Third Circuit Holds that Negligent Conduct Is Not a Basis for a Claim of Deepening Insolvency and Cautions Against a Broad Reading of Precedent Recognizing the Theory

“Deepening insolvency” is a theory under which an entity seeks to hold other parties liable for injuries caused by the fraudulent increase in the entity’s debts and improper extension of its corporate life. Defendants in deepening insolvency cases may include the troubled company’s officers, directors, controlling shareholders and, with increasing frequency, outside lenders and professional advisors. The theory has been much in vogue recently as debtors and creditors’ committees in high-profile chapter 11 cases involving allegations of fraud have sought to collect large damage awards from investment bankers, lenders and outside counsel for their purported role in loading the company with debt and driving it into bankruptcy.

Many courts and commentators have questioned the validity of the deepening insolvency theory as either a stand-alone cause of action or a measure of damages. The Chief Bankruptcy Judge of the Southern District of New York ruled that deepening insolvency is not a valid cause of action under New York law and noted that an increase in corporate debt to help a struggling company “may be bad banking, but it isn’t a tort.”1 One commentator summarized the patchwork of decisions over the last twenty-five years and questioned whether deepening insolvency can ever be a measure of damages or corporate harm.2 Deepening insolvency theories did gain some credibility from decisions of courts in the Third Circuit. In the 2001 decision Official Committee of Unsecured Creditors v. R.F. Lafferty & Co.,3 the Third Circuit held that Pennsylvania law recognized a cause of action for deepening insolvency as “an injury to [a debtor’s] corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life.”4 In 2003, a Delaware bankruptcy court ruled that a claim could be stated against a lender on the theory that the lender’s prepetition loan helped deepen the insolvency of the debtor.5 A recent Delaware bankruptcy court decision, relying on Lafferty, ruled that Delaware, New York and North Carolina law would recognize deepening insolvency.6 Based largely on these decisions in the Third Circuit, many lenders and professionals have expressed concern that chapter 11 debtors, or creditors’ committees acting on their behalf, will continue to seek to expand the deepening insolvency doctrine to hold professionals liable for the demise of their corporate clients.

3 267 F.3d 340 (3d Cir. 2001).
4 Id. at 347.
In its recent decision *In re CitX Corp.*, the Third Circuit addressed whether a defendant’s negligence, as opposed to its fraud, can result in that defendant being liable for deepening the corporation’s insolvency. In *CitX*, the defendants faced deepening insolvency as both a measure of damages in a malpractice cause of action and as a stand-alone cause of action. The Third Circuit ruled that deepening insolvency cannot be used as a measure of damages in an independent cause of action, such as professional malpractice, predicated on negligence. It also held that a deepening insolvency cause of action cannot be sustained solely on an allegation of negligent conduct, as opposed to fraud. In addition, in what may be a direct warning to bankruptcy courts within the Third Circuit and beyond, a footnote in *CitX* cautions courts against reading *Lafferty* as a basis for recognizing a deepening insolvency cause of action under any state’s law other than Pennsylvania’s. *CitX* thus provides some comfort to lenders and professionals that “deepening insolvency” will not be expanded to impose liability in cases that involve only negligence and not intentional wrongdoing. Moreover, the express limitation of *Lafferty*’s holding should make it more difficult to rely on Third Circuit precedent to broaden the reach of deepening insolvency both within the Third Circuit and in other jurisdictions.

### The Facts of *CitX*

*CitX Corporation, Inc.* (“CitX”) was an insolvent internet company operating an illegal Ponzi scheme that used its financial statements to attract investors. After CitX incurred millions in debt and exhausted investors’ money, it filed for chapter 11 protection. The case was converted to chapter 7, and a trustee was appointed.

The bankruptcy trustee sued the accounting firm that compiled the financial statements along with the partner responsible for compiling the statements. The trustee alleged that the accounting firm went beyond its written engagement and that it missed various red flags at CitX. These warnings included the fact that the company’s bookkeeper was the girlfriend of CitX’s founder and had not completed high school; that CitX was bouncing checks; that the only asset purportedly keeping CitX afloat was a receivable from Professional Resources Systems International, Inc. (“PRSI”), a fraudulent enterprise that had been shut down by the Florida Attorney General and was in receivership; and that without this receivable, CitX was insolvent.

