

Client Alert

Third Circuit Panel Circumscribes “Deepening Insolvency” Cause of Action

In an important recent ruling by the Third Circuit in the *CitX Corp.* case, a panel of three judges appeared to express misgivings with that circuit’s leading case on “deepening insolvency.” Parties who manage enterprises in the “zone of insolvency,” and those who lend to such entities, may take some comfort in the *CitX Corp.* decision.

An Introduction to Deepening Insolvency

Over the last several years, courts have come to recognize a cause of action for so-called “deepening insolvency” that may be asserted against a debtor’s officers and directors, accountants, lawyers, bankers and other professionals. Based on the premise that a business “is not a biological entity for which it can be presumed that any act which extends its existence is beneficial to it,” the essence of the action is that a commercial entity’s life has been improperly prolonged beyond insolvency resulting in damages caused by increased debt.

Because the concept of “deepening insolvency” is not rooted in the Bankruptcy Code or other federal law, a federal court that considers whether this relatively new theory (it appears to trace back about twenty years) is an actionable tort does so by predicting how the court of the applicable state would likely rule. Federal courts, including the Third Circuit Court of Appeals in the leading deepening insolvency case of *R.F. Lafferty & Co.*, have frequently referenced the adage, “where there is an injury, the law provides a remedy,” when making this determination. The result, not surprisingly, is almost always recognition of this new cause of action. The expansion of deepening insolvency’s application, however, may have finally reached its outer boundary.

The *In re CitX Corp., Inc.* Decision

In *In re CitX Corp., Inc.*, before the debtor filed for bankruptcy, it was able to obtain additional financing on the strength of a financial statement compilation that indicated solvency solely on the basis of a highly questionable receivable from a related entity that had been shut down by the Florida Attorney General and was under the control of a receiver. The chapter 7 trustee sued the accounting firm that had prepared the compilation alleging, among other things, professional malpractice and deepening insolvency. Following withdrawal of the reference, the District Court granted summary judgment for the defendants on both claims.

On appeal, the Third Circuit first addressed the malpractice action. In order to prevail on a claim for malpractice, the trustee was required to plead and prove: (i) the accountant owed a duty to the debtor, (ii) the accountant breached that duty, (iii) the debtor was actually harmed, and (iv) the accountant’s breach of duty caused that harm. In *CitX* the trustee alleged harm to the debtor in the form of “deepening insolvency;” that is, the alleged malpractice enabled the debtor to incur additional debt to its financial detriment.

The Third Circuit swiftly rejected the trustee’s contention that “deepening insolvency” is a viable *theory of damages* for negligence, noting that its prior decision in the *Lafferty* case merely predicted

that Pennsylvania law would recognize a separate *cause of action* for deepening insolvency—not that deepening insolvency was a valid theory of damages for an independent cause of action. Accordingly, the Third Circuit affirmed the District Court’s ruling for summary judgment in favor of the accountant on the trustee’s malpractice count.

The Third Circuit then turned to the deepening insolvency cause of action and carefully examined the trustee’s complaint to ascertain the specific misconduct on which the trustee sued. Noting that the trustee’s complaint “barely made out,” and the trustee’s evidence failed to support any allegation of fraudulent conduct by the accountant, the Third Circuit concluded that the trustee’s complaint sounded in negligence. Although the Third Circuit observed that there was some support for the proposition that negligence will support a deepening insolvency cause of action, the Court construed its prior ruling in *Lafferty* more narrowly and expressly held that a claim of negligence cannot sustain a cause of action for deepening insolvency. Rather, a party seeking recovery on deepening insolvency cause of action must allege and prove fraudulent conduct.

Analysis

The quickness with which the Third Circuit was willing to foreclose a cause of action for deepening insolvency predicated on negligence, especially in light of significant (but not controlling) authority to the contrary, may best be understood through review of footnote 11 of the opinion. There, the Third Circuit acknowledged that the “deepening insolvency” tort recognized in its prior decision in *Lafferty* has been subject to much criticism by commentators, but noted that the continuing viability of a cause of action for deepening insolvency was not before the Court and the precedential decision in *Lafferty* could only be overruled by the Third Circuit sitting *en banc*.

The Third Circuit panel seemed concerned about cases like *In re Oakwood Homes, Corp.*, a Delaware bankruptcy case cited in footnote 11, which recognized “the mounting pile of authority rejecting a [deepening insolvency] cause of action” yet felt bound by *Lafferty* to recognize the deepening insolvency cause of action under Delaware, New York and North Carolina law. The panel may also have been influenced by a number of recent decisions, including the Northern District of Texas bankruptcy court decision in *In re VarTec Telecom, Inc.* That opinion painstakingly reviewed and criticized the legal doctrine of deepening insolvency and determined that the applicable state court (Texas) would not adopt “deepening insolvency” as an independent tort because it would duplicate an existing tort. Suffice it to say, read in its entirety, footnote 11 suggests doubt by the panel sitting in *CitX* as to the correctness of the decision in *Lafferty*.

In summation, the Third Circuit’s decision is notable for three reasons. First, the court found that deepening insolvency is not an independent theory of damages. Second, negligent conduct will not support a cause of action for deepening insolvency in the Third Circuit. And, finally, it appears that at least three judges in that circuit have misgivings regarding whether deepening insolvency should be recognized as an independent cause of action.

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