Leicester Associates, LLC (Leicester), which is based out of Middletown, Rhode Island. Id. at ¶¶ 7, 22. Leicester was the record owner of real property located at 875 Aquidneck Avenue, Middletown, Rhode Island (the Property) via warranty deed, which served as Leicester's principal office. Id. at ¶¶ 7, 21.

II

Standard of Review

"'[T]he sole function of a motion to dismiss is to test the sufficiency of the complaint . . . .'" Goddard v. APG Sec.-RI, LLC, 134 A.3d 173, 175 (R.I. 2016) (quoting Ho-Rath v. R.I. Hosp., 115 A.3d 938, 942 (R.I. 2015)). The Court "will 'assume[] the allegations contained in the complaint to be true and view[] the facts in the light most favorable to the plaintiffs.'" Id. (quoting Ho-Rath, 115 A.3d at 942). Our Supreme Court has noted that there is a policy to interpret the pleading rules liberally so that "'cases in our system are not . . . disposed of summarily on arcane or technical grounds.'" Konar v. PFL Life Ins. Co., 840 A.2d 1115, 1118 (R.I. 2004) (quoting Hendrick v. Hendrick, 755 A.2d 784, 791 (R.I. 2000)). While the pleading does not need to include the ultimate facts to be proven or the precise legal theory upon which the claims are based, the complaint is required to provide the opposing party with a fair and adequate notice of any claims being asserted. Barrette v. Yakavonis, 966 A.2d 1231, 1234 (R.I. 2009). The goal is to give defendants sufficient notice of the type of claim being asserted against them. See Barrette, 966 A.2d at 1234; Konar, 840 A.2d at 1119. Accordingly, "'[a] motion to dismiss is properly granted when it is clear beyond a reasonable doubt that the plaintiff would

not be entitled to relief from the defendant under any set of facts that could be proven in support of the plaintiff's claim.'" Goddard, 134 A.3d at 175 (quoting Ho-Rath, 115 A.3d at 942).

III

Analysis

In the First Amended Verified Complaint, the Receiver alleges that the transfer of UWP from Linx to Napac was a fraudulent transfer, and Napac was unjustly enriched by the transfer and the subsequent actions of Linx and the UWP Employees. See First Am. Ver. Compl. ¶¶ 33-43, 44-54. The Receiver, standing in the shoes of Linx, also contends that Roche and Champagne breached their fiduciary duty to Linx when they: (1) "caused UWP to be transferred to Napac for less than fair market value"; (2) "caused employees of Linx to provide services to UWP after it was transferred to Napac without Linx receiving any payment for the services of Linx employees"; (3) "caused Linx to provide office facilities and office equipment to UWP after it was transferred to Napac without Linx receiving any payment therefor"; and (4) mismanaged Linx. Id. at ¶¶ 58, 60-63, 68-71. Importantly, Linx also alleges that "Roche and Champagne caused Linx's valuable assets to be transferred to Napac for less than fair value," which "worsened Linx's financial position," ultimately resulting in deepening Linx's insolvency. See id. at ¶¶ 73-82.[1] While the Rhode Island Supreme Court has not yet addressed whether "deepening insolvency" is a cognizable claim under Rhode Island law, the Receiver contends that Roche and Champagne caused valuable assets to be transferred from the company after Linx had become insolvent, thereby causing damages to Linx for which a remedy must exist.

[1] The Receiver requests, inter alia, relief in the form of a temporary restraining order—as well as a preliminary and permanent injunction—barring David P. Martland, Esq. from distributing or transferring net cash proceeds from the sale of the Property; restraining Roche and Champagne from requesting such sale proceeds be distributed to Leicester; and precluding Roche and Champagne from taking any action on their own to distribute or transfer any assets of Leicester.

In moving to dismiss the Receiver's deepening insolvency claim, Defendants argue that such a claim is not a cognizable cause of action under Rhode Island law. Defendants argue that because there is no state law recognizing an independent cause of action for deepening insolvency, this Court should exercise restraint, not recognize an independent cause of action for deepening insolvency, and dismiss this claim from the Receiver's Complaint accordingly.

Our Supreme Court has emphasized that Rhode Island courts are "bound by the law and can provide justice only to the extent that the law allows." State v. Lead Indus., Ass'n, Inc., 951 A.2d 428, 436 (R.I. 2008). It has been recognized that law is mostly comprised of Legislative enactments in addition to "certain principles, norms, and causes of action that have evolved over centuries as 'the common law.'" Id. at 436 n.4. Thus, justice "must be based upon the rule of law." Id. at 436. Unless law provides for a route to justice, justice may not be achieved. See id.

