Where Were the Accountants? Deepening Insolvency as a Means of Ensuring Accountants' Presence When Corporate Turmoil Materializes

Lauren Colasacco

Follow this and additional works at: https://ir.lawnet.fordham.edu/flr

Part of the Law Commons

Recommended Citation
Available at: https://ir.lawnet.fordham.edu/flr/vol78/iss2/11

This Article is brought to you for free and open access by FLASH: The Fordham Law Archive of Scholarship and History. It has been accepted for inclusion in Fordham Law Review by an authorized editor of FLASH: The Fordham Law Archive of Scholarship and History. For more information, please contact tmelnick@law.fordham.edu.
Where Were the Accountants? Deepening Insolvency as a Means of Ensuring Accountants' Presence When Corporate Turmoil Materializes

Cover Page Footnote
I would like to thank my inspiring and supportive advisor Professor Caroline Gentile and my tireless editor Jim Shea for their indispensable advice and guidance throughout the Note writing process. Also, I would like to thank my family and friends who provided me with invaluable encouragement.

This article is available in Fordham Law Review: https://ir.lawnet.fordham.edu/flr/vol78/iss2/11
NOTES

WHERE WERE THE ACCOUNTANTS?
DEEPENING INSOLVENCY AS A MEANS OF
ENSURING ACCOUNTANTS’ PRESENCE WHEN
CORPORATE TURMOIL MATERIALIZES

Lauren Colasacco*

Managerial fraud and corporate mismanagement are pervasive in today’s economic climate. Previously healthy corporations find themselves in economic turmoil and even in the throes of bankruptcy. Oftentimes these corporate failures can be prevented through responsible management and proper gatekeeping. Accountants, as vital intermediaries between corporations and the parties they do business with, ensure the credibility of corporate financial statements. This gatekeeping function cannot be underestimated. Accountants have the power to prevent corporations from taking on unnecessary debt via misstatements of corporate financial health. This Note proposes that the tort of deepening insolvency is a method of ensuring that accountants, by taking steps to prevent managerial fraud from bankrupting companies, will fulfill their gatekeeping role. Deepening insolvency will force accountants to use due care when certifying financial statements that will enable corporations to incur further debt, possibly to the detriment of the corporation. While deepening insolvency has been widely criticized by scholars and Delaware state courts, this tort is viable and necessary when brought by the trustee of a bankrupt corporation against its former, negligent accountant.

TABLE OF CONTENTS

INTRODUCTION.......................................................................................... 795
I. THE DUTIES, REGULATIONS, AND INTERPLAY OF MANAGERS AND
GATEKEEPERS IN CORPORATIONS.................................................. 799
   A. Insolvency.................................................................................... 799
      1. Equitable Insolvency.............................................................. 799
      2. Legal Insolvency................................................................. 800

* J.D. Candidate, 2010, Fordham University School of Law; B.A., 2007, Duke University. I would like to thank my inspiring and supportive advisor Professor Caroline Gentile and my tireless editor James Shea for their indispensable advice and guidance throughout the Note writing process. Also, I would like to thank my family and friends who provided me with invaluable encouragement.
III. DEEPENING INSOLVENCY: THE HISTORY AND CURRENT CONFLICT

A. The Development of Deepening Insolvency

1. General Definition

2. Cases Developing the Deepening Insolvency Claim

a. Bloor v. Dansker

b. Schacht v. Brown

c. Lafferty

d. CitX

e. Trenwick

B. The Four Conflicting Views on the Validity of Deepening Insolvency

1. Deepening Insolvency as an Independent Cause of Action
WHERE WERE THE ACCOUNTANTS?

2. Deepening Insolvency as a Theory of Damages .......... 833
3. Deepening Insolvency as Another Name for an Existing Tort ........................................................................ 835
4. Deepening Insolvency Is Not a Valid Cause of Action .... 835
C. Possible Characteristics of a Deepening Insolvency Claim .... 837
   1. The Harm ................................................................. 837
   2. The Possible Plaintiffs .............................................. 838
      a. The Debtor Corporation .............................................. 838
      b. The Creditors ......................................................... 839
   3. The Possible Defendants ........................................... 840
      a. Gatekeepers ............................................................. 840
      b. Directors and Officers .......................................... 842
      c. Lenders ................................................................ 843
   4. The Elements ......................................................... 843
   5. The Possible Defenses to Deepening Insolvency .......... 844
      a. In Pari Delicto ....................................................... 845
      b. Lack of Standing .................................................... 847
III. DEEPENING INSOLVENCY IS A VIABLE CAUSE OF ACTION AGAINST ACCOUNTANTS ........................................ 848
   A. Deepening Insolvency Is Valid as an Independent Cause of Action ......................................................... 848
   B. The Characteristics of a Successful Deepening Insolvency Claim Against Accountants ............................... 851
      1. The Debtor Corporation Is the Proper Plaintiff ........ 852
      2. Accountants Are the Proper Defendants ................. 852
         a. The Need for Increased Accountants' Liability ......... 852
         b. Heightened Liability Increases Reliability ............. 854
         c. The Causes of Action Currently Available Are Insufficient ................................................................. 854
            i. Professional Malpractice .................................. 855
            ii. Negligent Misrepresentation ............................ 855
            iii. Aiding and Abetting ...................................... 855
            iv. Fraud ............................................................... 856
      3. The Proper Elements to a Deepening Insolvency Claim ........ 856
      4. Overcoming the Applicable Defenses ......................... 859
         a. Standing and Privity Are Not at Issue .................... 859
         b. In Pari Delicto Does Not Apply ............................. 859

CONCLUSION ................................................................. 861

INTRODUCTION

Corporate fraud appears to be commonplace in our society, expected by a public made cynical by financial scandals that pervade newspaper headlines and corporate blogs. The problem of corporate fraud is so severe that there
is a federal task force devoted to its prevention.\textsuperscript{1} In 2002, President Bush created the Corporate Fraud Task Force to prosecute significant financial crimes and ensure the effective punishment of their perpetrators.\textsuperscript{2} The need for this task force arose from numerous, prominent corporate deceptions that robbed corporate employees, investors, and the public of hundreds of millions of dollars.\textsuperscript{3}

Since its birth, the Department of Justice, with the assistance of the Corporate Fraud Task Force, has obtained approximately 1300 corporate fraud convictions.\textsuperscript{4} Such a high number of corporate executives wrapped up in scandal leaves one wondering: where were the accountants? This Note offers a potential method of ensuring that auditors and accountants fulfill their gatekeeping role—to monitor, advise, and screen—and take steps to prevent managerial fraud from bankrupting companies.

