PLUMBING THE DEPTHS OF CORPORATE LITIGATION: REFORMING THE DEEPENING INSOLVENCY THEORY

JOHN TULLY

"Deepening insolvency" is a developing tort theory. Typically arising in bankruptcy proceedings, deepening insolvency claims are usually made by shareholders or creditors of the corporation against corporate directors, outside auditors, or lenders. This Note analyzes the widely differing approaches courts have taken to deepening insolvency. Some courts refuse to recognize deepening insolvency as a cause of action at all. Others admit deepening insolvency as a distinct tort, requiring a showing of either fraud or negligence on the part of the defendant. Finally, some courts recognize the theory as a measure of damages for existing tort claims. Ultimately, this Note recommends that the proper place for deepening insolvency claims in modern litigation is as a bar to the in pari delicto *defense for defendants who have engaged in fraud.*

I. INTRODUCTION

"Deepening insolvency" is a tort claim which typically arises in a bankruptcy proceeding.[1] The most common allegation is that a corporation's managers concealed a corporation's insolvency, enabling the corporation to continue to operate, perhaps as part of a scheme by management to loot corporate assets.[2] Through this scheme, the corporation is saddled with immense debt, its assets are significantly diminished, and its relationships with suppliers and customers become irreparably damaged.[3] The inevitable consequence is an outright liquidation of the few remaining corporate assets.[4] As part of the bankruptcy proceeding, the bankruptcy trustee is vested with all legal claims belonging to the corporation, one of which is a claim of deepening insolvency.[5] The hope is that, via a deepening insolvency claim, the trustee might recover the amount by which the corporate assets have been diminished through the fraudulent scheme.

1. *See, e.g.*, *infra* note 278 and accompanying text.
2. *See, e.g.*, *infra* note 50 and accompanying text.
3. *See, e.g.*, *infra* note 45 and accompanying text.
4. *See, e.g.*, *infra* note 45 and accompanying text.
5. *See, e.g.*, *infra* note 282 and accompanying text.

The theory of deepening insolvency has undergone immense change during the last decade.[6] While it began as a fairly innocent recognition of a unique type of corporate damage, courts have since expanded and distorted the theory.[7] This has subjected the concept to widespread criticism by some courts.[8] Nonetheless, despite the distortions and polemic attacks, the underpinnings of the theory remain sound, and this Note will demonstrate that there is a legitimate place for deepening insolvency in corporate litigation.[9]

As a tort claim, deepening insolvency is a matter of state law; however, it most often arises in the context of bankruptcy.[10] As a result, deepening insolvency is usually the subject of federal court decisions anticipating how a state supreme court would rule in a given case.[11] For this reason and others, courts have developed widely differing approaches to claims of deepening insolvency, ranging from enthusiastic acceptance[12] to outright disdain.[13] Some courts view deepening insolvency as a distinct tort.[14] Others only allow the claim of deepening insolvency as a theory of damages within another tort such as fraud.[15] Finally, some courts do not recognize deepening insolvency as actionable at all.[16]

This Note addresses the proper place for deepening insolvency claims in modern litigation.[17] Part II examines the origins and evolution of deepening insolvency, from a seemingly unremarkable statement uttered thirty years ago, to recognition as an independent tort cause of action ten years ago, to subsequent retreat and reprobation six years ago. Part III assesses the various approaches to deepening insolvency taken by courts and suggested by commentators, analyzing arguments both in

6. *Compare* Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 351 (3d Cir. 2001), *with* Trenwick Am. Litig. Trust v. Ernst & Young, LLP, 906 A.2d 168, 174 (Del. Ch. 2006).

7. *See, e.g.*, *infra* note 207.

8. *See, e.g.*, *infra* notes 294–96.

9. *See, e.g.*, *infra* Part IV.

10. *See, e.g.*, *infra* note 276.

11. *See, e.g.*, Jonathan Remy Nash, *Resuscitating Deference to Lower Federal Court Judges' Interpretations of State Law*, 77 S. CAL. L. REV., 975, 978 (2004) (stating that *Erie Railroad Co. v. Tompkins*, 304 U.S. 64 (1938) "mandated that a federal court faced with questions of state law should endeavor to resolve those questions as it believes that the high court of the state whose law is in question would resolve them.").

12. *See, e.g.*, Schacht v. Brown, 711 F.2d 1343, 1350 (7th Cir. 1983) ("[A]cceptance of a rule which would bar a corporation from recovering damages due to the hiding of information concerning its insolvency would create perverse incentives for wrong-doing officers and directors . . . .").

13. *See, e.g.*, Trenwick Am. Litig. Trust v. Ernst & Young, LLP, 906 A.2d 168, 174 (Del. Ch. 2006) ("Delaware law does not recognize this catchy term as a cause of action, because catchy though the term may be, it does not express a coherent concept.").

14. *See, e.g.*, Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 351 (3d Cir. 2001).

15. *See, e.g.*, *In re* Global Serv. Grp., LLC, 316 B.R. 451, 458 (Bankr. S.D.N.Y. 2004).

16. *See, e.g.*, *Trenwick*, 906 A.2d at 174.

17. While there are many facets of the deepening insolvency theory (such as the proper valuation of deepening insolvency damages or who has standing to bring a deepening insolvency claim), those elements are beyond the scope of this Note.

favor and against each approach. Part IV then recommends the proper place for deepening insolvency in Illinois courts.

II. BACKGROUND

Deepening insolvency is the artificial prolongation of a corporation's existence past the point of insolvency.[18] When this occurs, the actor responsible for the extension of corporate life may be liable to the corporation's estate for the resulting insolvency.[19] The particular features of deepening insolvency, however, are by no means settled. Since its inception, courts have approached deepening insolvency in different, and often conflicting, ways.[20] These approaches range from outright rejection of the theory,[21] to recognition as an independent tort action.[22] This Part discusses the origins and evolution of deepening insolvency.

A. *From Humble Beginnings: Extension of Corporate Life is Not Necessarily Beneficial to the Corporation*

The United States District Court for the Southern District of New York first articulated the principle that others would later term "deepening insolvency."[23] In the 1980 case of *In re Investors Funding Corpora-*

18. *See, e.g.*, *In re Global Serv. Grp.*, 316 B.R. at 456 ("'Deepening insolvency' refers to the 'fraudulent prolongation of a corporation's life beyond insolvency,' resulting in damage to the corporation caused by increased debt.") (*citing* Schacht v. Brown, 711 F.2d 1343, 1350 (7th Cir. 1983). *See generally*, *In re* SI Restructuring, Inc., 532 F.3d 355, 363 n.27 (5th Cir. 2008) (listing cases from several courts which found that deepening insolvency is not a valid theory of damages); Thabault v. Chait, 541 F.3d 512, 521 (3d Cir. 2008) ("Although neither the New Jersey legislature nor the New Jersey Supreme Court has authorized a 'deepening insolvency' cause of action . . . there has been a trend among the state's courts toward recognizing 'deepening insolvency' damages."); *In re* Gluth Bros. Const., 424 B.R. 379, 389 (Bankr. N.D. Ill. 2009) ("It is unclear whether deepening insolvency is recognized as a claim of action in Illinois."); N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92 (Del. 2007) (holding that creditors have standing to bring derivative actions against corporate directors for deepening insolvency); Coroles v. Sabey, 79 P.3d 974, 983 (Utah Ct. App. 2003) (rejecting "deepening insolvency" as a theory of damages because shareholders rather than the corporation suffer harm); TaeRa K. Franklin, Practitioner Note, *Deepening Insolvency: What It Is and Why It Should Prevail*, 2 N.Y.U. J. L. & BUS. 435, 437 (2006) (arguing that bankruptcy trustees have standing to sue under deepening insolvency causes of action); Thomas J. Vollbrecht & Theresa A. Gooley, *"Deepening Insolvency" Claims: Can You Become More Bankrupt? Can You (or Someone Else) Sue If You Do?*, 13 FIDELITY L.J. 167, 168–69 (2007); Sara E. Apel, Comment, *In Too Deep: Why the Federal Courts Should Not Recognize Deepening Insolvency as a Cause of Action*, 24 BANKR. DEV. J. 85, 85 (2008); Tracy Bateman Farrell, Annotation, *"Deepening Insolvency" as Cause of Action in Tort*, 23 A.L.R. 6th 457 (2007).

19. *See, e.g.*, *In re Global Serv. Grp.*, 316 B.R. at 456.

20. *See*, *e.g.*, *id*.

21. *See, e.g.*, Trenwick Am. Litig. Trust v. Ernst & Young, LLP, 906 A.2d 168, 174 (Del. Ch. 2006).

22. Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 351 (3d Cir. 2001).

23. *See, e.g.*, *In re Global Serv. Grp.*, 316 B.R. at 456 (stating that the origin of deepening insolvency "has been traced to *Bloor v. Dansker*"); Maaren A. Choksi, *Sink or Swim? A Case for Salvaging Deepening Insolvency Theory*, 7 J. BUS. & SEC. L. 163, 170 (2007) ("The concept of 'deepening insolvency' is widely considered to have originated with . . . *Bloor v. Dansker* . . . .").

tion of New York Securities Litigation (*Bloor v. Dansker*),[24] the court famously (or infamously) stated that "[a] corporation is not a biological entity for which it can be presumed that any act which extends its existence is beneficial to it."[25] This seemingly innocuous statement laid the groundwork for later courts to develop the theory of deepening insolvency.

The issue in *Bloor v. Dansker* was whether an outside auditor could be liable for falsifying financial statements that were used by the plaintiff corporation's managers to prolong the life of the corporation and facilitate looting by the managers.[26] This case arose out of the bankruptcy proceedings following the collapse of Investors Funding Corporation (IFC).[27] At one time owning one of the nation's largest breweries (P. Ballantine & Sons), the Boston Celtics basketball team, and numerous real estate holdings throughout the Northeast, IFC eventually collapsed in 1974 when its stock, which had previously traded for $46, dropped below $1.[28] Beginning in 1969 with the purchase of the brewery, the corporation began suffering serious financial difficulties.[29] After IFC posted a yearly net loss of $10.6 million, the Dansker brothers, who took turns serving as chairmen of IFC, hatched a scheme to raise capital.[30] The Danskers created shell companies to purchase IFC real estate holdings at inflated prices, allowing IFC to report profits on the sales.[31] With the illusion of high profits, the Danskers in turn secured loans of $67 million from a consortium of banks and $140 million in unsecured debentures.[32] The scheme continued for several years but came crashing down when problems arose with a real estate development on which the Danskers had bet everything.[33] In the course of the ensuing bankruptcy proceeding, the trustee filed an adversary claim against IFC's former auditor.[34] The complaint included claims of aiding and abetting fraud, breach of contract, and negligence.[35]

The auditor responded by raising an *in pari delicto* defense.[36] This is a common law doctrine whereby the actions of an agent (the auditor) are imputed on the principal (the corporation) so as to preclude liability on

24. Bloor v. Dansker (*In re* Investors Funding Corp. of N.Y. Sec. Litig.), 523 F. Supp. 533 (S.D.N.Y. 1980).

25. *Id*. at 541.

26. *Id*. at 533.

27. *Id*.

28. Gail Collins, *Trustee's Plan Gives Helmsley I.F.C. Control*, N.Y. TIMES, Oct. 5, 1980, at 1.

29. *Id*. at 8.

30. *Id*.

31. *Id*.

32. *Id*.

33. *Id*.

34. *See* Bloor v. Dansker (*In re* Investors Funding Corp. Sec. Litig.), 523 F. Supp. 533, 536 (S.D.N.Y. 1980).

35. *Id*.