The recognition of a new cause of action comes up scarcely; and rightfully so. The role of a judicial officer is inherently limited. In recognition of this fundamental principle, the Rhode Island Supreme Court has quoted, with approval, United States Supreme Court Justice Benjamin N. Cardozo:

> "'The judge, even when he is free, is still not wholly free. He is not to innovate at pleasure. He is not a knight-errant roaming at will in pursuit of his own ideal of beauty or of goodness. He is to draw his inspiration from consecrated principles. He is not to yield to spasmodic sentiment, to vague and unregulated benevolence. He is to exercise a discretion informed by tradition, methodized by analogy, disciplined by system, and subordinated to the primordial necessity of order in the social life.'" Id. (quoting Benjamin N. Cardozo, The Nature of the Judicial Process 141 (1921)) (internal quotation omitted).

In turn, the Rhode Island Supreme Court "consistently [has] adhered to 'principles of judicial restraint [that] prevent [courts] from creating a cause of action for damages in all but the most extreme circumstances.'" Lead Indus., Ass'n, Inc., 951 A.2d at 436 (emphasis added) (quoting

Bandoni v. State, 715 A.2d 580, 595 (R.I. 1998)). Accordingly, "[t]he judiciary may not properly create a new cause of action in order to deal with a particular perceived wrong." Cullen v. Lincoln Town Council, 960 A.2d 246, 249 (R.I. 2008). Rather, our Supreme Court has long held "'that the creation of new causes of action is a legislative function.'" Lead Indus., Ass'n, Inc., 951 A.2d at 436 (quoting Accent Store Design, Inc. v. Marathon House, Inc., 674 A.2d 1223, 1226 (R.I. 1996)); see Bandoni, 715 A.2d at 584. "After all, the judiciary's 'duty [is] to determine the law, not to make the law.'" Lead Indus., Ass'n, Inc., 951 A.2d at 436 (quoting City of Pawtucket v. Sundlun, 662 A.2d 40, 57 (R.I. 1995)). "'To do otherwise, even if based on sound policy and the best of intentions, would be to substitute [the Court's] will for that of a body democratically elected by the citizens of this state and to overplay [the Court's] proper role in the theater of Rhode Island government.'" Id. (quoting DeSantis v. Prelle, 891 A.2d 873, 881 (R.I. 2006)).

At the same time, the Court is not powerless to recognize new causes of action. On the one hand, as our Supreme Court noted in the Lead Indus., Ass'n, Inc. case, there may be instances where a court can recognize a new cause of action when the "'most extreme circumstances'" warrant such action, see 951 A.2d at 436 (quoting Bandoni, 715 A.2d at 595); although, to wit, no new cause of action has been recognized expressly in accordance with this passage. On the other hand, a court may be empowered to recognize a new tort—or extend relief beyond its previous boundaries—if the tort is merely an extension of the common law. See id.; see, e.g., Asermely v. Allstate Ins. Co., 728 A.2d 461, 464 (R.I. 1999) (extending, on a matter of first impression, the fiduciary obligation of an insurance company beyond its insured customers to those "whom the insureds have assigned their rights"); Emerson v. Magendantz, 689 A.2d 409, 411 (R.I. 1997) (extending, on a matter of first impression, the common law principles of

negligence to allow recovery for negligent performance of a sterilization procedure); Mallette v. Children's Friend & Serv., 661 A.2d 67, 71 (R.I. 1995) (extending negligent misrepresentation to the adoption context in accordance with common law principles).

"By definition, 'common law' is law subject to continuing judicial development." 15A Am. Jur. 2d Common Law § 2. If a court chooses to venture down the common law road—the one which is more often traveled—its journey in arriving to a previously unrecognized independent cause of action must be done so carefully. Rhode Island common law jurisprudence is subject to incremental changes over centuries: Evolution is only catalyzed by reason and judgment being applied cautiously to precedent to reflect issues of fairness and public policy in a manner befitting the passage of time. See Lead Indus., Ass'n, Inc., 951 A.2d at 436 n.4; 15A Am. Jur. 2d Common Law § 2.