In addition to prosecuting other frauds such as insider trading and options backdating, the Corporate Fraud Task Force has played a role in indicting and prosecuting accounting and financial fraud matters.\textsuperscript{5} One such scandal is the story of Refco, Inc., a commodities brokerage firm that covered up massive monetary losses and, in doing so, cost public investors more than two billion dollars.\textsuperscript{6} In 2005, Refco declared bankruptcy shortly after an employee noticed an abnormal interest payment made to the company on an outstanding loan.\textsuperscript{7} The abnormal interest payment was the result of an intricate scheme to conceal a debt owed by Refco as a debt owed to Refco.\textsuperscript{8}

Refco executives kept the company’s debts hidden for years from teams of accountants and auditors.\textsuperscript{9} Grant Thornton, Refco’s auditor, missed the signs of “book-cooking,” showing that current regulatory schemes of auditor liability are not working.\textsuperscript{10} An indictment against the private equity firm that controlled Refco, Thomas H. Lee Partners, stated that KPMG, the firm’s accounting advisor, “suggested an audit . . . would have uncovered

\begin{flushleft}
\textsuperscript{3} Id. at iii.
\textsuperscript{4} Id.
\textsuperscript{5} See id. at 1.10.
\textsuperscript{6} See id.
\textsuperscript{9} See Atlas & Glatner, supra note 7.
\end{flushleft}
the fraud."11 Further, the scandal occurred after legislative shake-ups in the world of finance and accounting regulation, such as the passage of the Sarbanes-Oxley Act of 2002 (SOX).12 Despite the increased costs associated with corporate fraud, Refco executives were not deterred.13

On July 3, 2008, Phillip R. Bennett, the former Chief Executive Officer and fifty percent owner of Refco, was sentenced to sixteen years in prison for his leadership of the fraud.14 Two other executives, including the Chief Financial Officer, Robert C. Trosten, and Tone N. Grant, a former owner, were also indicted for their involvement with the fraud.15 Cases against other parties, including lawyers and underwriters who had relationships with both Refco and Thomas H. Lee Partners, are still pending today.16

As evidenced by the Refco case and the multitude of convictions instigated by the Corporate Fraud Task Force, corporate executives are facing consequences for their actions. If, however, accounting professionals had a greater incentive to firmly regulate the actions of directors and officers, corporate fraud could be halted before the Corporate Fraud Task Force initiates an investigation. Given the state of the financial markets since 2008,17 increased liability for accountants could help alleviate unexpected financial distress and perhaps even bolster consumer confidence.

This Note shows that directors and officers make pivotal decisions for corporations in conjunction with their fiduciary duties. When directors and officers make decisions that, while detrimental for the corporation, do not explicitly breach their fiduciary duties, they are not often held liable. This gap in liability enables directors and officers to engage in undetected fraudulent behavior by way of, for example, manipulating earnings reports.

Accountants are equipped with the tools to stop fraud and prevent misleading earnings reports. An accountant may always report fraud to the appropriate authority or refuse to certify a financial statement if he or she feels it does not provide an accurate reflection of the worth of a corporation.18 But the incentive for action is lacking.19 Accountants will

---

not want to jeopardize important client relationships unless the consequence of inaction makes reporting more beneficial.\textsuperscript{20}

Deepening insolvency is a recently developed tort cause of action that could incentivize accountants to accurately report on the financial health of the corporations they audit. Under this theory a party can be held liable for negligently or fraudulently prolonging the life of a corporation, resulting in harm and increased debt to the corporation.\textsuperscript{21} In turn, if an accountant fails to stop fraudulent or negligent behavior that will result in deepened insolvency, he or she would be held liable for that inaction. However, deepening insolvency is not universally accepted as a valid cause of action and has been foreclosed in at least two states.\textsuperscript{22} This Note proposes that deepening insolvency should be a valid cause of action against accountants in order to reduce negligent or complicit accounting and to increase the reliability of corporate financial statements.

Part I of this Note explores the pertinent laws of corporations and the laws and regulations governing accountants. After an introduction to insolvency, this Part explores the duties that directors and officers owe to a corporation, including an analysis of how these duties may change as a corporation approaches insolvency. Next, Part I.C.1 introduces the concept of gatekeepers, such as accountants, as key players in the corporate world. Finally, Part I.C.2 explores the rules that govern accountants and ways to expose accountants, as gatekeepers, to liability in order to deter gatekeeper failure.

Part II of this Note presents the conflict concerning the existence and viability of the recently developed tort of deepening insolvency. Part II.A begins by outlining the history of the tort. Moving forward, Part II.B explores the four main views regarding the tort’s validity. Finally, Part II.C goes through the main arguments concerning each element of the deepening insolvency cause of action including the harm, possible plaintiffs, possible defendants, elements, and defenses.

Part III presents a novel solution to the conflict of whether or not deepening insolvency is a valid tort. This Note proposes that deepening insolvency, when brought by a debtor corporation against its accountant, is a viable and actionable tort that is not susceptible to the common defenses that defeat most deepening insolvency claims. This Note explains that deepening insolvency should be actionable against accountants because it will deter accountants from complying with fraudulent managerial practices.

\textsuperscript{20} See infra Part I.C.3.b.
\textsuperscript{21} See infra Part I.C.1.
<table>
<thead>
<tr>
<th>Page</th>
<th>Section</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009</td>
<td>WHERE WERE THE ACCOUNTANTS?</td>
<td>799</td>
</tr>
</tbody>
</table>

in corporations by exposing accountants to greater liability for harm resulting from that fraud.

I. THE DUTIES, REGULATIONS, AND INTERPLAY OF MANAGERS AND GATEKEEPERS IN CORPORATIONS

The tort of deepening insolvency may be a viable cause of action in instances where a corporation is harmed when the conduct of its directors, officers, or third-party professionals forces the corporation further into insolvency. Part I of this Note explores the concept of corporate insolvency and the roles of directors, officers, and third-party professionals as a corporation becomes insolvent. Part I builds the foundation for why deepening insolvency may be a viable cause of action, specifically against accountants.

Part I.A defines insolvency. Part I.B discusses the duties of directors and officers in corporations, how they make decisions, and the way in which they rely on the services of accountants.

Finally, Part I.C focuses on accountants, their responsibilities, and the laws by which they are governed. Part I.C.1 addresses the importance of liability for accountants due to their integral duties as gatekeepers. Part I.C.2 provides an overview of the laws and rules governing accountings, including the Sarbanes-Oxley Act, professional codes of conduct, and tort liability. Finally, Part I.C.3 shows that there is room and need for increased liability against accountants to promote the reliability of financial statements. This provides an appropriate channel for the introduction of the deepening insolvency cause of action against accountants.

A. Insolvency

This section provides a brief overview of the two definitions of insolvency. An understanding of the definition of insolvency is important to recognizing claims of deepening insolvency and to determining when such claims accrue.

1. Equitable Insolvency

There are two ways to define insolvency: financial (or commercial) insolvency and total (or legal) insolvency. Financial insolvency is also referred to as equitable insolvency. Equitable insolvency means that a business cannot procure the funds necessary to meet its presently accruing and overdue obligations. Under this definition of insolvency, there is still

23. See 1 Grant W. Newton, Bankruptcy and Insolvency Accounting: Practice and Procedure 41 (6th ed. 2000). This Note does not define when a company becomes insolvent and whether it is financially or totally insolvent. Instead, this is a matter to be determined by the court.