36. *See id*. at 540 ("With the hope of laying the groundwork for several affirmative defenses . . . PMM has urged the position that the knowledge and conduct of the Danskers (and others) must be legally imputed to IFC . . . .").

the part of the defendant.[37] An exception to the imputation rule of the *in pari delicto* defense is the "adverse interest exception."[38] This exception provides that where the agent is acting *entirely* for his own interest, and not that of the principal, his actions will not be imputed to the principal.[39] For the adverse interest exception to apply, however, the agent must have acted entirely for his own interest (i.e., the principal cannot have benefitted from the agent's actions).[40] Here, the trustee was suing on behalf of IFC.[41] The auditor argued that the fraud of the Danskers, as the agents of IFC, should be imputed to IFC itself, thus barring the trustee's suit under *in pari delicto*.[42] In addition, the auditor argued that the Danskers's actions benefitted IFC, by "enabling it to continue operations" for several years past the point of insolvency.[43] In other words, he argued that the corporation actually benefitted from the Danskers' fraud because the fraud resulted in an infusion of capital.[44] The argument did not impress the court. As discussed above, the court held that "[a] corporation is not a biological entity for which it can be presumed that any act which extends its existence is beneficial to it."[45] The court concluded that "it [was] manifest that the prolonged artificial solvency of IFC benefited only the Danskers and their confederates, not IFC."[46] The court thus found that the Danskers' actions harmed the corporation.[47] There-

37. *See, e.g.*, 27A AM. JUR. 2D *Equity* § 103 (2012) ("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."); *see also* 18B AM. JUR. 2D *Corporations* § 1452 (2012) ("[A] corporation will be charged with [an] agent's knowledge where any action taken by the agent would benefit the corporation."). The result of this is that a party suing on behalf of a corporation (such as a trustee, or a shareholder or creditor suing derivatively) is barred from bringing suit where the corporate directors were acting fraudulently but in some way benefitted the corporation. *See id.*; *see, e.g.*, *infra* Part III.C and text accompanying note 278.

38. *See* RESTATEMENT (SECOND) OF AGENCY § 282(1) (1958) ("A principal is not affected by the knowledge of an agent in a transaction in which the agent secretly is acting adversely to the principal and entirely for his own or another's purposes . . . .").

39. *See* J.B. Heaton, *Deepening Insolvency*, 30 J. CORP. L. 465, 470 (2005) ("Under the adverse interest exception, courts will not impute the actions and knowledge of a corporation's officers to the corporation if those corporate officers were acting adverse to the corporation.").

40. *See* Bloor v. Dansker, 523 F. Supp. 533, 541 (S.D.N.Y. 1980) (citing Farr v. Newman, 199 N.E.2d 369, 373 (N.Y. 1964)) ("This 'adverse interest' exception is not triggered, on the other hand, where the agent is also acting for the principal's benefit, even though the agent's primary interest is inimical to that of the principal."); Heaton, *supra* note 39, at 470 ("corporate officers must be acting completely adverse to the corporation; the adverse interest exception does not apply where the corporate officer acts both for his own interests . . . and for the corporation's interests, even when his personal interests are primary.").

41. *Bloor*, 523 F. Supp., at 536 ("Plaintiff James Bloor (Trustee), Chapter X Trustee for Investors Funding Corporation of New York (IFC), has instituted this suit . . . .").

42. *See id.* at 540 (stating that the defendant accountants argue "that the knowledge and conduct of the Danskers . . . must be legally imputed to IFC, so that IFC will be deemed to have known of all the alleged indiscretions").

43. *Id.* at 541.

44. *Id.* ("PMM's position is that . . . the Danskers, although motivated by personal interests, did benefit IFC by fraudulently obtaining for IFC huge quantities of funds from creditors and debenture holders.").

45. *Id.*

46. *Id.*

47. *See id.*

fore, the adverse interest exception to *in pari delicto* prevented the auditor from imputing the Danskers' fraud to the corporation.[48]

It is important to note that, while the origin of deepening insolvency can be traced to *Bloor v. Dansker*, that case did not involve a claim based on the "deepening" of IFC's insolvency. Indeed, the court in *Bloor* never used the phrase "deepening insolvency." The court merely stated that there are certain circumstances in which a corporation's continued existence would be harmful to the corporation itself, and the case before the court was one such circumstance.[49] The facts of *Bloor*, however, present a textbook example of what would later be known as "deepening insolvency": a corporation was mismanaged past the point of insolvency, the corporate officers committed fraud to conceal their mismanagement and to obtain large infusions of capital, those officers then looted the corporation's new capital, and corporate assets were dissipated by this scheme.[50] Thus, while *Bloor*'s holding is limited, it provided a useful groundwork for later courts to address the type of harm corporations suffer in these situations.

B. Expanding the Theory: Fraudulently Extending a Corporation's Life Is Inherently Harmful

The Seventh Circuit Court of Appeals was the next court to issue a significant opinion concerning the theory of deepening insolvency.[51] *Schacht v. Brown* was the first time a court discussed the "deepening" of a corporation's "insolvency."[52] *Schacht* involved a cause of action brought by the Illinois Director of Insurance against the managers of an insurance company called American Reserve Corporation (ARC).[53] Similar to *Bloor*, the managers of ARC allegedly engaged in a fraudulent scheme to extend the life of one of the company's subsidiaries, Reserve Insurance Company (Reserve), past the point of insolvency.[54] The directors looted the assets of the insolvent corporation, diverting its most profitable business to another subsidiary in anticipation of liquidation.[55]

48. *See id*.
49. *See id*.
50. *See generally id*.
51. Schacht v. Brown, 711 F.2d 1343, 1350 (7th Cir. 1983).
52. *See id*.
53. *Id*. at 1345, 1346 ("[T]he Director [of Insurance of the State of Illinois] alleges[] the defendant directors and officers were able to fraudulently obtain approval of the Illinois Department of Insurance for the cession agreements . . . . [T]he Director filed this action in district court in 1981, seeking relief for damages sustained by Reserve . . . .").
54. *Id*. at 1345 ("By concealing Reserve's continued liability for the retroceded business and hence Reserve's continued insolvency, the Director alleges, the defendant directors and officers were able to fraudulently obtain approval . . . .").
55. *Id*. at 1350 ("[T]he Director alleges that with the smoke-screen of the underlying mail fraud, Reserve's directors and other defendants were able to drain Reserve of over $3,000,000 of income, and to drain Reserve of its most profitable and least risky business, thereby deepening Reserve's insolvency.").

According to the court, Reserve was driven into insolvency due to its directors' policy of "accepting extraordinarily high-risk insurance business" and then "underreserving and maintaining insufficient surplus for potential claims."[56] According to the complaint, when the Illinois Department of Insurance became aware of the diminution of Reserve's surplus, it initiated negotiations with the directors of Reserve and ARC to address the inadequate surplus.[57] At the same time, however, the corporate directors entered into an agreement with Société Commerciale de Réassurance (SCOR), whereby "Reserve ceded to SCOR most of its more profitable and least risky business."[58] This business was then covertly ceded back to a different subsidiary of ARC, Guarantee Reserve Company (GRC).[59] The directors of ARC also "secretly agreed to guarantee GRC's obligations to SCOR."[60] This scheme enabled Reserve to report "a smaller volume of business and an increase in surplus," while at the same time allowing ARC to continue to benefit from this profitable business.[61]

By keeping Reserve's liability to SCOR secret, ARC's directors were able to enter into an agreement with the Illinois Department of Insurance, which enabled Reserve to continue operations on the condition it maintained surplus requirements.[62] The secret agreement, however, enabled Reserve to remain insolvent, as its surplus funds were much lower than the level required by the Illinois Department of Insurance agreement.[63] In addition, Reserve no longer had its "more profitable and less risky business" and the more than $3 million in income from that business.[64]

The Illinois Director of Insurance brought Racketeer Influenced and Corrupt Organizations Act (RICO)[65] claims against the directors of ARC, SCOR, and several outside accounting firms, all of whom were alleged to have colluded in the fraudulent scheme.[66] In defending the action, SCOR argued that the Director of Insurance lacked standing to sue.[67] In an action such as this, it argued, the Director may only bring claims belonging to the insolvent corporation, not those belonging to the

56. *Id*. at 1345.

57. *Id*. at 1345 ("In late 1974 . . . the Illinois Department of Insurance became concerned about the diminution of Reserve's surplus, and initiated negotiations with the officers and directors of Reserve and . . . Reserve's corporate parent, to rectify the problem.").

58. *Id*.

59. *See id*.

60. *Id*.

61. *Id*.

62. *See id*.

63. *See id*.

64. *See id*.

65. 18 U.S.C. §§ 1961–68 (2006).

66. *Schacht*, 711 F.2d at 1345–46 ("[T]he Director claims that SCOR, SCOR Re and the accounting firm defendants joined with ARC and Reserve's officers and directors in a multifaceted, fraudulent scheme . . . . [T]he Director filed this action . . . seeking relief for damages sustained . . . under RICO . . . .").

67. *Id*. at 1349 (referring to "SCOR and SCOR Re's fallback argument that . . . the Director still lacks standing to sue on behalf of Reserve").

corporation's policyholders or creditors.[68] SCOR further claimed that "a corporation may never sue to recover damages" resulting from "the artificial prolongation of an insolvent corporation's life," because the "mere extension of the normal business operation" does not itself damage the corporation.[69] Since Reserve dissipated its assets by continuing to operate past insolvency, SCOR reasoned that "the damages to Reserve occurred only because Reserve continued to do business past its point of insolvency."[70] Accordingly, because the damage resulted solely from the extension of business operations, SCOR argued that the corporation (and therefore the Director of Insurance) did not have standing to sue.[71]

The Seventh Circuit rejected this argument, stating that the alleged damages resulted not only from the extension of Reserve's corporate life past insolvency "but from specific actions crippling Reserve."[72] These actions were the "drain[ing]" of $3 million in Reserve's income, as well as the transfer of Reserve's most profitable business.[73] Moreover, the court stated that the cases on which SCOR relied were "seriously flawed" in holding that a corporation may never sue for damages from artificial extension of its life.[74] Each of those cases assumed "that the fraudulent prolongation of a corporation's life beyond insolvency is automatically to be considered a benefit to the corporation's interests."[75] Quite the contrary, the Seventh Circuit recognized that "[t]his premise collides with common sense, for the corporate body is ineluctably damaged by the deepening of its insolvency, through increased exposure to creditor liability."[76] The court recognized that the timely disclosure of insolvency is vital to allow shareholders or creditors to choose to dissolve the corporation "in order to cut their losses."[77] Because of this, to hold otherwise—and prevent a corporation or its representative from recovering damages for the concealment of insolvency—"would create perverse incentives for wrong-doing officers . . . to conceal the true financial condition of the corporation . . . as long as possible."[78] As a result, the Seventh Circuit al-

68. *See id*. at 1346.
69. *Id*. at 1350.
70. *Id*.
71. *Id*. ("[According to SCOR], the sole thrust of the Director's complaint is that the damages to Reserve occurred only because Reserve continued to do business past its point of insolvency. Therefore, they conclude, the Director's claim in this case is barred by the general rule prohibiting a corporation from suing for damages caused by the artificial prolongation of its life.").
72. *Id.*
73. *Id*. ("*Inter alia*, the Director alleges that with the smoke screen of the underlying mail fraud, Reserve's directors and other defendants were able to drain Reserve of over $3,000,000 of income, and to drain Reserve of its most profitable and least risky business, thereby deepening Reserve's insolvency.").
74. *Id*.
75. *Id*.
76. *Id*.
77. *Id*.
78. *Id*.

lowed the Director of Insurance's claim to proceed, overcoming the *in pari delicto* imputation of knowledge.[79]

Schacht is thus an expansion of the rationale first enunciated in *Bloor*. While *Bloor* merely stated that the continuation of a corporation's life is not always beneficial, *Schacht* stated that a corporation is "ineluctably damaged by the deepening of its insolvency."[80] This much stronger language signaled a recognition by the Seventh Circuit that fraudulent schemes like those seen in *Bloor* and *Schacht* do real harm to a corporation and its shareholders.[81] The court recognized that the fiction of corporate personhood only goes so far; when a corporation reaches the point of insolvency, the fraudulent continuation of corporate life can cause damage to the corporation which should be recoverable.[82]

Thus far, we have seen courts go from recognizing deepening insolvency as the basis for applying the adverse interest exception to *in pari delicto*, to using deepening insolvency as a theory of harm. Both of these relatively modest approaches to deepening insolvency were attempts to adapt existing causes of action to address a new type of harm. Almost twenty years later, the theory took a dramatic leap forward.