In other jurisdictions, the tort of deepening insolvency "has been defined as prolonging an insolvent corporation's life through bad debt." 23 A.L.R. 6th 457, 457 (2007). "Deepening insolvency claims are based on the theory that to the extent that liquidation is not already a certainty, the additional incurrence of debt or other actions make a salvageable situation impossible to the detriment of the corporation and its creditors." In re Enivid.Inc., 345 B.R. 426, 453 (Bankr. D. Mass. 2006). In practice:

> "[A]n insolvent corporation's trustee, receiver, or creditors' committee, standing legally in the insolvent corporation's shoes, sues the corporation's insiders and its deep-pocket outside professionals (e.g., the corporation's auditors, lawyers, and underwriters) alleging that the defendants injured the corporation through wrongdoing that caused the corporation to incur unpayable debt that deepened the corporation's insolvency." J.B. Heaton, Deepening Insolvency, 30 J. Corp. L. 465, 467 (2005).

Thus, a claim for deepening insolvency attaches personal liability to those individual officers and directors who cause further damage to the company by incurring more debt, diminishing the

company's assets and income, or increasing the company's exposure to creditors. See Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 350 (3d Cir. 2001); Schacht v. Brown, 711 F.2d 1343, 1359 (7th Cir. 1983). In essence, under the theory of deepening insolvency, the fiduciary duty that is owed to the corporation by officers and directors extends to the creditors of the company. See Segarra-Miranda v. Perez-Padro, 482 B.R. 59, 65-66 (D.P.R. 2012).

A plethora of states have discussed the tort of deepening insolvency. Some states have recognized this tort as an independent cause of action. See, e.g., R.F. Lafferty & Co., 267 F.3d at 350.[2] Other states have refused to recognize the tort of deepening insolvency. See, e.g., Trenwick Am. Litig. Tr. v. Ernst & Young, L.L.P., 906 A.2d 168, 204-07 (Del. Ch. 2006), aff'd en banc sub nom. Trenwick Am. Litig. Tr. v. Billett, 931 A.2d 438 (Del. 2007). In so doing, those courts have relied primarily on (1) the absence of state law recognizing a cognizable claim or theory of damages; (2) a lack of standing; and (3) the business judgment rule. See Sara E. Apel, Comment, In Too Deep: Why the Federal Courts Should not Recognize Deepening Insolvency as a Cause of Action, 24 Emory Bankr. Dev. J. 85, 99-100 (2008). In addition, many courts have refused to recognize the tort of deepening insolvency when faced with an in pari delicto defense.[3] Baena v. KPMG LLP, 389 F. Supp. 2d 112, 117 (Bankr. D. Mass. 2005).

This Court finds persuasive the reasoning set forth in Trenwick Am. Litig. Tr., a case in which the Delaware Chancery Court held that Delaware law does not recognize a cause of action

[2] In addition, some states have recognized deepening insolvency as a theory of damages requiring a separate tort. See, e.g., In re VarTec Telecom, Inc., 335 B.R. 631, 644 (Bankr. N.D. Tex. 2005).

[3] The maxim in pari delicto "literally means 'in equal fault.'" 27A Am. Jur. 2d Equity § 103 (2016). "The common-law defense of in pari delicto prohibits a party from recovering damages arising from misconduct for which the party bears responsibility[,] bears fault, or which resulted from his or her wrongdoing." Id.

for deepening insolvency and rejected the theory outright. See 906 A.2d at 205. In so doing, the Trenwick Am. Litig. Tr. court noted that Delaware law does not impose an absolute obligation on the board of a company to cease its operations and to liquidate when it is unable to pay its bills. Id. at 204. Instead, the court noted that even in such times as insolvency, the board may pursue, in good faith, strategies to maximize the value of the company. Id. The court also analogized insolvency to Chapter 11 of the Bankruptcy Code, which expresses a societal recognition that an insolvent company's creditors may actually benefit if the company continues to conduct operations in the hope of getting back on its feet. Id. Although the court ultimately rejected an independent cause of action for deepening insolvency, it emphasized that in doing so, the court did not seek to absolve directors of insolvent companies of responsibilities. Id. at 205. "Rather, it remits plaintiffs to the contents of their traditional toolkit, which contains, among other things, causes of action for breach of fiduciary duty and for fraud." Id.