24. See id.

a chance that the company will survive, because it may overcome the
difficulties in obtaining the funds.26

2. Legal Insolvency

The second form of insolvency is total insolvency, more commonly
known as legal insolvency, which is the bankruptcy definition of
insolvency.27 Legal insolvency occurs when the value of the liabilities of
the company exceeds the value of its assets.28 In other words, “the fair
market value of the firm’s assets is less than its total liabilities.”29 At this
point, the company will probably not be able to regain strength or avoid
filing a bankruptcy that results in liquidation as opposed to reorganization.30

3. The Accountant’s Role in Documenting Insolvency

Insolvency does not occur suddenly or unexpectedly.31 A corporation’s
accountant plays an important role in the transition from solvency to
insolvency by detecting impending financial failure in the course of
working with management.32 For instance, accountants play critical roles
in those transactions that bring a company into insolvency—particularly
when it involves a large transaction such as a leveraged buyout.33
Furthermore, accountants, by preparing a company’s financial statements
and auditing the company, participate in the documentation of the financial
condition of the company as it becomes insolvent and contends with
declaring bankruptcy.34

B. Directors and Officers and Their Role in a Corporation

A corporation is controlled by directors and officers, who owe specific
duties to the corporation.35 These duties may change as a corporation

26. See 1 NEWTON, supra note 23, at 41.
27. See id.
2004).
29. A. Mechele Dickerson, A Behavioral Approach To Analyzing Corporate Failures,
38 WAKE FOREST L. REV. 1, 15 (2003). Along with total insolvency comes the inability to
pay due debts. See id. There are various accounting methods by which to calculate
insolvency, but these will not be explored in this Note, as the particular means of
determining insololvency are not relevant to its analysis.
30. See Alan Schwartz, A Normative Theory of Business Bankruptcy, 91 VA. L. REV.
1199, 1200–01 (2005) (explaining that financially and economically distressed firms are
liquidated piecemeal); see also 1 NEWTON, supra note 23, at 41.
31. See 1 NEWTON, supra note 23, at 39.
32. See id. at 60.
33. See, e.g., Wieboldt Stores, Inc. ex rel. Raleigh v. Schottenstein, 111 B.R. 162, 173
(Bankr. N.D. Ill. 1990) (deciding a case against accountants for their potentially negligent
preparation of financial statements for a tender offer and buyout).
2002) (analyzing whether an accountant used proper methodology when engaging in
business valuation).
35. See infra Part I.B.1–2.
moves from solvency to insolvency. Part I.B.1 discusses the general duties of a corporation's directors and officers when the corporation is solvent. Next, Part I.B.2 discusses how those duties may change as a corporation slides into insolvency. Additionally, Parts I.B.3 and I.B.4 explore how directors and officers make decisions, often with the help of gatekeepers. Since the vast majority of corporations are incorporated in Delaware, Delaware law governs much of the jurisprudence regarding directors' and officers' duties.36

1. General Corporate Law Principles

A corporation is treated as a person under the law, but it is actually an artificial legal creation whose functioning depends on the actions of its duly authorized directors, officers, and agents.37 Nevertheless, a corporation is capable of suing and being sued.38 The fundamental duty of a corporation is to maximize the value of equity to the shareholders of the corporation.39

As a general matter, directors and officers are fiduciaries of the corporation and owe three duties to a corporation: obedience, loyalty, and care (or diligence).40 The duty of obedience requires directors and officers to act within the powers delegated to them to run the corporation.41 Specifically, these fiduciaries must not exceed the scope of authority given to them in the corporation's certificate of incorporation and its bylaws.42


38. See, e.g., Ripalda v. Am. Operations Corp., 977 F.2d 1464, 1468 (D.C. Cir. 1992) (acknowledging a corporation’s capacity to sue and be sued and stating that this capacity is determined by state incorporation law).

39. See Andrew Gold, Sidney Swinson & Ivan Reich, In the Zone: Fiduciary Duties and the Slide Towards Insolvency, 5 DEPAUL BUS. & COM. L.J. 667, 667 (2007). The board of directors operates under the business judgment rule, which shields them from much liability. See infra notes 57–68 and accompanying text. Under the business judgment rule, prolonging a debtor’s corporate life is not necessarily a good thing. See Gold, Swinson & Reich, supra at 668; see also Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919) (noting that a business corporation’s primary function is to create a profit for its stockholders). But see Lynn A. Stout, Why We Should Stop Teaching Dodge v. Ford, 3 VA. L. & BUS. REV. 163 (2008) (explaining that there is not good legal authority for the proposition that a corporation exists merely to maximize shareholder wealth).

40. See JAMES D. COX & THOMAS LEE HAZEN, COX AND HAZEN ON CORPORATIONS 476 (2d ed. 2002); see also Arnold v. Soc'y for Sav. Bancorp, Inc., 678 A.2d 533, 539 (Del. 1996) (stating that fiduciary duties are owed by directors and officers to a corporation and its stockholders).

41. COX & HAZEN, supra note 40, at 476; see also WILLIAM T. ALLEN ET AL., COMMENTARIES AND CASES ON THE LAW OF BUSINESS ORGANIZATION 241 (2d ed. 2007).

42. See ALLEN ET AL., supra note 41, at 241.
a. The Duty of Loyalty

The duty of loyalty concerns the motives, purposes, and goals of the directors and officers. Loyalty requires that directors and officers act in good faith to advance the interests of the corporation. The duty of loyalty may be violated if the director or officer engages in self-dealing or conflict-of-interest transactions.

The standard of loyalty, however, for directors and officers is high. In addition, liability of directors and officers arises when there is willful dishonesty, mismanagement, and, at times, negligence. Delaware statutes allow corporations to limit the liability of directors and officers for certain fiduciary violations. Liability for breaches of the duty of loyalty, however, are never exempted or limited.

b. The Duty of Care and Diligence

To properly exercise their duty of diligence, directors and officers must act with reasonable care in managing the corporation. The duty of care that directors and officers owe to a corporation promotes conscientious corporate management. This duty is a standard of director and officer conduct. It has been referred to as a duty of "reasonable diligence." Directors and officers must use such care and diligence that an ordinarily