C. *Outright Recognition: Deepening Insolvency as a Cause of Action*

In 2001, the Third Circuit Court of Appeals heard *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co*.[83] This case arose out of the bankruptcy proceedings of two lease financing companies.[84] Walnut Leasing Co. (Walnut), originally incorporated in 1969,[85] rented office equipment to small businesses.[86] For a time, business was good: many companies preferred to lease their office equipment rather than commit capital to purchase.[87] Walnut eventually hit hard times, however, as small business office managers allegedly found it easier to use credit cards to finance equipment purchases rather than lease equipment.[88] Walnut eventually could not raise sufficient capital by sales of debt certificates

79. *Id*. at 1348 ("Defendants argue nonetheless that since the alleged fraudulent scheme had the effect of continuing Reserve's active corporate existence past the point of insolvency to the detriment of outside creditors and policyholders, Reserve was *pro tanto* benefited. . . . We do not believe that such a Pyrrhic 'benefit' to Reserve is sufficient to even trigger the *Cenco* analysis which seeks to determine the propriety of imputing to the corporation the directors' knowledge of fraud.").

80. *Id*. at 1350.

81. *Id*.

82. *Id*.

83. Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340 (3d Cir. 2001).

84. *Id*. at 343.

85. Walnut Equip. Leasing, Co., Pennsylvania Corp. Filing No. 378968 (May 16, 1969), *available at* https://www.corporations.state.pa.us/corp/soskb/cSearch.asp (search "By Business Entity ID" for "378968").

86. *See* Joseph N. DiStefano, *Buyers of Certificates Wonder When Dreams Turned to Ashes: Two Leasing Firms Paid Above-Market Interest Rates. Now the Firms are in Bankruptcy Court*, PHILA. INQUIRER, Aug. 22, 1997, at C01.

87. *See* William Donoghue, *Prospectus Reveals All About "Fixed Rate Certificate" Offer*, SUN-SENTINEL (Fort Lauderdale, Fla), Mar. 14, 1994, at 28.

88. *See* DiStefano, *supra* note 86.

because its "performance and financial position were so poor."[89] To raise more capital, the officers of Walnut, William and Kenneth Shapiro, created a second corporation, Equipment Leasing Corporation of America (ELCOA).[90] ELCOA was wholly owned by Walnut, and was created to allow the sale of debt certificates unencumbered by the disappointing financial outlook of Walnut itself.[91] To ensure this separation between Walnut and ELCOA, the Shapiros allegedly offered the debt certificates through prospectuses containing only ELCOA's "clean" financial statements.[92] As a result, the ELCOA certificates were much more marketable than Walnut certificates.[93] This enabled the Shapiros to offer the ELCOA certificates at much lower interest rates because of ELCOA's positive financial outlook and the correspondingly lower risk to investors.[94] Having set up the vehicle for raising capital, the Shapiros then marketed the certificates, which were allegedly "designed to look like bank certificates of deposit."[95] ELCOA "fixed rate certificates" were prominently advertised in airports throughout the country, promising returns of eight to eleven percent annual interest.[96] With the promise of high, stable returns from a seemingly low risk corporation, it is not surprising that the ELCOA certificates became very popular.[97] Indeed, one author states that the returns promised by ELCOA were "twice what commercial banks paid."[98]

Ultimately, more than 6000 individuals invested more than $59 million in ELCOA certificates.[99] Though the certificates were made to look like bank certificates of deposit, there was one important factor distinguishing them: bank certificates of deposit are usually insured by the Federal Deposit Insurance Corporation, while the Walnut and ELCOA certificates were uninsured.[100] Indeed, certificate investors were merely debenture holders, which is "simply an unsecured IOU."[101] The only security provided to ELCOA investors was the financial strength of ELCOA and Walnut.[102] Towards the end of the scheme, however, Walnut posted increasingly heavy losses of as much as $3 million per year.[103]

Far from legitimately raising capital to support their leasing business, the Shapiros were operating a sophisticated Ponzi scheme that allowed them to continue operating their businesses far past the point of

89. Brief of Appellant at 5, *Lafferty*, 267 F.3d 340 (No. 00-1157) 2000 WL 33988837.
90. *Id*.
91. *Id*.
92. *Id*.
93. *Id*.
94. *Id*.
95. *Id*. at 3.
96. *See* DiStefano, *supra* note 86; Donoghue, *supra* note 87.
97. DiStefano, *supra* note 86.
98. *Id*.
99. *Id*.
100. *See id*.
101. Donoghue, *supra* note 87.
102. *Id*.
103. *Id*.

insolvency.[104] The Shapiros' initial fraud was the marketing of ELCOA as a separate entity from Walnut, which allowed the scheme to take off.[105] The fraud was not discovered until 1997, after which state securities regulators charged the Shapiros with continuing to sell the certificates after they were ordered to stop.[106] Walnut and ELCOA eventually filed bankruptcy in August of 1997,[107] more than ten years after the scheme began.[108]

In the bankruptcy proceeding, the trustee appointed a Committee of Creditors that brought suit against several third-party professionals who allegedly conspired with the Shapiros to perpetrate the Ponzi scheme.[109] Specifically, the Committee named as defendants the Shapiros' accountant and two underwriters, "whose opinions were legal prerequisites" for the public offering and sale of the ELCOA certificates.[110] The Committee of Creditors alleged not just that the creditors were harmed as the result of the Ponzi scheme but also that the corporations themselves suffered harm: the deepening of their insolvency.[111] The issue before the court was whether the Committee had standing to bring such a claim of harm to the corporation.[112] The defendants claimed that the corporations did not sustain a "cognizable injury" that was separate from injuries suffered by investors that had purchased the certificates.[113] Because the corporations therefore did not have any valid claim, the defendants argued that the Committee (which was in effect operating as a bankruptcy trustee) did not have standing to bring this suit on the corporations' behalf.[114] To determine whether the Committee had standing, the court was called upon to decide "whether 'deepening insolvency' [was] a valid theory giving rise to a cognizable injury" under state law, and whether "the injury [was] merely illusory."[115]

The court first analyzed what actual harm is alleged in a deepening insolvency claim.[116] The court stated that insolvency is simply a "financial condition" where the amount of a corporation's debt exceeds the value of its assets.[117] Thus, even though a corporation may be technically "insolvent," its assets still have value.[118] Deepening insolvency is the dimi-

104. Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 343–44 (3d Cir. 2001).

105. *Id*. at 344.

106. *See* DiStefano, *supra* note 86.

107. *See id*.

108. *See* Brief of Appellant, *supra* note 89, at 5.

109. *Lafferty*, 267 F.3d at 344.

110. Brief of Appellant, *supra* note 89, at 6.

111. *Id*. at 9.

112. *See Lafferty*, 267 F.3d at 344 ("[T]he District Court held that the Committee lacked standing to assert its claims against the third-parties because of the doctrine of *in pari delicto*. The Committee appeals.").

113. *Id*. at 347.

114. *Id*.

115. *Id*. at 348.

116. *See id*. at 349.

117. *Id*.

118. *Id.*

nution of this value.[119] For instance, "to the extent that bankruptcy is not already a certainty," the fraudulent incurrence of debt (after the point of insolvency) can make bankruptcy inevitable.[120] Thus, the "legal and administrative costs" of bankruptcy would be one measure of the harm to the corporation, as those costs would not otherwise be necessary.[121] Also, a bankruptcy that is caused by "unwieldy debt . . . creates operational limitations which hurt a corporation's ability to [profitably] run its business."[122] In other words, a corporation that is only slightly insolvent could file for bankruptcy and continue operating,[123] but a corporation forced into bankruptcy as a result of deepening insolvency may be encumbered by such immense debt that reorganization becomes impossible.[124] Moreover, in addition to the cost of bankruptcy, the court stated that deepening insolvency "can undermine a corporation's relationships with its customers, suppliers, and employees."[125] The specter of an impending bankruptcy brought on by massive amounts of fraudulent debt can "shake the confidence" of those who deal with a corporation.[126] This diminished confidence damages the corporation's assets, "the value of which often depends on the performance of other parties."[127] Finally, simply "prolonging an insolvent corporation's life through bad debt" causes some dissipation of the corporation's assets.[128] All of this damage is directly caused by the deepening of the corporation's insolvency, as the harm could have been avoided by the timely dissolution of the corporation.[129]

The court looked to *Schacht* for the proposition that the corporation is "ineluctably damaged" by deepening insolvency.[130] The question was whether this damage would be recognized under Pennsylvania law.[131] The Third Circuit cited the old maxim of tort law that "where there is an injury, the law provides a remedy,"[132] as well as several Pennsylvanian authorities which recognized this principle.[133] Thus, the court concluded

119. *Id*.
120. *Id*.
121. *Id*. at 349–50.
122. *Id*. at 350.
123. Indeed, this is the purpose of a Chapter 11 reorganization. *See, e.g.*, CHARLES JORDAN TABB, THE LAW OF BANKRUPTCY 1039 (2d ed. 2009) ("The premise underlying chapter 11 is that everyone—creditors, the debtor, stockholders, employees, suppliers, the community—can benefit if a debtor's financial affairs are restructured at an acceptable cost. . . . In essence, chapter 11 is based on the idea 'that a business is worth more alive than dead—i.e., it is worth more as a going concern than in a forced sale liquidation.'").
124. *Lafferty*, 267 F.3d at 349 ("[T]o the extent that bankruptcy is not already a certainty, the incurrence of debt can force an insolvent corporation into bankruptcy . . . .").
125. *Id*. at 350.
126. *Id*.
127. *Id*.
128. *Id*.
129. *Id*.
130. *Id.* (quoting Schact v. Brown, 711 F.2d 1343, 1350 (7th Cir. 1983)).
131. *See id*. at 351.
132. *Id*.
133. *Id*. (citing 37 PENNSYLVANIA. LAW ENCYCLOPEDIA, TORTS § 4, at 120 (1961); 1 SUMMARY OF PENNSYLVANIA JURISPRUDENCE, TORTS § 1.1 (2d ed. 1999)).

that "where 'deepening insolvency' causes damage to corporate property, . . . the Pennsylvania Supreme Court would provide a remedy by recognizing a cause of action for that injury."[134] The court went even further, stating that to the extent any other cases suggest that a corporation may never sue for deepening insolvency, "we believe . . . that Pennsylvania courts would reject them."[135] The court also determined that "'deepening insolvency' is generally a valid theory for federal law claims."[136] Thus, the Third Circuit used the foundation laid by *Bloor* and *Schacht*, which recognized deepening insolvency as a type of harm but then went much further by recognizing deepening insolvency as a distinct cause of action.

It is interesting, however, that even after the Third Circuit took the dramatic step of recognizing this new cause of action, the court ultimately upheld the lower court's dismissal of the Committee of Creditors' claims against the third-party accountant and underwriters.[137] In response to these claims, the defendants raised an *in pari delicto* defense.[138] It was clear that the Shapiros were operating in the course of their employment.[139] While their actions would normally fall under the "adverse interest exception," that exception "is itself subject to an exception—the 'sole actor' exception."[140] Because the Shapiros were the sole shareholders of the corporations, the interests of the corporations were necessarily aligned with the interests of the Shapiros.[141] Thus, despite the recognition of deepening insolvency as a cause of action by the Third Circuit, the *in pari delicto* defense nevertheless precluded the claim.

The recognition of deepening insolvency as a cause of action has several important implications. The most obvious is that the elements required to prove deepening insolvency must be established.[142] Under the *Bloor* and *Schacht* analyses, deepening insolvency arises out of traditional tort theories, such as fraud, which have their own elements.[143] After *Lafferty*, however, it was unclear how broad deepening insolvency should become.

134. *Id*.

135. *Id*.

136. *Id.* at 354.

137. *Id*. at 344 ("[W]e hold that because the Committee, standing in the shoes of the debtors, was *in pari delicto* with the third parties it is suing, its claims were properly dismissed.").

138. *Id.* at 358–59. Indeed, we have seen this defense before in the context of deepening insolvency. *See, e.g.*, *supra* notes 36–40 and accompanying text.

139. *Lafferty*, 267 F.3d at 359 ("The allegations in the Amended Complaint leave no doubt that the first part of the imputation test is satisfied—the fraud allegedly perpetrated by the Shapiro family took place in the course of their employment for the Debtors.").

