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Ario v. Deloitte & Touche: Pennsylvania's Commonwealth Court Re-Kindles Confusion About the "Deepening Insolvency" Doctrine

By Stephen J. Shapiro

In 2001, the Court of Appeals for the Third Circuit predicted that the Pennsylvania Supreme Court would recognize a cause of action known as "deepening insolvency," which the Court defined as "an injury to a debtor's corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life." *Official Committee of Unsecured Creditors v. R. F. Lafferty & Co., Inc.*, 267 F.3d 340, 347 (3d Cir. 2001). In other words, assisting an insolvent corporation delay its ultimate demise by helping to fraudulently expand the corporation's debt could expose an entity to liability for "deepening insolvency." The defendant in *Lafferty* was a securities underwriter that allegedly assisted its client register and offer for sale fraudulent debt securities. In the years following *Lafferty*, plaintiffs have pursued deepening insolvency claims against a broad range of defendants, including officers and directors of insolvent corporations, as well as the lenders, law firms, accountants and other service providers and professionals who worked with them.

Based on language in *Lafferty* describing deepening insolvency as a "type of injury" and "theory of injury," *see Lafferty*, 267 F.3d at 347, 349, confusion arose as to whether deepening insolvency was a stand-alone cause of action or a measure of damages that a plaintiff could seek when pursuing other tort claims. In 2006, the Third Circuit revisited and clarified the deepening insolvency doctrine. In *Seitz v. Detweiler, Hershey and Associates, P.C. (In re CitX Corp.)*, 448 F.3d 672 (3d Cir. 2006), an insolvent corporation used compiled financial statements prepared by its accountants, which indicated that the corporation had a positive balance sheet, to solicit and acquire additional funding from investors. After the corporation eventually collapsed, its bankruptcy trustee sued the accountants for malpractice, arguing that damages could be measured in terms of the additional debt the corporation was able to acquire using the negligently-prepared financial statements; *i.e.*, the amount by which the corporation's insolvency was "deepened." In upholding the trial court's grant of summary judgment on behalf of the accountants, the Third Circuit held that deepening insolvency was not "a valid theory of damages for an independent cause of action . . . [and] should not be interpreted to create a novel theory of damages for [a] cause of action like malpractice." *See id.* at 677. In other words, the Third Circuit re-affirmed *Lafferty*'s holding that deepening insolvency is a cause of action under Pennsylvania law, but expressly held that deepening insolvency is not a category of damages that can be recovered for some other tort. [1]

Just when it appeared that the Third Circuit had resolved some of the confusion surrounding the deepening insolvency doctrine, the Commonwealth Court, one of Pennsylvania's two intermediate appellate courts, muddied the waters. In *Ario v. Deloitte & Touche LLP*, No. 734 M.D. 2002 (Pa. Commw. Ct. June 13, 2008), Pennsylvania's Insurance Commissioner, acting in his capacity as statutory liquidator, brought a professional malpractice action against Deloitte & Touche, the accountants and auditors for the failed Reliance Insurance Company. The Commissioner alleged that Deloitte improperly certified that Reliance's loss reserves were reasonable and overstated Reliance's surplus in its audited financial statements. *See Ario*, slip op. at 8-9.[2]

[1] The *Seitz* court took pains to note that its holding applied only to claims brought under Pennsylvania law. *See id.* at 680 n.11 ("[N]othing we said in *Lafferty* compels any extension of the doctrine beyond Pennsylvania."). Indeed, some jurisdictions, such as Delaware, have rejected the deepening insolvency doctrine altogether, making choice of law analysis critical when litigating a deepening insolvency claim. *See Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168 (Del Ch. 2006), *aff'd*, 931 A.2d 438 (Del. 2007).

[2] A copy of the *Ario* decision, which is unpublished, is available on Schnader's webpage at the following URL: http://www.schnader.com//files//upload/Financial%20Litigation%20Alert.pdf

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As a result, Reliance was able to avoid regulatory scrutiny, which resulted in a $134 million underwriting loss. The Commissioner argued that these losses deepened Reliance's insolvency and sought to recover them as damages on his malpractice claim. *See id*. In response, Deloitte relied on *Seitz* to argue that deepening insolvency is not a theory of damages and, therefore, that the Commissioner could not establish damages on his malpractice claim by pointing to the underwriting losses. *See id*. at 10.

The Commonwealth Court first distinguished *Seitz* by pointing out that the accountants in *Seitz* prepared compiled financial statements, which do not require accountants to verify the financial data provided by their clients, while Deloitte prepared audited financial statements of Reliance, which do require such verification. *See id.* at 15. The court suggested that deepening insolvency damages may not be available where an accountant has prepared compiled, as opposed to audited, financial statements. *See id.* at 16. More broadly, though, the court declined to follow the Third Circuit's lead, concluding that, under the right circumstances, deepening insolvency can constitute a measure of damages. *See id.* at 17.

The Commonwealth Court analyzed *Lafferty* and *Seitz*, occasionally using language suggesting that it agreed with the Third Circuit's conclusion that deepening insolvency is a cause of action. For instance, the court wrote that "deepening insolvency allows for the *imposition of liability* upon those professionals who through the failure to perform their duties, plunge institutions into financial despair . . . ." *Id.* at 16 (emphasis added). However, after making such broad statements, the Commonwealth Court reached a seemingly contradictory holding: "where . . . the accountants have prepared an audited financial statement and the plaintiff has asserted independent causes of action, such as negligence, based upon the compiled [sic] financial statement, deepening insolvency damages are available." *Id* at 17. The court did not limit its holding to the factual scenario before it, however, announcing instead a much broader rule: "we conclude that while we do not recognize the deepening insolvency theory as an independent cause of action, if negligence is alleged and proven, the plaintiff may use the deepening insolvency matrix in calculating the damages caused by the defendant's negligence." *Id.* In other words, while the Third Circuit has concluded that deepening insolvency is a cause of action but not a measure of damages on an independent tort claim, the Commonwealth Court has come to the exact opposite conclusion.[3]

Until the Pennsylvania Supreme Court resolves the issue, application of the deepening insolvency doctrine will vary depending upon the court in which an action is litigated. Federal trial courts will continue to be bound by the holding of *Seitz* – that deepening insolvency is a cause of action, but not a measure of damages. State trial courts, on the other hand, may feel bound to follow *Ario*, which holds that deepening insolvency is a measure of damages, but not an independent cause of action.

Regardless of which holding ultimately prevails, financial services providers and others that work with clients that are insolvent or near insolvency should exercise extreme caution when assisting the client in a course of action that increases the client's debt. Whether pursued as a cause of action or a measure of damages, the deepening insolvency doctrine is a dangerous weapon in the arsenal of liquidators, receivers and bankruptcy trustees in search of a deep pocket. ◆

[3] The Commonwealth Court has scheduled oral argument on Deloitte's application for reargument for October 2, 2008.

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