43. See Cox & Hazen, supra note 40, at 517.
44. See In re Gaylord Container Corp. S'holders Litig., 753 A.2d 462, 475–76 & n.41 (Del. Ch. 2000); see also Allen et al., supra note 41, at 241.
45. See Cox & Hazen, supra note 40, at 517. A director or officer can violate this duty in many other ways, including usurping a corporate opportunity, acting to protect his own personal interests, or not serving the interests of the corporation. See id. Further, a director or officer may not compete with the corporation or appropriate its property. See Allen et al., supra note 41, at 241.
46. See Cox & Hazen, supra note 40, at 478.
47. See id. at 479; see also Gagliardi v. Trifoods Int'l, Inc., 683 A.2d 1049, 1051 (Del. Ch. 1996) (stating that absent facts that show self-dealing or improper motive, a director or officer is not legally responsible for losses suffered as long as decisions were made in good faith). But see Brehm v. Eisner, 746 A.2d 244, 256 (Del. 2000) (noting that aspirations of ideal corporate governance do not define the standards of liability for directors and officers).
48. See Del. Code Ann. tit. 8, § 102(b)(7) (2001); see also Cox & Hazen, supra note 40, at 510. The limitation on liability only applies to monetary damages paid out by the director or officer. See id.
49. See Del. Code Ann. tit. 8, § 102(b)(7). Directors and officers may not be exempted from liability arising out of situations where the director breaches the duty of loyalty to the company, involves himself in intentional misconduct, or derives improper personal benefit from any transaction. Id.
50. See Bowerman v. Hamner, 250 U.S. 504, 510–13 (1919) (explaining the nebulous nature of the standard of the duty of care for fiduciaries); see also Cox & Hazen, supra note 40, at 476.
51. See Meyers v. Moody, 693 F.2d 1196, 1211 (5th Cir. 1982) (explaining that a director, as a fiduciary, is held to a higher standard of care than a nonfiduciary and must exercise reasonable business judgment); see also Cox & Hazen, supra note 40, at 480.
52. See Cox & Hazen, supra note 40, at 483.
53. Allen et al., supra note 41, at 242; see also Cox & Hazen, supra note 40, at 476 (explaining that directors must exercise reasonable care and prudence).
careful and prudent person would exercise in managing the affairs of the corporation in a similar situation. In the arena of the duty of care, Delaware law always allows corporations to limit the liability of directors and officers.

In cases involving an alleged breach of the fiduciary duty of diligence, courts defer heavily to the judgments of directors and officers. The so-called "business judgment rule" reflects this deference. The business judgment rule represents the standard that courts set for assessing directors' and officers' decision making.

The business judgment rule emphasizes that directors and officers are not liable for losses incurred by the company due to errors in judgment or imprudent business practices. The Supreme Court of Delaware has explained that courts generally do not measure or quantify the judgments of directors and officers; instead, courts look to see if a decision is made in good faith as a part of the business judgment test.

There are two main features of the business judgment rule: (1) directors are not liable for losses caused by their decisions; and (2) the court will not impose its judgment on the decision of the director. Courts following this rule do not review the practicality of contracts or transactions that directors and officers authorize. This is because the business judgment rule is based on the assumption that reasonable diligence and care are exercised by directors and officers. Therefore, as long as the directors and officers have not breached the duty of loyalty to the corporation, they will retain the protection of the business judgment rule.

In a solvent company, the business judgment rule governs judicial review of the conduct of officers and directors. The rule is designed to "encourage

---

54. See DePinto v. Provident Sec. Life Ins. Co., 374 F.2d 37, 43–44 (9th Cir. 1967); see also ALLEN ET AL., supra note 41, at 242; COX & HAZEN, supra note 40, at 491.
56. See COX & HAZEN, supra note 40, at 478–82 (describing the business judgment rule, which courts have designed in order to prevent the stifling of entrepreneurialship and encourage managerial risk taking while at the same time setting standards for the demands placed on directors and officers).
57. See COX & HAZEN, supra note 40, at 483.
58. See In re Reading Co., 711 F.2d 509, 517 (3d Cir. 1983) (noting that a court will not disturb the judgment of a director if it is attributable to a rational business purpose); see also ALLEN ET AL., supra note 41, at 245 (explaining that the business judgment rule is a fundamental protection against liability for simple errors in judgment); COX & HAZEN, supra note 40, at 482–83.
59. See Brehm v. Eisner, 746 A.2d 244, 264 (Del. 2000).
60. See COX & HAZEN, supra note 40, at 483–84.
61. See Bridgeport Holdings, Inc. v. Boyer (In re Bridgeport Holdings, Inc.), 388 B.R. 548, 569 (Bankr. D. Del. 2008) (stating that board decisions resulting in loss are reviewable under the business judgment rule only when directors make fully informed decisions); see also COX & HAZEN, supra note 40, at 484.
62. See Bridgeport Holdings, 388 B.R. at 567 (noting that in Delaware directors enjoy a presumption of honesty); see also COX & HAZEN, supra note 40, at 484.
63. See Bridgeport Holdings, 388 B.R. at 567 (noting that unless plaintiff can allege sufficient facts that defendant breached his fiduciary duties, the protections of the business judgment rule will not be overcome); see also COX & HAZEN, supra note 40, at 485.
directors to freely exercise their managerial discretion and to remove uncertainty from corporate transactions."\textsuperscript{64} This means that even though shareholders can sue a director or officer for making decisions that were harmful to a corporation, the "business judgment rule ensures that successful suits against directors will be rare."\textsuperscript{65}

Ultimately, in deciding whether directors or officers have acted negligently, courts show a healthy respect for the judgment of directors and officers as far as business matters go.\textsuperscript{66} In \textit{Gagliardi v. Trifoods International, Inc.},\textsuperscript{67} the Delaware Court of Chancery emphasized this standard, explaining that a party alleging that a corporation has suffered a loss due to a transaction authorized by a fiduciary acting in good faith does not state a claim for relief "no matter how foolish the investment may appear."\textsuperscript{68}

2. The Shift in Duties as a Corporation Moves from Solvency to Insolvency

The Delaware Court of Chancery has proffered that the duties of directors and officers shift to include the protection of creditors when a corporation enters the zone of insolvency.\textsuperscript{69} However, the changing duties of directors and officers when a company moves from solvency to insolvency remain unsettled.\textsuperscript{70} In a company that is financially stable, the directors and officers owe duties to the corporation and shareholders, while the rights of the creditors are limited.\textsuperscript{71}

\textsuperscript{64} Dickerson, \textit{supra} note 29, at 10.

\textsuperscript{65} \textit{Id.} at 11. If corporations cannot recover against managers for their flawed decisions because they are shielded by the business judgment rule, then enhancing accountant liability may be the next best thing. Accountant liability may discourage negligent or reckless accounting practices that enable risky managerial decision making.

\textsuperscript{66} See \textit{COX \& HAZEN, supra} note 40, at 487--88.

\textsuperscript{67} 683 A.2d 1049 (Del. Ch. 1996).

\textsuperscript{68} \textit{Id.} at 1052. Mistakes of poor judgment do not amount to legally significant allegations. See \textit{id.} at 1053.

\textsuperscript{69} See generally Credit Lyonnais Bank Nederland, N.V. v. Pathe Comme'ns Corp., No. 12150, 1991 WL 277613, at *3 (Del. Ch. Dec. 30, 1991) (stating that directors and officers might owe a duty to the corporate enterprise as a corporation enters the vicinity of insolvency).

\textsuperscript{70} See Michelle M. Harner, \textit{The Corporate Governance and Public Policy Implications of Activist Distressed Debt Investing}, 77 \textit{FORDHAM L. REV.} 703, 763--65 (2008) (explaining that when solvency is questionable the duties of directors and officers are less clear). The creditors' role in restructuring may change as the corporation's state of solvency changes, and it is not clear what standard of care the management must meet to satisfy its fiduciary obligations to the corporate body, including the creditors. See \textit{id.} at 765.