140. *Id*.

141. *Id*. at 359–60 ("The rationale for [the sole actor exception] is that the sole agent has no one to whom he can impart his knowledge, or from whom he can conceal it, and that the corporation must bear the responsibility for allowing an agent to act without accountability.").

142. OHC Liquidation Trust v. Credit Suisse First Boston (*In re* Oakwood Homes Corp.), 340 B.R. 510, 528 (Bankr. D. Del. 2006) ("Those [courts] that have determined that [deepening insolvency] is a cause of action are then faced with defining the elements and scope of the tort.").

143. *See, e.g.*, Schacht v. Brown, 711 F.2d 1343, 1346 (7th Cir. 1983) (stating that the complaint was based on "RICO and a variety of Illinois statutory and common law theories").

Despite the varying outcomes of the cases discussed above, some baseline requirements for deepening insolvency began to emerge. First, the debtor corporation must have been insolvent at some point.[144] Second, management must have fraudulently concealed this insolvency.[145] Third, after the point of insolvency, the corporate managers must have then used the artificially inflated financial situation to incur new loans or otherwise raise capital.[146] Fourth, this new capital must have enabled the corporation to continue operating past the point of insolvency.[147] Finally, this artificial prolongation of corporate life itself must have caused harm to the corporate assets.[148] While some courts might dispute certain aspects, most claims alleging deepening insolvency came to include these elements.[149] Nonetheless, despite the fairly steady progression of the theory after *Lafferty*, deepening insolvency was dealt a serious blow by the Delaware Court of Chancery in *Trenwick America Litigation Trust v. Ernst & Young, LLP*.[150]

D. A Hasty Retreat: Deepening Insolvency "Does Not Express a Coherent Concept"

Trenwick Group Inc. (Trenwick) was a publicly traded specialty insurance underwriter, operating solely through a wholly-owned subsidiary, Trenwick America Corporation (Trenwick America).[151] In 1998, Trenwick "embarked on a strategy of growth by acquisition."[152] First, Trenwick entered the international insurance markets by acquiring Sorema (UK) Limited.[153] After the arm's-length negotiation and acquisition, Trenwick's book value increased to $31.49 per share, up from $29.93 the year before.[154] Also, after this transaction, Trenwick's assets totaled approximately $1.4 billion, and it had stockholder equity of approximately $348 million.[155] The next year, Trenwick completed another major acquisition, this time with a corporation that was listed on the New York Stock Exchange, Chartwell Re.[156] After the acquisition, Trenwick's assets more than doubled to $3.24 billion and its stockholder equity exceeded $462 million, although its book value dipped to $27.37 per

144. *Lafferty*, 267 F.3d at 347 (defining deepening insolvency as "the fraudulent expansion of corporate debt and prolongation of corporate life [past the point of insolvency]").
145. *See, e.g.*, *id*.
146. *See, e.g.*, *id*. (describing the "fraudulent expansion of corporate debt").
147. *See, e.g.*, *id*. (referring to the "prolongation of corporate life").
148. *See generally* Heaton, *supra* note 39, at 468 (arguing that the proper valuation of deepening insolvency damages is damage to the corporate assets, rather than increased debt).
149. For instance, some courts require fraud to prove deepening insolvency, while others require only negligence. *See,* discussion *infra* Part III.A.
150. Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P., 906 A.2d 168 (Del. Ch. 2006).
151. *Id*. at 175.
152. *Id*. at 172.
153. *Id*. at 176.
154. *Id*.
155. *Id*.
156. *Id.*

share.[157] These transactions were negotiated at arm's length, and a majority of the stockholders voted in approval.[158] Indeed, almost three quarters of Trenwick's stockholders voted in favor of the deal.[159] Trenwick went on to acquire another major corporation in 2000, and through this period engaged in several internal reorganizations designed to integrate new insurance entities acquired in the transactions and to decrease Trenwick's tax liability.[160] As part of these reorganizations, Trenwick America eventually took on all of the American domestic insurance entities of the acquired corporations, as well as several hundred million dollars in debt.[161]

Ultimately, both Trenwick America and Trenwick filed for bankruptcy in August 2003.[162] The corporations sought bankruptcy protection because "the claims made by the insureds" of Trenwick and Trenwick America (and the companies they acquired) "exceeded estimates and outstripped the holding company's capacity to service the claims and its debt."[163] As part of the bankruptcy proceeding, a Litigation Trust was created and assigned all causes of action owned by Trenwick America.[164] That Litigation Trust then brought suit against the directors of both companies and "certain former advisors of Trenwick."[165]

The pertinent allegations of the Litigation Trust were that the directors of Trenwick breached their fiduciary duties and caused Trenwick America to take on debt belonging to the entities acquired by Trenwick during this period, to the detriment of Trenwick America.[166] This was despite the fact that Trenwick America was a wholly owned subsidiary (and therefore had no shareholders other than Trenwick),[167] and the fact that the directors made the acquisitions with the strong approval of the Trenwick shareholders.[168] To support its claim of deepening insolvency, the complaint "allege[d], without factual support, that Trenwick America was 'insolvent'" prior to the pertinent acquisition.[169] The judge clarified

157. *Id*. at 178.

158. *Id*. (noting that 82.8% of Trenwick's stockholders participated in the vote, with "over 90% voting to approve the deal").

159. *Id*.

160. *Id*. at 176–81 (describing the various reorganizations surrounding the mergers as well as the creation of "Trenwick Group Limited" and redomiciliation in Bermuda "designed to secure advantageous tax treatment").

161. *Id*. at 182–84 (describing the allegations in the complaint regarding the increased indebtedness taken on by Trenwick America).

162. *Id.* at 175.

163. *Id*. at 172.

164. *Id*. ("[The Litigation Trust] was assigned all the causes of action that the U.S. subsidiary owned.").

165. *Id*. at 175–76.

166. *See, e.g.*, *id*. at 183. The court describes in the Litigation Trust's complaint that Trenwick America was "on the hook" for $400 million in debt from entities that Trenwick America did not own.

167. *Id*. at 182 ("Trenwick owned all of the equity in Trenwick America. Therefore, if the reorganization was in the best interests of Trenwick and its stockholders, it was in the best interests of Trenwick America's equity owners.").

168. *Id.* at 172. *See supra* text accompanying note 158.

169. *Id.* at 182.

that "[w]hen I say without factual support, I mean that nothing in the complaint supports the assertion. Nothing."[170]

Unconvinced by the claims in the complaints, the Delaware Court of Chancery issued a scathing reprobation.[171] The court said at various times that the complaint "fail[ed] to articulate a coherent narrative,"[172] "achieve[d] a level of obscurity and incomprehensibility that is truly remarkable,"[173] and was "a confusing muddle, laden with irrelevancies, and failing to set forth a coherent course of events."[174] Perhaps as an outgrowth of its caustic censure of plaintiff's counsel, the court also turned its ire to the theory of deepening insolvency itself. The court stated that "Delaware law does not recognize this catchy term as a cause of action, because catchy though the term may be, it does not express a coherent concept."[175] The court went on to state that "under Delaware law, 'deepening insolvency' is no more a cause of action when a firm is insolvent than a cause of action for 'shallowing profitability' would be when a firm is solvent."[176] Of crucial importance, however, is the fact that these statements by the court were mere dicta. As the court itself pointed out, there was no evidence that the corporations were even insolvent at the time of the relevant transactions.[177] That fact itself was amply sufficient to bar any claim of deepening insolvency.[178] As the term "deepening insolvency" itself suggests, actual insolvency is a necessary core component of a deepening insolvency claim. Therefore, once the court found that the corporations were solvent at the time of the transactions, a determination of the general efficacy of a cause of action for deepening insolvency was unnecessary. Nevertheless, dicta carries some precedential weight, particularly dicta from the Delaware Court of Chancery.[179]

E. Deepening Insolvency in Illinois

Despite the evolution (and devolution) of deepening insolvency in other states like Delaware and Pennsylvania, Illinois has not yet recognized or rejected deepening insolvency. In the 2009 case *In re Gluth Brothers Construction*, the Bankruptcy Court for the Northern District of Illinois addressed deepening insolvency under Illinois law, ultimately concluding that "[i]t is unclear whether deepening insolvency is recog-

170. *Id*.
171. *Id*. at 174.
172. *Id*. at 181.
173. *Id*. at 182.
174. *Id.* at 176.
175. *Id*. at 174.
176. *Id*.
177. *Id*. at 173 ("[T]he Litigation Trust has failed to plead facts supporting the inference that either the holding company or its top U.S. subsidiary were insolvent at the time of the transactions challenged in the complaint.").
178. *See, e.g.*, *supra* notes 144–49 and accompanying text.
179. *See, e.g.*, Ian T. Mahoney, *Casebrief The* CitX *Decision: Has the Tort of "Deepening Insolvency" Gone Bankrupt?*, 52 VILL. L. REV. 995, 1017 (2007) (referring to the "highly influential Delaware Court of Chancery").

nized as a claim of action in Illinois."[180] That case involved a claim by a bankruptcy trustee against a banking association that loaned $2 million dollars to the debtor construction corporation.[181] The sole shareholder of the debtor had a close relationship with several members of the board of directors of the defendant banking association.[182] In fact, the debtor's sole shareholder served on the defendant's board for three years.[183] Perhaps as a result of this close relationship, the defendant and the debtor corporation entered into several "change-in-terms" agreements which extended the maturity date of the loan more than six years beyond the original date and ultimately required the sole shareholder of the debtor corporation to agree to be jointly and severally liable on the loan.[184] The debtor corporation eventually filed for bankruptcy after a "substantial decline in . . . new projects" for several years and a thirty percent decline in revenue in a single year.[185] In the bankruptcy proceeding, the debtor's assets were sold and the proceeds paid to the defendant in satisfaction of the promissory note.[186] Subsequently, the bankruptcy trustee filed a claim against the defendant, alleging *inter alia* that the defendant wrongfully deepened the debtor's insolvency.[187]

The trustee alleged that the lender should be liable for damages because it continued to extend credit to the debtor after the debtor became insolvent.[188] The defendant extended the maturity date of the loan, loaned additional funds, and agreed to forebear its rights under the loan agreement.[189] According to the trustee, this allowed the debtor to continue operating past the point of insolvency and harmed the unsecured creditors of the debtor.[190] Because of the defendant's extension of credit, the trustee alleged that it should be liable for compensatory and punitive damages for the deepened insolvency of the debtor.[191] In response, the defendant filed a motion to dismiss the cause of action for failure to state a claim.[192]

In ruling on the motion, the bankruptcy court examined Illinois law to determine the efficacy of a claim for deepening insolvency.[193] The court noted the uncertainty in other states regarding deepening insolvency, and quoted from an earlier case applying Illinois law which stated "[w]hether Illinois law recognizes a distinct cause of action for deepening

180. Dixon v. Am. Cmty. Bank & Trust (*In re* Gluth Bros. Constr.), 424 B.R. 379, 389 (Bankr. N.D. Ill. 2009).
181. *Id*. at 385–86.
182. *Id*. at 387–88.
183. *Id*. at 388.
184. *Id*. at 386.
185. *Id*.
186. *Id*. at 387.
187. Complaint at 17–19, *In re Gluth Bros. Constr*., 424 B.R. 379 (No. 09-A-96132).
188. *Id*.
189. *Id*.
190. *Id*. at 17–19.
191. *Id*. at 19.
192. *In re Gluth Bros. Constr*., 424 B.R. at 388.
193. *Id*. at 389–90.

insolvency is an open question."[194] The court determined, however, that "even if Illinois were to recognize the theory of deepening insolvency, it would only do so in the context of a claim of fraud."[195] As a result, the bankruptcy court ruled that because the trustee's complaint did not contain any allegations of fraud, it should be dismissed.[196]

Deepening insolvency therefore has not been recognized as a cause of action in Illinois. As has been discussed, however, there are widely differing approaches Illinois courts might decide to follow with regard to deepening insolvency. The next Part will discuss these and other approaches courts have taken in other states, and Part IV will recommend an approach to deepening insolvency in Illinois.