Moreover, the court in Trenwick Am. Litig. Tr. highlighted that Delaware law "already requires the directors of an insolvent corporation to consider, as fiduciaries, the interests of the corporation's creditors who, by definition, are owed more than the corporation has the wallet to repay." Id. Thus, the concept of "deepening insolvency" was considered not as an independent cause of action, but rather a factor to consider in determining whether a board member would be liable for a breach of fiduciary duty. See id. ("No doubt the fact of insolvency might weigh heavily in a court's analysis of, for example, whether the board acted with fidelity and care in deciding to undertake more debt to continue the company's operations, but that is the proper role of insolvency, to act as an important contextual fact in the fiduciary duty metric.").

Similar to Delaware law, Rhode Island law also imposes on the officers and directors a fiduciary duty that is owed to the company. See Hendrick, 755 A.2d at 789. Like the Trenwick

Am. Litig. Tr. court, our Supreme Court has recognized that fulfillment of that duty may involve business practices that are "not ideal," such as authorizing loans in a "desperate[] attempt[] to save the . . . business[.]" See Broccoli v. Broccoli, 710 A.2d 669, 673 (R.I. 1998) (per curiam). Rhode Island also "has never absolved directors and officers of an insolvent corporation from their fiduciary duty to its creditors." Nat'l Hotel Assocs. ex rel. M.E. Venture Mgmt., Inc. v. O. Ahlborg & Sons, Inc., 827 A.2d 646, 656 (R.I. 2003) (hereinafter Nat'l Hotel). "'When a corporation becomes insolvent and can no longer continue in business, the directors and other managing officers occupy a fiduciary relation towards creditors by reason of their position and their custody of the assets.'" Id. (quoting 15A Fletcher, Cyclopedia of the Law of Private Corporations, § 7469 at 227-28 (perm. ed. 2000)).

The Superior Court has recognized that, in general, to succeed on a breach of fiduciary duty claim in this state, the plaintiff must show "(1) the existence of a fiduciary duty; (2) breach of that duty; and (3) damage proximately caused by the breach." See R.I. Res. Recovery Corp. v. Van Liew Trust Co., No. PC-10-4503, 2011 WL 1936011, at *7 (R.I. Super. May 13, 2011) (Silverstein, J.); see also 37 Am. Jur. 2d Fraud and Deceit § 31. Similarly, federal courts falling under the umbrella of the First Circuit have ascribed the following elements to a prima facie case of deepening insolvency: "(1) fraud, (2) which causes the expansion of corporate debt, and (3) which prolongs the life of the corporation." In re Felt Mfg. Co., 371 B.R. 589, 621 (Bankr. D.N.H. 2007).

In Rhode Island, "'[c]orporate officers and directors of any corporate enterprise, public or close, have long been recognized as corporate fiduciaries owing a duty of loyalty to the corporation and its shareholders . . . .'" Takian v. Rafaelian, 53 A.3d 964, 973 (R.I. 2012) (quoting A. Teixeira & Co. v. Teixeira, 699 A.2d 1383, 1386 (R.I. 1997)). When faced with

insolvency, the officers and directors of a company also owe a fiduciary duty to creditors of the company. See Nat'l Hotel, 827 A.2d at 656. Fraudulent activities have been held to constitute a breach of the fiduciary duty owed by the officers and directors to the creditors of the company. See id. at 655-57. Similarly, corporate officers are liable for breaching the fiduciary duty owed to the company by usurping corporate opportunities. See A. Teixeira & Co., 699 A.2d at 1386. Whether the fiduciary breached his or her duty is a triable issue of fact, and therefore, such a determination requires a fact-intensive inquiry. See Takian, 53 A.3d at 975. As such, financial mismanagement in times of insolvency would likely be a fact considered by the fact-finder.

Thus, like the court in Trenwick Am. Litig. Tr., 906 A.2d 168, this Court finds that recognizing an independent cause of action for deepening insolvency would, in essence, recognize a singular factor in considering breaches of fiduciary duty as an independent cognizable claim.[4] If the Court were to recognize an independent cause of action for deepening insolvency, it would not be extending the current common law; rather, it would be duplicating an already-cognizable cause of action—i.e., a breach of fiduciary duty claim. Cf. In re Parmalat Sec. Litig., 377 F. Supp. 2d 390, 419 (S.D.N.Y. 2005) (applying Illinois law, the court held that a claim for deepening insolvency was duplicative of professional malpractice claims brought against the auditors of the company); In re VarTec Telecom, 335 B.R. at 644 (declining to adopt deepening insolvency as an independent cause of action because it "is substantially duplicated by torts already established in Texas"). Such duplication is plainly evident from a careful examination of the Receiver's First Amended Verified Complaint. In this case, the Receiver's deepening insolvency claim rests on the allegation that Roche and Champagne caused the