\textsuperscript{71} See \textit{COX \& HAZEN, supra} note 40, at 541. Shareholders may also be limited by their ability to bring a direct suit, due to a lack of standing. Additionally, shareholders may have difficulty enforcing directors' and officers' duties. See Stafford Invs. LLC v. Vito, Nos. 04-3182, 06-1112, 06-4424, 2008 WL 5062136, at *2 (E.D. Pa. Dec. 1, 2008) (stating that, under Pennsylvania law, only the corporation has standing to enforce the director's duties). Creditors' rights are limited because they only have rights based on contracts with their debtors and not based on fiduciary duties. See Richard A. Booth, \textit{The Duty to Creditors...}
Generally, when directors or officers are guilty of breaching a duty or are found to be negligent in dealing with corporate affairs, the right of action is granted to the corporation. In a solvent company, shareholders cannot bring such direct claims for individual losses they may have suffered as a result of a director’s breach of duty. At times, however, shareholders may bring derivative suits. Additionally, when a company is solvent, creditors cannot sue for losses suffered as a result of a director’s breach of a fiduciary duty.

Building upon the general duties owed to the corporation while it is solvent, the Delaware Court of Chancery expressed in Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp. that the duties of the directors and officers may expand or change when a company is acting in the zone of insolvency. Specifically, the court held that directors should manage a firm’s assets for the benefit of the corporate enterprise when the firm is in the zone of insolvency. The Credit Lyonnais court further stated that “where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residual risk bearers, but owes its duty to the corporate enterprise.” This language engendered a debate over whether or not the duties of directors and officers had been altered by the Delaware court.

The Delaware Court of Chancery attempted to clarify its statement in Credit Lyonnais in the later case, Production Resources Group, L.L.C. v. NCT Group, Inc. Here, the court explained that fiduciary duty claims brought by creditors are purely derivative in nature, and the injury is to the corporation itself. The court went on to state that the fact that a company


72. See Cox & Hazen, supra note 40, at 540. Such causes of action are transferred to the corporation’s trustee in bankruptcy if and when the corporation becomes insolvent. See id.

73. See id.


77. See id. at *34 n.55; see also Cox & Hazen, supra note 40, at 541. Credit Lyonnais has been modified by more recent decisions that seem to discount its holding that the fiduciary duties of directors expand to creditors while in the zone of insolvency. See, e.g., N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007); Prod. Res., 863 A.2d at 789–93.

78. See Credit Lyonnais, 1991 WL 277613, at *34.

79. Id.

80. See generally Symposium, Twilight in the Zone of Insolvency: Fiduciary Duty and Creditors of Troubled Companies, 1 J. BUS. & TECH. L. iii (2006) (collecting papers that focus on the trend towards imposing a fiduciary duty on a firm’s board of directors for the benefit of the firm’s creditors as a firm nears insolvency and on whether this trend is sound).

81. 863 A.2d 772 (Del. Ch. 2004).

82. See id. at 776.
has become insolvent "does not turn such claims into direct creditor
claims," but merely provides standing for the creditors to assert the claims
on behalf of the corporation.\textsuperscript{83} Also, creditors may assert derivative claims
against directors when a company is insolvent.\textsuperscript{84}

To further clarify the law on this point, the \textit{Production Resources} court
stated that the \textit{Credit Lyonnais} holding was odd and provided a protection
for directors from stockholders who would want them to engage in extreme
risk.\textsuperscript{85} In fact, the court commented that, because \textit{Credit Lyonnais}
focuses on protecting directors' business judgment, it is not plausible that directors'
duties "somehow change profoundly as the [corporation] approaches
insolvency."\textsuperscript{86} The court explained that reading \textit{Credit Lyonnais} to mean
that directors are liable to creditors for breaches of fiduciary duties in the
zone of insolvency is an overly expansive interpretation.\textsuperscript{87} The court
concluded by explaining that, once a firm has reached insolvency, the
directors and officers have a fiduciary duty to the company's creditors.\textsuperscript{88}
This, however, does not turn claims that accrue prior to insolvency—which
rightfully belong to the corporation—into claims that belong to the
creditors.\textsuperscript{89}

Finally, the Delaware Supreme Court, in its 2007 decision, \textit{North
American Catholic Educational Programming Foundation, Inc. v. Gheewalla},\textsuperscript{90}
clarified the Delaware position on directors' duties to
creditors as a corporation approaches insolvency. The court held that the
creditors of a Delaware corporation that is either insolvent or in the zone of
insolvency have "no right, as a matter of law, to assert direct claims for
breach of fiduciary duty" against directors and officers.\textsuperscript{91} In the zone of
insolvency, direct claims cannot be brought by creditors against directors
and officers for breach of fiduciary duties.\textsuperscript{92} The court noted that the focus
of directors while in the zone of insolvency remains the same and they must
exercise their business judgment for the benefit of the corporation.\textsuperscript{93} The
court maintains that creditors, once a company is insolvent, do attain

\begin{itemize}
\item \textsuperscript{83} \textit{See id.}\ The court further explains that the fact that the creditors often become the
residual claimants of a corporation when the corporation is insolvent does not mean that
claims the corporation rightfully owns should be expanded to the creditors. \textit{See id. at 777.}
When the company becomes insolvent, it means only that the creditor now has standing to
assert those claims against the directors on behalf of the corporation. \textit{See id.}
\item \textsuperscript{84} \textit{See id. at 789–90 n.56.}
\item \textsuperscript{85} \textit{See id. at 788–89.}
\item \textsuperscript{86} \textit{See id. at 788 n.52.}
\item \textsuperscript{87} \textit{See id. at 789.}
\item \textsuperscript{88} \textit{See id. at 790–91.}
\item \textsuperscript{89} \textit{See id. at 792.}
\item \textsuperscript{90} 930 A.2d 92 (Del. 2007).
\item \textsuperscript{91} \textit{See id. at 94.}
\item \textsuperscript{92} \textit{See id. at 99–101.} The court explained that directors owe fiduciary obligations to the
corporation and that the benefit of expanding this duty to creditors in the zone of insolvency
is significantly undermined by the liability that could arise for directors from direct claims
made by creditors. \textit{See id.; see also Hu & Westbrook, supra note 74 (discouraging a duty-
shifting doctrine for creditors' benefit).}
\item \textsuperscript{93} \textit{See N. Am. Catholic, 930 A.2d at 101.}
\end{itemize}
standing to bring derivative actions on behalf of the corporation for breach of directors' fiduciary duties.\textsuperscript{94}

While it seems that this area of law was settled by the Delaware Supreme Court's \textit{North American Catholic} decision, there remains much debate over creditors' rights in the zone of insolveney.\textsuperscript{95}

3. Directors and Officers as Corporate Decision Makers

Adherence to fiduciary duties is critical since directors and officers make business decisions for the corporations they serve. In making these decisions, there is reason to believe that these managers do not always act in the best interests of the corporation or its shareholders.\textsuperscript{96} To the extent the interests of the directors and officers conflict with those of the corporation and the shareholders, the directors and officers can be expected to pursue their own interests.\textsuperscript{97} Further, directors and officers have a tendency to underestimate risks and overestimate "their ability to save an insolvent or near insolvent firm."\textsuperscript{98}

Recent corporate scandals, such as the collapses of Enron Corporation\textsuperscript{99} and Parmalat SpA,\textsuperscript{100} evidence the likelihood that corporate managers will engage in "questionable business practices."\textsuperscript{101} In making decisions for the corporation, these managers often make flawed decisions or fail to act at all, which leads to a failure of the business.\textsuperscript{102} In fact, in a study of business failure, every accountant interviewed listed inefficient management as the

\textsuperscript{94} See id. at 101-02.