III. ANALYSIS

The theory of deepening insolvency, as discussed above, developed from a rather innocuous proposition—that a corporation does not necessarily benefit from continued existence—to a distinct tort action.[197] During this development, various courts approached deepening insolvency in fractured, and often conflicting, ways: from outright rejection, to a bar of *in pari delicto* imputation of knowledge, to recognition merely as a theory of damages for a pre-existing tort claim, to a distinct cause of action (at times requiring proof of fraud on the part of the defendant, at other times requiring mere negligence).[198] This Part will discuss and evaluate the various approaches courts have taken in response to deepening insolvency.

A. Recognize as a Distinct Cause of Action

One approach taken by some courts is to recognize deepening insolvency as a distinct cause of action, requiring fraud as an element.[199] This is the position taken by the *Lafferty* court.[200] To prevail, a plaintiff

194. *Id*. at 389 (quoting Bondi v. Grant Thornton Int'l (*In re* Parmalat Sec. Litig.), 377 F. Supp. 2d 390, 418 (S.D.N.Y. 2005)).

195. *Id*. at 390.

196. *Id*. at 390–91.

197. *See, e.g.*, Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 351 (3d Cir. 2001); Bloor v. Dansker (*In re* Investors Funding Corp. of N.Y. Sec. Litig.), 523 F. Supp. 533, 541 (S.D.N.Y. 1980).

198. *See, e.g.*, Smith v. Arthur Andersen LLP, 421 F.3d 989, 1004 (9th Cir. 2005) (holding that plaintiff's complaint "states a cognizable harm . . . when it alleges that the defendants 'prolonged' the firm's existence," despite the fact that the complaint only alleged negligence on the part of the defendants); Trenwick Am. Litig. Trust v. Ernst & Young, LLP, 906 A.2d 168, 174 (Del. Ch. 2006) (rejecting deepening insolvency as a "catchy term" which "does not express a coherent concept"); *In re* Flagship Healthcare, Inc., 269 B.R. 721 (Bankr. S.D. Fla. 2001) (holding that "the additional debt incurred [after the corporation's insolvency], and allegedly as a result of the Defendants' negligence, may provide a measure of damages.").

199. *See Lafferty*, 267 F.3d at 347 (defining deepening insolvency as "the fraudulent expansion of corporate debt and prolongation of corporate life [past the point of insolvency]").

200. *Id*. at 349–52.

only needs to prove the elements of deepening insolvency.[201] This allows more claims for deepening insolvency, as these claims are not contingent on proving the elements of existing torts.[202] For example, to prevail in a distinct cause of action for deepening insolvency, the plaintiff does not also have to prove that the defendant owed the plaintiff a duty (as would be required in a claim for breach of a fiduciary duty).[203] Admitting more causes of action that would otherwise be deficient is a double-edged sword, as this may also allow more frivolous claims.[204] Many courts have attempted to mitigate this danger by requiring fraud as an essential element of a cause of action for deepening insolvency.[205] Some courts, however, have allowed a cause of action to prevail upon proof of negligence, rather than fraud.[206] While this responds to the sentiment of allowing recovery by plaintiffs who otherwise could not recover, this lower standard also greatly magnifies the potential for frivolous lawsuits alleging deepening insolvency when all other causes of action fail.[207]

1. Advantages of a Cause of Action Requiring Fraud

As stated by the court in *In re Oakwood Homes Corp.*, "[t]he soundness of the theory [of deepening insolvency], rests in part, on the necessity to remedy certain harms."[208] For example, the court discusses the "harms associated with causing a corporation to petition for bankruptcy," as well as "damages associated with the 'dissipation of corporate assets' arising from not dissolving the corporation in a timely manner."[209] These harms are described in detail by the Third Circuit in *Lafferty*: "Even when a corporation is insolvent, its corporate property may have value. The fraudulent and concealed incurrence of debt can damage that value in several ways."[210] For instance, if a corporation is only slightly insolvent, bankruptcy protection might not be necessary.[211] A scheme that drives the corporation further into debt, however, might ultimately force the corporation to file bankruptcy, resulting in the "legal and administrative costs" associated with bankruptcy.[212] In addition, bankruptcy precipitated by "unwieldy debt" can create "operational limitations which hurt

201. *See supra* notes 145–50 and accompanying text.
202. *See infra* notes 220 and accompanying text.
203. RESTATEMENT (SECOND) OF TORTS § 874 (1979) ("One standing in a fiduciary relation with another is subject to liability to the other for harm resulting from a breach of duty imposed by the relation.").
204. *See infra* Part III.D.
205. *See, e.g.*, Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340 (3d Cir. 2001).
206. Smith v. Arthur Andersen LLP, 421 F.3d 989, 995, 1004 (9th Cir. 2005).
207. *See infra* Part III.A.4.
208. *In re* Oakwood Homes Corp., 340 B.R. 510, 531 (Bankr. D. Del. 2006).
209. *Id.* at 530–31 (quoting *Lafferty*, 267 F.3d at 350).
210. *Lafferty*, 267 F.3d at 349.
211. *Id*. ("[T]o the extent that bankruptcy is not already a certainty, the incurrence of debt can force an insolvent corporation into bankruptcy . . . .").
212. *Id*. at 349–50.

a corporation's ability to run its business in a profitable manner."[213] Deepening insolvency can also "undermine a corporation's relationships with its customers, suppliers, and employees."[214] Finally, "[t]he very threat of bankruptcy . . . can shake the confidence of parties dealing with the corporation, calling into question its ability to perform, thereby damaging the corporation's assets, the value of which often depends on the performance of other parties."[215] A cause of action for deepening insolvency allows plaintiffs to recover for these harms.[216]

Some courts, however, have required fraud as an essential element in a cause of action for deepening insolvency.[217] These courts have expressed concern that an overly-expansive application of deepening insolvency will chill attempts by corporate directors to resuscitate floundering corporations.[218] As some commentators have pointed out, a broad application of deepening insolvency could severely negatively impact the freedom of corporate directors and perhaps might disincentivize many qualified individuals from serving as directors.[219] In response, courts following *Lafferty* hope to compensate the significant harms of deepening insolvency and simultaneously protect the legitimate business decisions of corporate directors from undue scrutiny. To achieve this balance, these courts have decided to limit the scope of deepening insolvency to those circumstances of actual fraud on the part of the defendant, thus protecting the good-faith decisions of corporate directors.

2. *Disadvantages of a Cause of Action Requiring Fraud*

The standard for proving fraud, however, is relatively high.[220] As a result of this high standard, many claims by stockholders and creditors for mismanagement by corporate directors or auditors might not be brought at all.[221] These claims may be meritorious,[222] but requiring fraud as an element of deepening insolvency may make deepening insolvency

213. *Id*. at 350.
214. *Id*.
215. *Id*.
216. *See generally supra* Part II.C.
217. *See, e.g.*, *infra* note 221.
218. Mahoney, *supra* note 179, at 1015 ("By declining to extend deepening insolvency to mere negligence, the *CitX* court has enabled a board of directors to make reasonable business decisions on behalf of corporations with the assurance that decisions made in good faith will be shielded from liability by the business judgment rule.").
219. *See, e.g.*, *infra* note 238 and accompanying text.
220. *Id*. at 1014 (referring to the "stringent fraud requirements").
221. *Id*. ("By predicating deepening insolvency on fraudulent acts rather than mere negligence, *CitX* makes it much more difficult for a plaintiff to assert a claim for deepening insolvency. Under this heightened standard, a plaintiff seemingly must prove the stringent fraud requirements in addition to the requisite damage to corporate property to successfully assert a claim for deepening insolvency.").
222. For example, the negligence by corporate management may have been particularly grievous, or auditors may have failed in their duty as a last line of defense against corporate misdeeds.

claims much more difficult to prove.[223] This is because a plaintiff will have to prove all of the elements of fraud as well as an injury directly resulting from the deepening of the corporation's insolvency.[224] As one commentator notes, such a requirement effectively "[makes] it more difficult to assert a deepening insolvency cause of action than a fraud claim," which removes much of the utility of deepening insolvency as a cause of action.[225]

In addition, some courts have stated that an independent cause of action for deepening insolvency may be redundant with existing causes of action. For example, in a suit against corporate directors for deepening insolvency, the bankruptcy court in *In re Fleming Packaging Corp*. stated that "the difficulty" with deepening insolvency "is often one of redundancy. . . . Where the target defendant is a director who is alleged to have breached one or more fiduciary duties, a court should determine . . . whether a cause of action labeled 'deepening insolvency' is no different than an ordinary one for breach of fiduciary duty."[226]

3. Advantages of a Lower Standard Requiring Negligence

While some courts have followed *Lafferty* in requiring fraud as an element of a cause of action for deepening insolvency, others have lowered the *Lafferty* standard to allow negligence.[227] This means that a plaintiff does not need to prove fraudulent intent on the part of the defendant. Rather, the plaintiff has the considerably lower burden of proving merely that the defendant's negligent action caused deepening insolvency.[228] Lowering the standard to require only negligence arguably allows meritorious claims of deepening insolvency to become actionable.[229] As one court stated, "[U]nder some set of facts two years of negligently prepared financial statements could have been a substantial cause" of a debtor corporation's deepening insolvency.[230] Thus, the primary benefit of requiring only negligence to prove a claim for deepening insolvency is to ensure that the harm caused by deepening insolvency is actionable in all cases. Indeed, most of the cases that allow deepening insolvency for claims of negligence do so with the purpose of compensat-

223. Mahoney, *supra* note 179, at 1014–15 (noting that requiring fraud "made it more difficult to assert a deepening insolvency cause of action than a fraud claim, which will undoubtedly result in the assertion of far fewer deepening insolvency causes of action").

224. *Id*. at 1014 ("Should a plaintiff bring a deepening insolvency suit within a state that recognizes the tort as an independent cause of action, the plaintiff would have to prove all five elements of fraud [according to the court in *CitX*], and presumably also prove 'an injury to the debtor's corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life.'").

225. *Id*. at 1015.

226. Rafool v. The Goldfarb Corp. (*In re* Fleming Packaging Corp.), 336 B.R. 398, 400 (Bankr. C.D. Ill. 2006).

227. *See, e.g.*, *supra* note 206 and accompanying text.

228. *But cf. supra* notes 217–18 and accompanying text.

229. *See supra* notes 223–25 and accompanying text.

230. Gourian Holdings, Inc. v. DeSantis (*In re* Gourian Holdings, Inc.), 165 B.R. 104, 107 (E.D.N.Y. 1994).

ing for this harm.[231] These courts often cite to *Lafferty* or other cases for the proposition that deepening insolvency is harmful and allow the claim of deepening insolvency to proceed.[232] The basis for doing so is alluded to in *In re Greater Southeast Community Hospital Corp.* where the court stated "this court [is un]aware of any common law principle holding that an injury sustained as a result of one tort (fraud) is somehow not an injury when it is caused by a different tort (negligence)."[233]

4. *Disadvantages of a Lower, Negligence Standard*

Some courts, including the Third Circuit in *Lafferty*, have rejected negligence as the basis for a claim, perhaps responding to the fear that allowing deepening insolvency claims based only on negligence might circumvent the business judgment rule and produce "a de facto duty to liquidate in the face of insolvency."[234] The business judgment rule is a judicial standard of review that protects the decisions of corporate directors, whereby "directors are not liable for honest errors or mistakes of judgment, when they act without corrupt motive and in good faith."[235] Thus, it "absolves directors for all but gross negligence."[236] If courts allowed claims of deepening insolvency for corporate directors' negligence, however, this would effectively bypass the business judgment rule.[237] Not only would such a regime disincentivize corporate directors from attempting to "resuscitate" insolvent corporations, but many capable businessmen would likely refuse to serve as corporate officers, fearing personal liability for negligent decisions.[238]

231. *See id.*; Tabas v. Greenleaf Ventures, Inc. (*In re* Flagship Healthcare, Inc.), 269 B.R. 721 (Bankr. S.D. Fla. 2001).