The accounting firm compiled two sets of financial statements for CitX over approximately 2½ years. The first statement covered two fiscal years, and the second statement covered the first six months of a third fiscal year. The second statement, which formed the basis of the trustee’s lawsuit, stated that CitX, PRSI and others were named as defendants and charged with certain securities law violations by the Florida Attorney General and that the company was not sure what impact, if any, the charges would have on its financial position. The second financial statement also contained language in its certification (which did not appear in the first financial statement and is not part of a standard compilation certification) noting that CitX’s management “has elected to omit substantially all of the disclosures ordinarily included in the financial statements prepared on the income tax basis of accounting” and that if such disclosures were included “they might influence the user’s conclusions about the Company’s assets, liabilities, equity, revenue, and expenses.” The financial statements were therefore “not designed for those who are not informed about such matters.”

The second financial statement was used at a CitX meeting of shareholders. Although CitX was in a weakened financial

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7 *Seitz v. Detweiler, Hershey & Assoc. (In re CitX Corp.),* No. 05-2760, 2006 WL 1453117 (3d Cir. May 26, 2006).

8 Id. at *1.

9 *CitX* notes that the accountants were asked to provide a “compilation” of the financial statements, which is the lowest level of analysis in which the accountant does not undertake to express any assurance on the statements. Id. at *1 n.3. A compilation thus differs from a review, in which accountants perform spot checks on information given to them and provide limited assurance, and an audit, in which the accountant must verify the financial statements. Id.

10 Id. at *2 n.5.

11 Id.
condition due to suspect circumstances (and one shareholder already had decided the company was a Ponzi scheme), CitX raised more than $1 million in equity. CitX thus prolonged its existence and went on to incur millions of dollars of debt.

The chapter 7 trustee sued the accountants for various causes of action, including malpractice, negligent representation and deepening insolvency. After the reference was withdrawn from the Bankruptcy Court, the District Court granted summary judgment for the accountants on the trustee’s malpractice, negligent representation and deepening insolvency claims. The trustee appealed the summary judgment ruling on the malpractice and deepening insolvency claims to the Third Circuit.

The CitX Decision on Deepening Insolvency

A. Deepening Insolvency as a Measure of Damages in a Malpractice Cause of Action

In his malpractice action, the chapter 7 trustee had to show that the accountants breached a duty to CitX that caused harm to the company. The trustee sought to establish harm by alleging that the accountants “dramatically deepened the insolvency of CitX, and wrongfully expanded the debt of CitX and waste of its illegally raised capital, by permitting CitX to incur additional debt by virtue of the compilation statements prepared and relied upon by third parties.”

This required the Third Circuit to decide “whether deepening insolvency is a viable theory of damages for negligence,” as opposed to a viable cause of action on its own. Ultimately, the Third Circuit concluded that deepening insolvency was not a measure of “harm” in a malpractice action and that the trustee could not establish that any malpractice by CitX’s accountants caused any such harm.

The Third Circuit started its analysis with a review of Lafferty. Lafferty defined deepening insolvency under Pennsylvania law as “an injury to [a debtor’s] corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life.” CitX noted that Lafferty had concluded that deepening insolvency was a valid Pennsylvania cause of action but “[a]lthough we did describe deepening insolvency as a ‘type of injury,’ and a ‘theory of injury,’ we never held that it was a valid theory of damages for an independent cause of action.” The statements in Lafferty were in the context of a deepening insolvency cause of action and “[t]hey should not be interpreted to create a novel theory of damages for an independent cause of action like malpractice.”

The Third Circuit also held that summary judgment was appropriate because the trustee did not provide sufficient evidence to establish harm. Even if financial statements compiled by the accountants allowed CitX to raise money, this did not deepen CitX’s insolvency. By enabling CitX to raise over $1 million in equity, CitX’s level of insolvency was reduced. Any increase in insolvency resulting from the debt incurred after equity was raised was wrought by CitX’s management, not by the accountants.

Management did not use the investment to turn the company around; this was the harm to CitX. Citing a commentator, the Third Circuit concluded that “[t]he deepening of a firm’s insolvency is not an independent form of corporate damage. Where an independent cause of action gives a firm a remedy for the increase in its liabilities, the decrease in fair asset value, or its lost profits, then the firm may recover, without reference to the incidental impact upon the solvency calculation.”