\textsuperscript{96} See Tomkins, supra note 37, at 1905.

\textsuperscript{97} See id.

\textsuperscript{98} Dickerson, supra note 29, at 1. \textit{But see} Gagliardi \textit{v. Trifoods Int'l}, Inc., 683 A.2d 1049, 1052 (Del. Ch. 1996) (arguing that directors and officers are more risk-averse than shareholders because their wealth is concentrated, whereas shareholders' wealth may be dispersed). Dickerson's approach, however, may be accurate because, as a corporation approaches bankruptcy, directors and officers stand to lose everything. See Dickerson, supra note 29, at 22-23.


\textsuperscript{100} For a description of the Parmalat collapse, see Eric Sylvers, \textit{Indictments Are Sought in the Collapse of Parmalat}, N.Y. TIMES, May 19, 2004, at W1.

\textsuperscript{101} Dickerson, supra note 29, at 2.

\textsuperscript{102} See 1 NEWTON, supra note 23, at 34.
However, while directors and officers are key decision makers for corporations, they rarely act without the guidance of third-party professionals.

4. Directors’ and Officers’ Reliance on Gatekeepers

In publicly held companies, managers run the show, and third-party professionals, such as accountants, both monitor and assist these managers. The financial statements prepared by accountants are the principal means of conveying a company’s resources and financial condition. Directors and officers take the financial condition of the company into consideration when deciding whether to take risks or proceed with caution. Further, accountants and auditors help assure that investors in the market receive reliable information about the target corporation.

Additionally, accountants and auditors play critical roles in proving whether or not a company is insolvent. The accountant’s financial statements will show if the company is legally solvent but has a temporary shortage of liquid assets or, on the other hand, if the company is legally insolvent but temporarily paying its debts. This information will be important in calculating the next steps for the company, as managers and directors rely on financial statements when making risk assessments and business strategies. Further, accountants can detect financial failure before it is imminent and highlight problems in a company, allowing remedial action to be taken.

C. Accountants as Gatekeepers: Protecting Financial Information

As described above, gatekeepers, and accountants in particular, play an integral role in corporate decision making. This part describes gatekeepers, their role in corporations, and the liability to which they are currently exposed. The focus is limited to accountants as gatekeepers. Part I.C.3 concludes with a discussion of why gatekeeper liability is necessary and how this liability promotes reliable financial statements when applied to accountants.

---

103. See id. at 35.
104. See Tomkins, supra note 37, at 1906. In these types of corporations, the third-party professionals play a larger role in reducing agency costs, which include, in addition to monitoring and bonding costs, residual loss. Id.
106. See id. at 17–22.
108. See 1 NEWTON, supra note 23, at 116.
109. See id. at 118.
110. See id. at 60.
1. Gatekeepers and Gatekeeper Theory

Gatekeepers are “independent professionals who are interposed between investors and managers in order to play a watchdog role that reduces the agency costs of corporate governance.” Gatekeepers function as reputational intermediaries that provide verification and certification services to investors who are interested in working with corporations. Essentially, the “professional gatekeeper . . . vouches for the corporate client’s own statements about itself.” Because third-party professionals render services that are necessary to the perpetration of “insider wrongdoing,” they are natural gatekeepers; these professionals can prevent wrongdoing by refusing to cooperate with wrongdoers or by refusing information to fraudulent insiders. They include lawyers, accountants, auditors, and other consultants who work with corporate decision makers and aid them in making decisions.

a. The Importance of Accountants as Gatekeepers

Gatekeepers, accountants in particular, are vital intermediaries between corporations and the parties with whom corporations do business. Financial information is useful to investors, creditors, employees, and taxing and antitrust authorities. Financial statements are crucial when companies raise capital and make new investments because accurate information is necessary for sound investing. This importance extends to investors in the market; it is essential that companies represent their worth accurately to the market so that stock prices reflect reliable information for investors. When prices are accurate, capital can be put to its best use.

Despite this goal, boards of directors, in recent years, have been passive about accurate financial reporting in order to “drive capitalization” and accrue greater profits in their business endeavors. Further, managerial
control over financial statements can result in manipulation of the truth.\textsuperscript{121} Auditors and accountants may be able to prevent such manipulation by checking these managerial practices.\textsuperscript{122}

In addition, accountants in particular play an important role in assisting management as a company finds itself in financial difficulty.\textsuperscript{123} Accountants are able to recognize signs of financial struggle well before a company needs to declare bankruptcy and should work with management to make the best decisions possible for the company to avoid insolvency.\textsuperscript{124} Additionally, accurate financial statements are critical for lenders and investors (who could assist a company in rebuilding its capital), allowing them to assess the risks involved in investing in the company.\textsuperscript{125}

b. Consequences of Gatekeeper Failure

Gatekeeper liability is essential because financial information is only useful if it is accurate and prepared according to verifiable standards.\textsuperscript{126} Gatekeeper liability can be described as “liability imposed on private parties who are able to disrupt misconduct by withholding their cooperation from wrongdoers.”\textsuperscript{127} The caveat is that accountants and auditors want to “make [their] client happy.”\textsuperscript{128} Due to the need to serve their clients, professional gatekeepers may fail because they “acquiesce in managerial fraud, even though the apparent reputational losses seem to dwarf the gains to be made from the individual client.”\textsuperscript{129}

tension that exists for corporate managers who want to remain secretive about their company’s financial records but must disclose financial information in order to attract investors. See \textit{Litan & Wallison}, supra note 117, at 15. Corporations must employ accountants to audit their financials and attest to the accuracy and reliability of these statements in order to provide assurance to outside investors and lenders. See id.

121. See \textit{Benston}, supra note 105, at 34–35. When reporting net income, for example, management has to make assumptions and judgments enabling them to affect the report. See \textit{id.} at 34. Further, managers can plan when to report and engage in transactions to alter the reported revenue and expenses of the company. See \textit{id.} at 35. Generally Accepted Accounting Principles (GAAP) are one of the mitigating factors in managerial manipulation of financial reports, but there are still ways to create manipulated financial statements that are seemingly in accordance with GAAP standards. See \textit{id.} at 35–36.


123. See supra Part I.B.4.

124. See 1 \textit{Newton}, supra note 23, at 60.

125. See \textit{Litan \& Wallison}, supra note 117, at 14. Investors need accounting professionals and auditors to attest to the accuracy of a corporation’s financial statements so that they may confidently finance a business venture with the company. See \textit{id.} at 15.