232. *See, e.g.*, Smith v. Arthur Andersen LLP, 421 F.3d 989, 995, 1004 (9th Cir. 2005) (citing *Lafferty* and concluding that "the complaint states a cognizable harm to [the debtor] when it alleges that the defendants 'prolonged' the firm's existence" by, among other things, "misrepresenting (not necessarily intentionally) the firm's financial condition"); *In re* Flagship Healthcare, 269 B.R. at 728 (citing *Lafferty* and stating that "if it can be proven that [the financial hardships which possibly resulted from the increased insolvency] were a result of the increased insolvency, liability may be found").

233. Alberts v. Tuft (*In re* Greater Se. Cmty. Hosp. Corp. I), 353 B.R. 324, 337 (Bankr. D.D.C. 2006).

234. Mahoney, *supra* note 179, at 1016.

235. WILLIAM MEADE FLETCHER, 3A FLETCHER CYCLOPEDIA OF THE LAW OF CORPORATIONS § 1036 (2012).

236. *Id*.

237. Mahoney, *supra* note 179, at 1016 ("[B]y rejecting negligence as a basis for deepening insolvency, the *CitX* court upheld the . . . protection that the business judgment rule provides to corporate directors who act in good faith, with due care and in compliance with their fiduciary duties.").

238. *See generally* WILLIAM E. KNEPPER, ET AL. LIABILITY OF CORPORATE OFFICERS AND DIRECTORS 18 (7th ed. 1998) ("If management were liable for mere good faith errors in judgment, few capable individuals would be willing to incur the financial and emotional risk of serving as directors or officers."); Daniel E. Harrell, Comment, *Pandora's Bankruptcy Tort: The Potential for Circumvention of the Business Judgment Rule Through the Tort Theory of Deepening Insolvency*, 36 CUMB. L. REV. 151, 153 (2005) ("[I]f courts extend the deepening insolvency theory to include negligent decisions in the face of insolvency, thereby ignoring the business judgment presumption, then the best and brightest will likely decline these positions due to the increased potential for personal liability.").

B. Allow Deepening Insolvency as a Theory of Damages for Existing Torts

Rather than allow deepening insolvency as a distinct cause of action, some courts have recognized deepening insolvency only as a theory of damages for existing torts.[239] Indeed, this was the approach of *Schacht*, the first case to recognize deepening insolvency as such.[240] This approach has some appeal because it allows recovery for the damage caused by deepening insolvency while avoiding the potential problems of frivolous lawsuits brought under a novel cause of action.[241] On the other hand, the effect of this approach is to limit the effectiveness of deepening insolvency, as plaintiffs must prove both the elements of deepening insolvency as well as the elements of the separate tort (such as fraud or breach of fiduciary duty).[242] In addition, some commentators have pointed out that this approach does not accurately measure harm and may be arbitrary.[243] Thus, under this regime deepening insolvency loses much of its effectiveness.[244]

1. Advantages of Deepening Insolvency as a Theory of Damages

In an effort to allow recovery for deepening insolvency damages, some courts have recognized the theory as a measure of damages for preexisting torts.[245] One such court was *Schacht*, where deepening insolvency was recognized as a theory of harm in a civil action brought under RICO.[246] Indeed, some courts have questioned whether deepening insolvency even makes sense as a separate cause of action.[247] According to the court in *In re Global Service Group*, "the distinction between 'deepening insolvency' as a tort or damage theory may be one unnecessary to make."[248] This is because a plaintiff alleging deepening insolvency must always "show that the defendant prolonged the corporation's life in breach of a separate duty, or committed an actionable tort."[249] Simply

239. *See, e.g.*, Schacht v. Brown, 711 F.2d 1343 (7th Cir. 1983).

240. *See, e.g.*, *supra* Part II.B.

241. *Compare infra* Part III.B.1, *with supra* Part III.A.4.

242. *See, e.g.*, *infra* notes 251–53 and accompanying text.

243. *See, e.g.*, *infra* notes 261–64 and accompanying text.

244. *See generally infra* Part III.B.2.

245. Schacht v. Brown, 711 F.2d 1343 (7th Cir. 1983); Rafool v. Goldfarb Corp. (*In re* Fleming Packaging Corp.), 336 B.R. 398, 401 (Bankr. C.D. Ill. 2006) ("[T]his Court is not convinced that the Delaware Supreme Court will recognize deepening insolvency as a unique cause of action, suggesting instead, that it is more correctly construed as a term that describes damages.").

246. *Schacht*, 711 F.2d at 1350 ("[A]cceptance of a rule which would bar a corporation from recovering damages due to the hiding of information concerning its insolvency would create perverse incentives for wrong-doing officers and directors to conceal the true financial condition of the corporation from the corporate body as long as possible.").

247. Kittay v. Atlantic Bank of New York (*In re* Global Serv. Grp.), 316 B.R. 451, 458 (Bankr. S.D.N.Y. 2004).

248. *Id*.

249. *Id*.

prolonging the life of an insolvent corporation "will not result in liability under either approach."[250]

In addition, when deepening insolvency is alleged against certain parties (such as lenders), it may not survive as a separate tort.[251] As some courts have pointed out, to prove deepening insolvency as a separate tort one must first prove that the defendant owed a duty to the plaintiff.[252] When deepening insolvency is alleged against a lender, for example, this first element will often fail because "lenders are not commonly understood to have a fiduciary duty to their borrower."[253] Indeed, the bankruptcy court in *In re VarTec Telecom, Inc.* dismissed the plaintiff's claim for this very reason: the plaintiff could not establish that the defendant owed a duty to the corporation, which was subsequently breached by deepening the corporation's insolvency.[254] Citing *Limor v. Buerger (In re Del-Met Corp.)*,[255] the court found that for the plaintiff to prevail, the defendant must have owed a duty to the corporation "by virtue of their domination and control" over the corporation.[256] Because the plaintiff in *In re VarTec Telecom, Inc.* could not prove that the defendant "controlled the actions or took over the management" of the corporation, the plaintiff's claim was dismissed.[257]

The advantage of limiting deepening insolvency to a theory of damages is that it prevents the unfettered use of the theory to unfairly impose increased liability on third parties, which is possible when deepening insolvency is recognized as a separate cause of action requiring only negligence on the part of the defendant.[258] Furthermore, recognizing deepening insolvency as a theory of damages will help ensure that all of the harm it causes will be recoverable.[259]

250. *Id*.

251. *See* Michael L. Bernstein & Charles A. Malloy, *Deepening Insolvency: An Emerging Theory of Liability*, 1 BLOOMBERG CORP. L. J. 406, 417 (2006).

252. *See* Official Comm. of Unsecured Creditors of VarTec Telecom, Inc. v. Rural Tel. Fin. Coop. (*In re* VarTec Telecom, Inc.), 335 B.R. 631, 645 (Bankr. N.D. Tex. 2005) ("The theory of 'deepening insolvency' cannot pass the first hurdle—duty. An essential element of a cause of action sounding in tort in Texas is the requirement that the defendant owe a duty to the plaintiff.").

253. Bernstein & Malloy, *supra* note 251, at 417.

254. *In re VarTec Telecom, Inc*., 335 B.R. at 646.

255. Limor v. Buerger (*In re* Del-Met Corp.), 322 B.R. 781, 808 (Bankr. M.D. Tenn. 2005).

256. *Id.*; *In re VarTec Telecom, Inc*., 335 B.R. at 646.

257. *In re VarTec Telecom, Inc.*, 335 B.R. at 646.

258. *See* Mahoney, supra note 179, at 1016 (discussing the "de facto duty to liquidate in the face of insolvency" which would result from courts allowing deepening insolvency causes of action based upon negligence).

259. *See, e.g*., Bernstein & Malloy, *supra* note 251, at 415 ("The tort in these cases is not deepening insolvency but instead consists of the breach of a fiduciary duty or duty of care, with the damages calculated based on the deepening of the company's insolvency.").

2. *Disadvantages of a Damages Theory*

While limiting deepening insolvency to a theory of damages has certain advantages, some commentators question this approach.[260] Using deepening insolvency as a measure of damages ensures that the actual harm caused by the deepening of the corporation's insolvency will be compensated.[261] There is no reason, however, why the damages should be limited to the increase of insolvency.[262] As one commentator points out, if a defendant has breached a duty to a company, there is no reason why the damage calculation should differ between a company whose insolvency is deepened, and "a company that begins solvent but is rendered insolvent by the same conduct—or for that matter a company that is solvent and is rendered less solvent (but not insolvent)."[263] Rather, "the damages in each of these cases [should] be measured simply by the losses imposed as a result of the wrongful conduct."[264]

Indeed, several years after deciding *Lafferty*, the Third Circuit revisited the theory of deepening insolvency in *In re CitX Corp.* explicitly to exclude deepening insolvency as a theory of damages.[265] The court stated that while it described deepening insolvency as a "type" or "theory" of injury in *Lafferty*, it "never held that it was a valid theory of damages for an independent cause of action."[266] Rather, the court pointed out that "[t]hose statements in *Lafferty* were in the context of a deepening-insolvency *cause of action*," and "should not be interpreted to create a novel theory of damages for an independent cause of action."[267]

C. *Allow Deepening Insolvency as a Counter to* In Pari Delicto

Deepening insolvency was first conceived as a defense to *in pari delicto* when the court in *Bloor* recognized that the prolongation of corporate life is not necessarily beneficial.[268] In raising the *in pari delicto* defense, the defendant seeks to impute the wrongdoing of corporate managers and directors to the corporation itself, barring suit by anyone

260. *See, e.g.*, *id*. at 415 n.43 ("One may legitimately question whether deepening insolvency is a proper measure of damages in these cases."); Mahoney, *supra* note 179, at 1005 ("The use of deepening insolvency as a theory of damages is problematic because it does not reflect an accurate measure of harm to the corporation resulting from the defendant's acts and is 'inconsistent with the traditional understanding . . . of corporate injury.'").

261. *See* Bernstein & Malloy, *supra* note 251, at 415 ("[T]here are situations in which a duty may exist which, if breached, arguably gives rise to liability for deepening insolvency damages. . . . The tort in these cases is not deepening insolvency but instead consists of the breach of a fiduciary duty or duty of care, with the damages calculated based on the deepening of the company's insolvency.").

262. *See infra* text accompanying note 263.

263. Bernstein & Malloy, *supra* note 251, at 415 n.43.

264. *Id*.

265. Seitz v. Detweiler, Hershey, & Associates, P.C. (*In re* CitX Corp, Inc.), 448 F.3d 672 (3d Cir. 2006).

266. *Id*. at 677.

267. *Id*. (emphasis in original).

268. *See* Bloor v. Dansker (*In re* Investors Funding Corp. Sec. Litig.), 523 F. Supp. 533, 541 (S.D.N.Y. 1980); *supra* notes 45–47 and accompanying text.

bringing claims on behalf of the corporation (such as a trustee, a creditors' committee, or shareholders in a derivative suit).[269] To prevail, the plaintiff must then successfully assert the adverse interest exception, which applies when the wrongdoers acted completely adverse to the interests of the corporation.[270] If they did, their wrongdoing is not imputed to the corporation.[271] Deepening insolvency is the basis by which a plaintiff might argue that a corporation did not benefit from the increase of insolvency.