[4] Rhode Island courts often look to Delaware for guidance and support when there are undeveloped corporate law issues. See Bove v. Cmty. Hotel Corp. of Newport, R.I., 105 R.I. 36, 42, 249 A.2d 89, 93 (1969).

transfer of valuable assets for less than fair value when Linx was insolvent, thereby causing damage to Linx. See First Am. Ver. Compl. ¶¶ 74-79. This conduct is also alleged to constitute a breach of Roche and Champagne's fiduciary duty owed to Linx. Id. at ¶¶ 55-64, 65-72. Accordingly, because there is a remedy available for Linx, this Court will not replicate the already-existing common law[5] to add a separate ground for relief. See In re Amcast Indus. Corp., 365 B.R. 91, 118 (Bankr. S.D. Ohio 2007) ("There is no need to recognize a new cause of action when the traditional toolkit of claims against directors and officers of a corporation covers the same ground that a deepening insolvency cause of action would tread.").

[5] The Receiver correctly cites to two sections of the Rhode Island General Laws for the proposition that liability for common-law breaches of fiduciary duty can be limited, and, as such, the ability of a shareholder or member to seek relief is curtailed. Indeed, directors of a company, and managers of a limited liability company, may limit their liability for breaches of fiduciary duty. See G.L. 1956 §§ 7-1.2-202(b)(3), 7-16-18. The existence of these statutes, however, leads the Court to two important conclusions that disfavor the Receiver's position that the Court should recognize an independent cause of action for deepening insolvency. First, §§ 7-1.2-202(b)(3) and 7-16-18 evidence that the Legislature specifically intended to provide directors of a company and managers of a limited liability company the ability to limit their liability for breaches of fiduciary duties. Second, the statutes cited by the Receiver provide for serious limitations; notably, both sections prohibit directors and managers from limiting their personal liability for, inter alia, breaches of the directors' or managers' fiduciary duty of loyalty to the company or its shareholders or members. See §§ 7-1.2-202(b)(3)(i), 7-16-18(b)(1). These legislatively-crafted statutes and their limitations have two important effects: (1) they allow the individuals running the company to make business decisions as long as they are in good faith; and (2) they allow for such persons to be held liable for serious deviations from prudent decision-making. If this Court were to recognize an independent cause of action for deepening insolvency against such directors and managers, it would act in contradiction to the Legislature's intent by expanding liability on those insider-fiduciaries. As our Supreme Court has stated on prior occasions, the creation of an independent cause of action is generally a function for the Legislature. See Lead Indus., Ass'n, Inc., 951 A.2d at 436. Accordingly, this Court declines to craft an independent cause of action out of the common law that would act in opposition to, and undermine, the specific intent of the Legislature.

IV

Conclusion

Deepening insolvency cases have been dismissed when the theory behind the tort is pleaded in other counts of a plaintiff's complaint. In re Enivid.Inc., 345 B.R. at 453. Such is the case in this instance. Accordingly, and for the above reasons, this Court grants Defendants' Motion to Dismiss, as deepening insolvency is not an independent, cognizable claim under the laws of Rhode Island, and thus, the Receiver has, beyond a reasonable doubt, failed to present a cause of action upon which relief can be granted.[6] Counsel shall prepare the appropriate order for entry.

[6] The Court pauses to note that in jurisdictions where deepening insolvency exists as a cause of action, such claims may be brought against auditors, accountants, and other "outsiders" to the company. See J.B. Heaton, Deepening Insolvency, 30 J. Corp. L. 465, 467 (2005). Under the facts of this specific case, however, this Court is not obligated to address whether deepening insolvency would exist as an independent cause of action when brought against outsiders to the company. Rather, this Court's Decision is specifically limited to the facts of this case.

RHODE ISLAND SUPERIOR COURT

Decision Addendum Sheet

TITLE OF CASE:	**Richard J. Land v. Charles W. Roche, et al.**
CASE NO:	**NC-2016-0371**
COURT:	**Newport County Superior Court**
DATE DECISION FILED:	**March 30, 2017**
JUSTICE/MAGISTRATE:	**Stern, J.**

ATTORNEYS:

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