126. See \textit{id.} at 14.


This leaves auditors and accountants, who should be diligently checking companies’ books, trapped in a scheme whereby they could “make more money through consulting than through auditing,” so they enter into cahoots with directors and officers.\(^{130}\)

The downfall of Enron is an important example of gatekeeper failure because it was one of the first major publicized corporate collapses.\(^{131}\) Enron “furnish[es] ample evidence of a systematic governance failure.”\(^{132}\) Behind the Enron disaster is the fact that the company and its creditors could not rely on professional gatekeepers, including auditors, whose role was to verify and assess financial information.\(^{133}\)

In the Enron failure, auditors and accountants were a piece of the puzzle because their flexible accounting practices enabled Enron to take advantage of financial accounting laws and craft financial statements that did not reflect the risk exposure of Enron’s investors or the true earning amount of the company.\(^{134}\) The directors and officers of Enron were able to get away with this creative financial scheme because many conflicts of interest were present among the members of the board of directors.\(^{135}\) The board’s audit committee was akin to a “closely connected community” with conflicts that made it difficult for board members to raise issues.\(^{136}\) Further, the board “did not have full information from the management” about the nature of the company’s transactions.\(^{137}\)

Since Enron’s board of directors was unable to stop fraud from occurring, it was the responsibility of the accountants to make sure the

---

\(^{130}\) Hearing, supra note 120, at 4. It is important to note that the Sarbanes-Oxley Act of 2002 (SOX) required accountants to separate their auditing and accounting businesses in an effort to control this problem. See infra Part I.C.2.a.

\(^{131}\) The Parmalat scandal also exemplifies gatekeeper failure. See generally Claudio Storelli, Corporate Governance Failures—Is Parmalat Europe’s Enron?, 2005 COLUM. BUS. L. REV. 765. Parmalat engaged in almost scientific book-cooking. See id. at 782. Further, Parmalat’s management would have had to deceive both the internal and external auditors and analysts to get away with its scheme, evidencing that the scheme should not have gone undetected for so long. See id. at 804–05.

\(^{132}\) Coffee, Gatekeepers, Stupid, supra note 107, at 1404.

\(^{133}\) See id. at 1404–05.

\(^{134}\) See Alexei Barrionuevo, Warning on Enron Recounted, N.Y. TIMES, March 16, 2006, at C1 (describing the dangerous off-the-books scheme Enron engaged in to disguise its financial condition); see also Marianne M. Jennings, A Primer on Enron: Lessons from a Perfect Storm of Financial Reporting, Corporate Governance and Ethical Culture Failures, 39 CAL. W. L. REV. 163, 174–75 (2003). Jennings explains that it would take someone who had great expertise and performed significant research to understand the totality of Enron’s financial situation. See id. at 173–74. Further, the financials provided were technically not violating any laws. See id.

\(^{135}\) See Storelli, supra note 131, at 807 (explaining that Enron’s board failure stemmed from a hesitation of directors to second-guess decisions); see also Jennings, supra note 134, at 201.

\(^{136}\) See Jennings, supra note 134, at 201; see also Charles M. Elson, Enron and the Necessity of the Objective Proximate Monitor, 89 CORNELL L. REV. 496, 499–500 (2004) (noting that the Enron board failed because it lacked independence). The weak board trusted that its auditor acted according to accounting standards despite the fact that it was employing aggressive accounting tactics. See Jennings, supra note 134, at 207.

\(^{137}\) Jennings, supra note 134, at 208.
financials were accurate. The auditors were independent outsiders who were charged with detecting Enron's questionable financials and business structure.138 Had the auditors provided sound and clear financial statements, the board may have been able to stop the management from pushing the company further into trouble. They were the last line of defense for the corporation, its creditors, and shareholders.

In Enron's case, however, the weak board was paired with complicit auditors who could have stopped the scheme but did not.139 In order for Enron to have survived as long as it did, the "auditors had to buy into aggressive accounting."140 The Enron disaster lends support to those who assert the need for increased liability of accountants, which may deter future complicit accounting. Enron shows that active and diligent accounting is necessary to prevent managerial fraud.

2. Laws and Rules Governing Accountants

Since accountants play such a crucial role in preventing managerial fraud in corporations, it is important to assess the liability that accountants currently face. This section outlines the securities laws, the professional codes of conduct, and the tort claims that regulate the accounting profession.

a. The Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act of 2002 addresses financial behavior in the context of corporate and financial services.141 The purpose of SOX is to "protect investors by improving the accuracy and reliability of corporate disclosures made pursuant to the securities laws and for other purposes."142 SOX was passed in light of infamous corporate scandals, namely Enron Corporation and other scandals that had a large negative impact on both

138. See Elson, supra note 136, at 500–01 (explaining the role of Arthur Andersen LLP, Enron's auditor); see also Jennings, supra note 134, at 213.
139. See Storelli, supra note 131, at 808 (explaining that Arthur Andersen LLP, Enron's external auditor, used lax accounting standards to conceal Enron's financial transactions); see also Jennings, supra note 134, at 213. The auditors did not even raise any questions to alert the public to the financial schemes going on within Enron. See id. This could be considered accountant negligence. See infra Part I.C.2.c. It is possible that since no consequences would arise for the accountants due to low accountability, accountant complicity may have been encouraged.
American and global financial markets.\textsuperscript{143} The legislative hearings prior to the passage of SOX show concerns about the state of corporate America. The committee members spoke of the incentive in corporate America to manipulate earnings and overemphasize revenue, among other things.\textsuperscript{144}

In an effort to limit these problems, much of SOX is directed at two purposes: (1) cutting back on creative accounting practices employed in financial statements and (2) increasing corporate responsibility for financial statements by placing more requirements on executive officers.\textsuperscript{145} The committee responsible for SOX proposed that "meaningful oversight of the audit profession" could help solve the corporate downturn.\textsuperscript{146}

The committee emphasized that financial statements belong to the shareholder and that they should reflect the "accurate financial condition of the corporation."\textsuperscript{147} Further SOX emphasizes that there must be "independence in the preparation of [the] audit statement" in order to prevent management from scheming with auditors and accountants.\textsuperscript{148}

i. SOX and Accountants

SOX first created the Public Company Accounting Oversight Board (PCAOB), which was established to oversee the auditing of public companies that are subject to securities laws.\textsuperscript{149} Section 101 of SOX specifies the duties of this board, which include registering public accounting firms; establishing standards governing auditing, independence, and quality; conducting inspections of accounting firms to ensure compliance with the rules and regulations of the Securities and Exchange Commission (SEC); and investigating and disciplining auditors and accountants who are not in compliance.\textsuperscript{150}

There are many additional ways SOX seeks to make accountants stronger and more reliable gatekeepers and to improve the reliability of financial disclosures. For example, SOX limits the ability for auditors to engage in consulting services.\textsuperscript{151} Additionally, SOX clarifies that the audit committee within a company is the group that works directly with the outside auditors.