This approach to deepening insolvency overcomes many of the shortcomings of the other approaches. First, this approach does not promote frivolous lawsuits because a plaintiff must be able to prove the elements of an existing cause of action.[272] At the same time, this approach respects the logical purpose of deepening insolvency and is not subject to criticisms of arbitrary line-drawing.[273]

1. *Advantages of Deepening Insolvency as a Response to* In Pari Delicto

In pari delicto is an affirmative defense that "provides that a plaintiff may not assert a claim against a defendant if the plaintiff bears fault for the claim."[274] This defense to fraud claims has been raised in many deepening insolvency cases.[275] The essential allegation of the defense is that even if the defendant deepened the corporation's insolvency, the defendant was acting for the benefit of the corporation.[276] Because of this, the wrongdoing of the defendant is imputed to the corporation, barring most suits for deepening insolvency.[277] As mentioned, an exception to *in pari delicto* is the "adverse interest exception," which applies "when a corporate agent has totally abandoned his principal's interests and [acts] entirely for his own or another's purposes."[278] Some courts, such as *Bloor*, have held that this is the proper application of deepening insolvency: a recognition that the deepening of a corporation's insolvency is inherently harmful to it, and therefore the defendant's interests were completely adverse to those of the corporation, even though the corpora-

269. *See Bloor*, 523 F. Supp. at 540–41; *supra* notes 36–40 and accompanying text.
270. *See supra* notes 38–40 and accompanying text.
271. *See supra* note 39 and accompanying text.
272. *See supra* Part III.A.4 and notes 241, 257 and accompanying text.
273. *See supra* notes 262–64 and accompanying text.
274. Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 354 (3d Cir. 2001).
275. *See, e.g.*, Lauren Colasacco, Note, *Where Were the Accountants? Deepening Insolvency as a Means of Ensuring Accountants' Presence When Corporate Turmoil Materializes*, 78 FORDHAM L. REV. 793, 845 (2009) ("The *in pari delicto* doctrine is pled as a defense in virtually every deepening insolvency action.").
276. Sabin Willett, *The Shallows of Deepening Insolvency*, 60 BUS. LAW. 549, 558 (2005) ("The knowledge and conduct of corporate officials acting within the scope of their duties generally is imputed to the corporation.").
277. *Id*.
278. Allard v. Arthur Andersen & Co. (USA), 924 F. Supp. 488, 495 (S.D.N.Y. 1996) (internal quotation marks omitted).

tion might have received some capital.[279] One commentator, discussing the application of this defense to claims of deepening insolvency stated, "[T]here is little doubt that the doctrine of *in pari delicto* is now in retreat."[280]

There are good reasons for applying deepening insolvency to overcome *in pari delicto*. At its core, deepening insolvency was conceived in recognition of this unique type of harm. Every court which has subsequently recognized the theory in any form (whether as a cause of action, a theory of damages, or an exception to *in pari delicto*) has necessarily done so in recognition of the fact that a corporation is harmed by the wrongful prolongation of its life. Thus, the adverse interest exception should logically overcome *in pari delicto* in many of these cases because this prolongation of corporate life is "completely adverse" to the corporation's interests. Stated another way, a defendant who wrongfully extends a corporation's life and causes damage has not benefitted the corporation in any way. Thus, a court properly applying deepening insolvency will allow the *in pari delicto* defense in the small number of cases where the sole actor exception applies, meaning that the sole shareholders are the very people who harmed the corporation.[281] By recognizing a special application of the adverse interest exception for cases where the defendant fraudulently deepened a corporation's insolvency, courts will be able to ensure that deepening insolvency is not applied too loosely and simultaneously allow cases to proceed which would otherwise be barred by this defense.

2. *Disadvantages of Deepening Insolvency as a Response to* In Pari Delicto

If deepening insolvency is only recognized as a bar to the *in pari delicto* defense, however, the harm it causes will only be recoverable in relatively few cases.[282] Claims of deepening insolvency are typically asserted by a bankruptcy trustee or a committee of unsecured creditors.[283] The Seventh Circuit held in *Scholes v. Lehmann*, however, that the doctrine of *in pari delicto* does not bar suit once a receiver has been appointed.[284]

279. Bloor v. Dansker (*In re* Investors Funding Corp. Sec. Litig.), 523 F. Supp. 533, 541 (S.D.N.Y. 1980) ("[I]t is manifest that the prolonged artificial solvency . . . benefitted only the Danskers . . . . On this record, the Court cannot sustain [the defendant's] position that the knowledge and conduct of the Danskers (and others) must be legally imputed to IFC.").

280. Willett, *supra* note 276, at 560.

281. *See, e.g.*, *supra* notes 135–40.

282. Scholes v. Lehmann, 56 F.3d 750, 755 (7th Cir. 1995); David E. Gordon, Comment, *The Expansion of Deepening Insolvency Standing: Beyond Trustees and Creditors' Committees*, 22 EMORY BANKR. DEV. J. 221, 244 (2005) ("[T]he logic employed in *Scholes* insulates bankruptcy trustees and court appointed receivers from *in pari delicto* challenges . . . .").

283. Gordon, *supra* note 282, at 259 ("Actions for deepening insolvency are typically brought by either a trustee in bankruptcy or a committee of unsecured creditors.").

284. *Scholes*, 56 F.3d at 755 ("Now that the corporations created and initially controlled by Douglas are controlled by a receiver whose only object is to maximize the value of the corporations for the benefit of their investors and any creditors, we cannot see an objection to the receiver's bringing suit

As Judge Posner stated, this is because "the defense of *in pari delicto* loses its sting when the person who is *in pari delicto* is eliminated."[285] In *Scholes*, therefore, once a receiver replaced the sole shareholder, "[t]he corporations were no more [his] evil zombies,"[286] and thus they were entitled to recover for the deepening of their insolvency.[287] The implication of *Scholes* for the deepening insolvency theory is that the defense of *in pari delicto* (and therefore the need for the theory to respond to this defense) will not be available in cases brought by trustees.[288] Rather, the defense will only be available in cases brought by creditors' committees.[289] Thus, a regime that recognizes deepening insolvency solely as a response to an *in pari delicto* defense will result in applying deepening insolvency to a relatively small number of cases.[290]

Additionally, an application of deepening insolvency that eliminates all claims of *in pari delicto* will place an inordinate burden on defendants, particularly third-party professionals. The *in pari delicto* defense is one of the primary defenses relied upon by third-party professionals in deepening insolvency cases.[291] If courts use the theory of deepening insolvency to apply the adverse interest exception against all third-party professionals, these professionals will be exposed to enormous liability. This will result in significantly more expensive audits, as well as other professional services, and will discourage third parties from performing services for companies on the brink of insolvency.[292] This can be overcome, however, by a modified application of the adverse interest exception which would only apply the exception to defendants who acted fraudulently.[293]

D. Refusal to Recognize Deepening Insolvency in Any Form

Despite the recognition by many courts of the harm caused by deepening insolvency, some courts have rejected any application the theory.[294] These courts are primarily concerned with the risk of increased

to recover corporate assets unlawfully dissipated by Douglas. We cannot see any legal objection and we particularly cannot see any practical objection.").

285. *Id*. at 754.

286. *Id*.

287. *Id*.

288. *See supra* note 282 and accompanying text.

289. Gordon, *supra* note 282, at 245 ("In summary, *in pari delicto* defenses against deepening insolvency claims may ultimately succeed as an affirmative defense only when asserted against creditors' committees.").

290. This is not necessarily a bad thing, however. *See supra* Part III.A.4.

291. *See, e.g.*, Colasacco *supra* note 275, at 845.

292. *See, e.g.*, Jay M. Feinman, *Liability of Accountants for Negligent Auditing: Doctrine, Policy, and Ideology*, 31 FLA. ST. U. L. REV. 17, 50 (2003) (arguing that as litigation costs for accountants increase, costs of accounting services will also increase). "Indeterminate liability, for example, either would impose such intolerable burdens on accountants that they would be forced to leave the market for auditing services by the costs of insurance or liability judgments, or it would simply raise the cost of auditing services to an appropriate and bearable level, given the risks of liability to third parties." *Id.*

293. *See, e.g.*, *infra* Part IV.

294. *See, e.g.*, Trenwick Am. Litig. Trust v. Ernst & Young, LLP, 906 A.2d 168, 174 (Del. Ch. 2006); *see also, e.g.*, Part III.D.1.

frivolous lawsuits posed by certain approaches to deepening insolvency.[295] These courts fear that increased exposure to liability for corporate directors will disincentivize efforts to salvage insolvent corporations.[296] Also, many of these courts contend that deepening insolvency is duplicative with existing claims and reject the theory for efficiency reasons.[297] While this hard stance might provide efficiency gains, plaintiffs in these jurisdictions cannot fully recover damages for the injury caused by deepening insolvency.[298] Additionally, this harsh approach is not necessary to prevent frivolous claims.[299]

1. Advantages of Rejecting Deepening Insolvency

Some courts, such as the Delaware Court of Chancery in *Trenwick*, have held that deepening insolvency is neither a valid cause of action nor a theory of damages.[300] The rationales for these rulings are varied. As discussed above, some of these courts may be fearful of expanding liability against corporate directors such that directors will become wary of attempts to repair insolvent corporations.[301] Other courts have held that deepening insolvency is duplicative of other causes of action.[302] According to these courts, while deepening insolvency causes harm to a corporation, that harm is best recovered in individual causes of action for fraud, breach of fiduciary duty, or breach of contract.[303]

Referring to deepening insolvency, the bankruptcy court in *In re Greater Southeast Community Hospital Corp.* stated, "There is no point in recognizing and adjudicating 'new' causes of action when established ones cover the same ground."[304] Accordingly, the court dismissed the plaintiff's "duplicative" deepening insolvency claim.[305] In a later ruling on the same case, the court held that while deepening insolvency can cause harm to a corporation, the corporation is also necessarily benefitted by this harm.[306] The court believed that "[n]o matter how much evidence of wrongdoing [a trustee] produces, there simply are no set of facts under which a company that is harmed by the artificial prolongation of its existence does not also benefit to some degree by that same prolongation."[307] Thus, the court rejected the plaintiff's attempt to invoke the ad-

295. *See supra* Part III.A.4; *see also, e.g.*, Part III.D.1.
296. *See supra* note 234 and accompanying text; *see also, e.g.*, Part III.D.1.
297. *See Trenwick*, 906 A.2d at 174; *see also, e.g.*, Part III.D.1.
298. *See* discussion *infra* Part III.D.2.
299. *See* discussion *infra* Part IV.
300. *Trenwick*, 906 A.2d at 174.
301. *See supra* note 234 and accompanying text.
302. *Trenwick*, 906 A.2d at 174; *see infra* note 305 and accompanying text.
303. *Trenwick*, 906 A.2d at 174.
304. Alberts v. Tuft (*In re* Greater Se. Cmty. Hosp. Corp. II), 333 B.R. 506, 517 (Bankr. D.D.C. 2005).
305. *Id*.
306. Alberts v. Tuft (*In re* Greater Se. Cmty. Hosp. I.), 353 B.R. 324, 368 (Bankr. D.D.C. 2006).
307. *Id*.

verse interest exception to the *in pari delicto* defense.[308] The bankruptcy judge appeared unmoved by the twenty-year-old Seventh Circuit opinion in *Schacht* (followed by dozens of later courts) which recognized this as a "seriously flawed assumption" that "collides with common sense."[309]

2. Disadvantages of Rejecting Deepening Insolvency

Conversely, the Seventh Circuit recognized in *Schacht* that "the corporate body is ineluctably damaged by the deepening of its insolvency."[310] The timely disclosure of insolvency is arguably vital to allow shareholders or creditors to choose to dissolve the corporation "to cut their losses."[311] By refusing to recognize deepening insolvency, courts following *Trenwick's* logic prevent a very real and devastating harm from being compensated.[312] Moreover, some courts incorrectly state that deepening insolvency is duplicative—that is, that the harm suffered can be compensated via existing causes of action.[313] While it is true that some of the harm caused by deepening insolvency can be recovered through causes of action for fraud or breach of fiduciary duty, that harm cannot be fully compensated without the deepening insolvency theory.[314]

One type of damage caused by deepening insolvency that cannot be easily recovered in other causes of action was identified by the court in *Lafferty*: the "legal and administrative costs" of bankruptcy.[315] These are costs that would have been avoided had the corporation not been forced into bankruptcy as a result of the fraudulent prolongation of the corporate life.[316] Another type of harm discussed in *Lafferty* is the inability of a corporation to continue operating after bankruptcy.[317] This harm occurs when a corporation is slightly insolvent but could be rehabilitated through a bankruptcy reorganization.[318] Instead, a fraudulent scheme deepens the corporation's insolvency, encumbering the corporation with