The Third Circuit also rejected the trustee’s arguments on causation. The trustee alleged that by failing to investigate CitX’s problems, determine the errors in the financial statements and tell CitX’s board that these issues existed, the accountants did not give the board the opportunity to

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12 Id. at *3 (citation omitted).
13 Id.
15 CitX, 2006 WL 1453117 at *3 (citations omitted).
16 Id.
17 Id.
18 Id. at *4 (citing Willett, The Shallows of Deepening Insolvency, 60 Bus. Law. 549, 575 (2005)).
“safeguard the remaining assets of CitX.” The affidavit of CitX’s COO on which this allegation was based, however, was largely discredited. The affiant had disavowed his affidavit in deposition testimony and had provided the affidavit as part of a deal to get a suit against him dropped. Without the affidavit, there was nothing in the record to support a finding that anyone extended credit to CitX in reliance on the financial statements compiled by the defendants.

B. Deepening Insolvency Cause of Action Based on Negligent Conduct

In addition to addressing deepening insolvency as a theory of damages, the Third Circuit addressed what constituted a valid deepening insolvency cause of action under Pennsylvania law. CitX’s chapter 7 trustee alleged that the accountants should have known about the errors in the financial statements. This allegation barely made out, and the evidence completely failed to support, any allegation of fraud. Without fraud, the trustee had to rely on the allegation that the accountants negligently deepened CitX’s insolvency. The Third Circuit had to decide, therefore, “whether an allegation of negligence can support a claim of deepening insolvency.”

CitX cited a series of cases in which courts held or suggested that deepening insolvency does not require intentional conduct. The Third Circuit then looked at Lafferty, which recognized the economic tort of deepening insolvency and held that it is a valid theory that gives rise to a cognizable injury under Pennsylvania law. The CitX court noted that Lafferty also cited a case suggesting that allegations of negligence would support a deepening insolvency cause of action.

Nonetheless, the CitX court held that “a claim of negligence cannot sustain a deepening-insolvency cause of action.” Reviewing Lafferty, the court noted in that case the debtor’s shareholders allegedly conspired with third parties, including outside professionals, to operate the debtor as a Ponzi scheme and fraudulently induced the debtor to incur debt and force it into bankruptcy. Lafferty had defined deepening insolvency as a “fraudulent expansion of corporate debt and prolongation of corporate life” and referred expressly to the “fraudulent and concealed incurrence of debt.” Lafferty, therefore, held “only that fraudulent conduct will suffice to support a deepening-insolvency claim under Pennsylvania law.” Lower courts within the Third Circuit also had recognized deepening insolvency claims only on the basis of fraud. The CitX court concluded that “[w]e know no reason to extend the scope of deepening insolvency beyond Lafferty’s limited holding. To that end, we hold that a claim of negligence cannot sustain a deepening-insolvency cause of action.”

24 Id.
26 Id.
27 Id. (citing Lafferty, 267 F.3d at 347).
28 Id. (citing Lafferty, 267 F.3d at 349).
29 Id.
31 Id.
C. No Recognition of Deepening Insolvency Under the Laws of Other States

In addition to refusing to extend the scope of the deepening insolvency recognized in *Lafferty* to circumstances involving negligence, and referring to *Lafferty*’s holding as “limited,” the CitX court cautioned against reading *Lafferty* beyond recognizing that a deepening insolvency cause of action exists under Pennsylvania law. The Third Circuit noted that in the recent decision *OHC Liquidation Trust v. Credit Suisse First Boston (In re Oakwood Homes Corp.)*, a Delaware bankruptcy court extended *Lafferty* and ruled that Delaware, New York and North Carolina would recognize a deepening insolvency cause of action. The CitX court appeared to criticize this decision, noting in a footnote that “nothing we said in *Lafferty* compels any extension of the doctrine beyond Pennsylvania.”

33 *CitX*, 2006 WL 1453117 at *6 n.11.

Impact of the *CitX* Decision

*CitX* is good news for defendants in deepening insolvency cases and for financial institutions, lenders and other third party professionals that are often named as defendants in such cases. In any actions brought under Pennsylvania law, it is clear that deepening insolvency allegations must be predicated on fraud. *CitX* also expressly limits *Lafferty*’s value as precedent to matters governed by Pennsylvania law. As a result, other courts, whether or not within the Third Circuit, are unlikely to rely heavily on *Lafferty* to sustain an independent claim for deepening insolvency under the law of another state. *CitX* takes this step itself, openly questioning lower court decisions that relied on *Lafferty* to find an independent deepening insolvency cause of action under the laws of other states, including the critical states of Delaware and New York. Perhaps the greatest beneficiaries of *CitX* will be outside professional advisors to bankrupt companies, against whom it will be more difficult to prove intentional misconduct and complicity in a fraud than presumably negligence or malpractice. *CitX* is good news for potential defendants in cases involving deepening insolvency.