308. *Id*.
309. Schacht v. Brown, 711 F.2d 1343, 1350 (7th Cir. 1983).
310. *Id*.
311. *Id*.
312. Choksi, *supra* note 23, at 205 (distinguishing between "different levels of insolvency," stating that at "the point at which the corporation first became insolvent, . . . restructuring and rebirth may have still been possible," while "a deepening insolvency fraud . . . leads not only to millions in unrecoverable corporate assets, but to unsalvageable corporate demise").
313. *See, e.g.*, Trenwick Am. Litig. Trust v. Ernst & Young, LLP, 906 A.2d 168, 174 (Del. Ch. 2006) ("Put simply, under Delaware law, 'deepening insolvency' is no more of a cause of action when a firm is insolvent than a cause of action for 'shallowing profitability' would be when a firm is solvent. Existing equitable causes of action for breach of fiduciary duty, and existing legal causes of action for fraud, fraudulent conveyance, and breach of contract are the appropriate means by which to challenge the actions of boards of insolvent corporations.").
314. *See* Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 349–50 (3d Cir. 2001).
315. *Id*.
316. *Id*.
317. *Id*. at 350 ("When brought on by unwieldy debt, bankruptcy also creates operational limitations which hurt a corporation's ability to run its business in a profitable manner.").
318. *Id*.

immense debt, making it impossible to rehabilitate.[319] In such an instance, the necessity of liquidation—as opposed to reorganization—directly results from deepening insolvency.[320] In addition, even if liquidation would be required in the absence of a scheme to deepen the corporation's insolvency, the continuation of the corporate life will necessarily diminish the value of the corporate assets.[321] These potential harms can be devastating and might not be recoverable in a jurisdiction that rejects deepening insolvency.[322]

IV. RECOMMENDATION

Deepening insolvency thus causes very real harm—harm which Illinois courts should recognize. Just as the *Lafferty* court determined that Pennsylvania law would recognize a cognizable harm caused by deepening insolvency—and would provide a remedy for that harm—Illinois law should likewise provide a remedy, adhering to the maxim "where there is an injury, the law provides a remedy."[323] Deepening insolvency thus has a proper place in modern tort law within the context of *in pari delicto*. While some courts have argued that existing causes of action address aspects of the harm suffered by a corporation that falls victim to deepening insolvency, those causes of action are often deficient.[324] To overcome this deficiency, the proper role of deepening insolvency is in the limited application of *in pari delicto*.

The theory of deepening insolvency arose as a response to *in pari delicto*, and that is where its application remains the most logical.[325] When a defendant fraudulently prolongs the life of a corporation and causes deepening insolvency damages, courts should expand the adverse interest exception to preclude the imputation of the wrongdoing of corporate agents to the corporation. Attempts by some courts to use deepening insolvency as a measure of damages suffer criticism for arbitrary line-drawing and improper damage calculation.[326] Other attempts to stretch the theory to encompass mere negligence represent an undue expansion of deepening insolvency that unfairly places much greater burdens on defendants who are responsible for nothing more than failing to

319. *Id*. at 349–50.

320. *Id.* at 350.

321. *Id*. ("[P]rolonging an insolvent corporation's life through bad debt may simply cause the dissipation of corporate assets.").

322. *See, e.g.*, *supra* note 304 and accompanying text.

323. *See* ILL. CONST. art. I, § 12 ("Every person shall find a certain remedy in the laws for all injuries and wrongs which he receives to his person, privacy, property or reputation."); *Lafferty*, 267 F.3d at 351.

324. *See generally* Choksi, *supra* note 23, for a discussion of the shortcomings of existing causes of action *viz* deepening insolvency. It is beyond the scope of this Note to engage in a detailed discussion of the numerous instances where deepening insolvency has been alleged to be duplicative of a preexisting cause of action.

325. Bloor v. Dansker (*In re* Investors Funding Corp. Sec. Litig.), 523 F. Supp. 533, 541 (S.D.N.Y. 1980); *see supra* note 279.

326. *See supra* Part III.B.2.

discover an ongoing fraud.[327] Rather, applying deepening insolvency so as to allow the plaintiff to avoid the *in pari delicto* defense, but simultaneously requiring the plaintiff prove fraud by the defendant, avoids criticism for arbitrariness while limiting the potential for greatly increased litigation. When applied indiscriminately,[328] however, deepening insolvency will lead to unjust results and unfairly increased liability for certain defendants.[329] Therefore, the theory should be limited to claims against fraudulent defendants who prolong a corporation's life, and those defendants should not have the benefit of the *in pari delicto* defense.

In addition, Illinois law would support this approach. While the court in *In re Gluth Brothers Construction* found that it was unclear whether Illinois would recognize deepening insolvency, it did not reject the possibility.[330] The court held that a deepening insolvency claim in Illinois must allege fraud by the defendant[331] but did not consider the theory as a measure of damages or a response to *in pari delicto*.[332] Illinois courts should be open to recognizing deepening insolvency as a response to *in pari delicto*, pursuant to the Illinois constitutional provision that "[e]very person shall find a certain remedy in the laws for all injuries and wrongs which he receives."[333] Thus, Illinois courts should be willing to provide a remedy for the injury caused by deepening insolvency.[334]

As discussed, deepening insolvency causes a cognizable injury which should be compensated. The proper method of ensuring recovery balances the interest of compensating injury with the risk of fostering frivolous lawsuits and exposing third parties to excessive liability. This balancing yields the conclusion that Illinois should recognize deepening insolvency as an application of the adverse interest exception. If the plaintiff can prove the defendant acted fraudulently in a claim of deepening insolvency, the adverse interest exception should be applied to overcome the *in pari delicto* defense. In this way, Illinois courts will remedy the injury of deepening insolvency while mitigating any unintended consequences of that remedy.

Not only does this rule provide the most consistent and rational results, but policy, economic, and risk allocation considerations favor this approach. By allowing plaintiffs to overcome the *in pari delicto* defense while concurrently limiting deepening insolvency only to those circumstances of actual fraud on the part of the defendant, this rule strikes the proper balance between the rights of plaintiffs and defendants. This insulates a merely negligent third-party professional from potentially

327. These innocent parties might include accountants, lenders, attorneys, or others.

328. For instance, applying deepening insolvency against merely negligent defendants when the corporation was engaged in fraud against investors, creditors, or professionals.

329. *See* discussion *supra* Part III.C.2.

330. Dixon v. Am. Cmty. Bank & Trust (*In re* Gluth Bros. Constr.), 424 B.R. 379, 389–90 (Bankr. N.D. Ill. 2009).

331. *Id*.

332. *Id*.

333. ILL. CONST. art. I, § 12.

334. *See id*.

enormous exposure to liability, but still leaves the corporation with recourse against fraudulent parties for damages.[335] To hold otherwise, while not only unfair to these professionals, would also likely greatly increase the cost of audits and other professional services.[336] This would incentivize corporate managers to engage in fraud because any liability for their actions would effectively be insured by the corporate auditors and professionals. Rather, the proper application of deepening insolvency mitigates the risk of imposing greater liability on third parties by applying deepening insolvency only in instances when the plaintiff can prove the defendant acted fraudulently.

An analogous approach can be found in federal securities law, which for policy and efficiency reasons attempts to strike a balance between a lower standard of proof for one element of a claim, while heightening the burden for other elements.[337] Section 10(b) of the Securities and Exchange Act of 1934 broadly defines securities fraud as using any deceptive practice in connection with the purchase or sale of certain securities.[338] In interpreting this section the Supreme Court has stated that the requirement of reliance by the plaintiff is "an essential element of the §10(b) private cause of action."[339] At the same time, the Court has recognized that the reality of modern securities markets makes it extremely difficult for a plaintiff to prove that he or she personally relied on a public misrepresentation.[340] In response, the Court developed the "fraud-on-the-market" theory, whereby "reliance is presumed when the statements at issue become public."[341] Under this theory, the plaintiff need not prove individual reliance on the statements, thus substantially lowering the burden on investors bringing securities fraud actions.[342] By lowering the plaintiff's burden of proving reliance, however, the Court recognized

335. This is extremely important because third-party professionals, especially auditors, are often seen as the last line of defense for shareholders. Thus, fraud on the part of auditors should be strongly discouraged.

336. This would be necessary to account for the professional's increased risk of liability from performing that service.

337. *See infra* notes 335–38 and accompanying text.

338. 15 U.S.C. § 78j (2006) ("[B]y the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . . . us[ing] or employ[ing], in connection with the purchase or sale of any security . . . any manipulative or deceptive device . . . ."). To prevail in a claim under this section, the Supreme Court has found that a plaintiff must prove, "(1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation." Stoneridge Inv. Partners LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 157 (2008) (citing Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 341–342 (2005)).

339. *Stoneridge*, 552 U.S. at 159.

340. "In an open and developed market, the dissemination of material misrepresentations or withholding of material information typically affects the price of the stock, and purchasers generally rely on the price of the stock as a reflection of its value." Basic Inc. v. Levinson, 485 U.S. 224, 244 (1988) (quoting Peil v. Speiser, 806 F.2d 1154, 1161 (3d Cir.1986)).

341. *Stoneridge*, 552 U.S. at 159.

342. *Basic*, 485 U.S. at 242 ("Requiring proof of individualized reliance from each member of the proposed plaintiff class effectively would have prevented respondents from proceeding with a class action, since individual issues then would have overwhelmed the common ones.").

the risk of greatly increasing the amount of securities fraud litigation.[343] In response, the Court required plaintiffs to prove two additional elements: individual purchase or sale of securities, and scienter on the part of the defendant.[344] In this way, the Court balanced the lowered reliance standard against the heightened burden to prove the other elements, ensuring that only legitimate causes of action could be pursued. A later court observed that this balancing "reflect[ed] a deliberate effort, guided by judicial experience with securities fraud cases, to balance the advantages associated with a presumption of reliance against the danger of speculative and harassing claims."[345]

Thus, the Supreme Court employed a presumption of reliance in securities fraud actions, while at the same time requiring plaintiffs to prove intentionality. Similarly, the deepening insolvency rule recommended above employs a presumption of harm to the corporation when plaintiffs prove the defendant fraudulently deepened the corporation's insolvency. This presumption allows plaintiffs to overcome the *in pari delicto* imputation of knowledge. By balancing a presumption in favor of the plaintiff with a heightened burden that the plaintiff prove intentionality (fraud) on the part of the defendant, courts can ensure that plaintiffs are able to recover damages but only against culpable defendants.

Illinois courts, therefore, should provide a remedy for the injury caused by deepening insolvency. Balancing the interests of plaintiffs and defendants, Illinois courts should apply deepening insolvency only against defendants who have engaged in fraud and should not allow these defendants to impute knowledge to the corporation under the *in pari delicto* defense. By following the example of the Supreme Court in securities fraud jurisprudence, this weighing of interests is responsive to the deepening insolvency injuries sustained by the plaintiff, while at the same time protecting merely negligent defendants from greatly expanded liability.

V. CONCLUSION

Ultimately, deepening insolvency is a tool that belongs to the corporation in response to fraudulent acts that wrongfully extend the corporate life, which should allow a trustee or other party suing a fraudulent defendant on the corporation's behalf to overcome the defense of *in pari delicto*. Deepening insolvency should not be a separate cause of action, it should not be measured by the amount of debt incurred, it should not compensate for mere negligence, and neither should it be ignored.

This regime responds to the deficiencies in existing causes of action by recognizing that corporations can suffer this unique harm. At the

343. *See, e.g.*, Mirkin v. Wasserman, 858 P.2d 568, 583 (Cal. 1993).

344. *See id.* at 584 (defining scienter as "a degree of fault greater than negligence"); *Stoneridge*, 552 U.S. at 157.

345. *Mirkin*, 858 P.2d at 584.

same time, it balances the risk of unfairly placing increased liability on merely negligent third parties by requiring actual fraud on the part of those parties. Despite the polemic dicta in *Trenwick*, deepening insolvency does represent a coherent concept, which is responsive to deficiencies in existing causes of action. But the theory has been distorted beyond its logical limits by courts too eager to sanction expansive theories of recovery against corporate directors, officers, or third parties. It is time to restrain the theory, consistent with the rationale of the courts that first developed it. Documentary film director Robert Flaherty once said that "[o]ne often has to distort a thing to catch its true spirit."[346] In the context of deepening insolvency, however, clarity can be achieved not through distortion but instead through respect for the purposes for which the theory was first conceived.

346. ARTHUR CALDER-MARSHALL, THE INNOCENT EYE: THE LIFE OF ROBERT J. FLAHERTY 97 (1963).