\begin{itemize}
  \item 144. See \textit{Hearing, supra} note 120, at 4.
  \item 146. \textit{Hearing, supra} note 120, at 6.
  \item 147. \textit{Id. at} 8.
  \item 148. \textit{Id.}
  \item 151. See \textit{Sarbanes-Oxley Act of 2002 §§ 201–09, 15 U.S.C. §§ 7231–34; see also BAINBRIDGE, supra} note 149, at 191. Bainbridge explains that an auditor may not provide bookkeeping or design or implement financial information systems for the corporations they audit, as this may compromise auditor independence, while some nonaudit services are still allowed. \textit{See id.} at 191–92.
\end{itemize}
as opposed to management. The rationale for many of these specific provisions is SOX’s insistence on auditor independence.

ii. Section 302 of SOX

Additionally, SOX strengthens the requirements on directors and officers to assure accurate financial reporting. Section 302 of SOX makes corporate financial statements more reliable by requiring the Chief Executive Officer (CEO) and Chief Financial Officer (CFO) of a corporation to certify them. Section 302 of SOX states that CEOs and CFOs are required to personally execute certifications of their company’s financial reports. Further, CEOs and CFOs may be exposed to civil sanctions and criminal penalties for certifying statements with knowledge of any falsity. This requirement also existed under the Securities Exchange Act, but the Sarbanes-Oxley Act heightened corporate responsibility.

Section 302 requires certification of the following: (1) the officer has reviewed the report being filed; (2) based on the officer’s knowledge, there are no untrue statements of material fact or material omissions; (3) based on the officer’s knowledge, the financial statements and other information fairly present in all material aspects the financial condition of the issuer for the periods presented; (4) the officers are responsible for establishing and maintaining controls; (5) the officers have designed such internal controls to ensure that material information is made known to such officers; (6) the officers have evaluated the effectiveness of the corporation’s internal controls within ninety days of the report; (7) the officers have presented their conclusions about internal control effectiveness as of the date of evaluation in the report; (8) the officers have disclosed to the corporation’s auditors and audit committee all significant deficiencies in internal controls and identified any material weaknesses in internal controls; (9) the officers have disclosed to the corporation’s auditors all significant deficiencies in internal controls and any fraud, material or not, involving management or other employees significant to the internal controls; and, finally, (10) the officers have indicated in the report whether any significant changes in internal controls have occurred subsequent to the evaluation date.

Further, the CEO and CFO must personally sign the statement and cannot delegate this duty to another party. The CEO and CFO are therefore responsible for the financial report itself and for the internal controls of the

152. See Bainbridge, supra note 149, at 193.
153. See id. at 197.
154. See id. at 75–76.
157. See Alverson, supra note 143, at 17. Briefly, section 302 reflects existing securities laws that corporate officers cannot make material misrepresentations. See id. Section 302 creates a certification requirement that officers have not made fraudulent misstatements, which was already illegal under the Securities Exchange Act of 1934. See id.
159. See id.
Importantly, these certifications are based on the officers' knowledge. This knowledge includes only that which a reasonable officer could know.

Further, the SEC has explained that when SOX qualifies financial statements by saying they must "fairly present[] in all material respects" the corporation's financial condition, the representation is not limited by Generally Accepted Accounting Principles (GAAP). The certification is intended to speak to a "standard of overall material accuracy and completeness that is broader than financial reporting requirements" under GAAP.

The certification required by section 302 of SOX is designed to require CEOs and CFOs to attest to an "amorphous concept of overall fairness and completeness that has no definitive boundaries" in the corporation's financial reports. Section 302 does not, however, alter the liability scheme for false statements in financial reports that existed prior to the enactment of SOX. SOX merely increases corporate responsibility for financial statements. In addition to the protections imposed by SOX, financial statements are also verifiable since accountants must abide by professional codes of conduct.

b. Professional Codes of Conduct

Accountants and auditors make up a professional body and are governed by standards embodied in professional codes of conduct. The American Institute of Certified Public Accountants (AICPA) is a national professional organization that assists accountants in providing services to benefit the public and their clients. One objective of the AICPA is to establish professional standards and assist accountants and auditors in "continually improving their professional conduct, performance and expertise" as well as to monitor accountants' performance "to enforce current standards and requirements."

The AICPA authorizes the promulgation of GAAP standards by various bodies, including the Auditing Standards Board (ASB) and the Financial

---

160. See Alverson, supra note 143, at 20–21.
162. See Alverson, supra note 143, at 17.
163. See id. at 22. For a discussion of GAAP standards, see infra Part I.C.2.b.
165. See Alverson, supra note 143, at 22.
166. See id.
168. Id.
169. For more information on this organization see AICPA, Audit and Attest Standards, http://www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/ (last visited Oct. 18, 2009).
Accounting Standards Board (FASB). GAAP comprises the standards on which corporations base their financial statements. These standards permit market participants, including shareholders and creditors, to assess the profits and financial health of different companies. In general, there is "[n]o definitive list of accounting principles." Rather, auditors must have sound knowledge of accounting theory and keep abreast of recent AICPA, FASB, and ASB releases and pronouncements of GAAP and Generally Accepted Accounting Standards (GAAS). Principles developed by the FASB provide standards of accounting that help those in the market to assess the profits and financial health of different companies.

When completing audits, as opposed to simple accountings, accountants must conduct them in compliance with GAAS, which means that the examination must be performed with professional competence by a properly trained professional. Generally, the standard for all accountants' work product is that of the prudent person: the standard is met if other competent auditors or accountants would reach the same conclusion given the specific circumstances.

Further, accountants must be aware of indications that abnormal events are taking place at the corporations they audit, as there is always the opportunity for managerial manipulation of financial reports. In cases of insolvency and bankruptcy, accountants' past records and current audits are particularly important as they are the predominant source of information for any party interested in the debtor's operations and financial dealings.

c. Tort Liability

In addition to the general practice standards and federal securities regulations that accountants must comply with, accountants may also be subject to tort and contract liability. This part uses the Restatement (Second) of Torts as well as case law from New York and Delaware to demonstrate the availability of tort remedies against accountants.

171. See LITAN & WALLISON, supra note 117, at 4.
172. See id. at 3.
173. See 1 NEWTON, supra note 23, at 521.
174. See id.
175. See LITAN & WALLISON, supra note 117, at 3.
176. See 1 NEWTON, supra note 23, at 520.
177. See id.
178. See id. at 490. Irregularities of which accountants should be aware include fraudulent transfers, transactions with parties related to the corporation such as insiders or relatives, and concealment of assets. See id. at 491.
179. See id. at 593.
i. Prerequisites for Tort Liability

Two considerations must be satisfied in order for a plaintiff to bring a successful claim against an accountant: privity and standing. The presence (or absence) of privity with accountants is important for determining which parties may bring a cause of action against them. In a bankruptcy proceeding, state law determines who has the right to sue: the debtor or the creditor. The trustee in bankruptcy always stands in the shoes of the debtor corporation and can file only those claims that the corporation itself could have filed. Further, a bankruptcy trustee may generally only assert claims on behalf of the bankrupt corporation itself—not on behalf of creditors. This rule varies, however, from state to state.

ii. Professional Malpractice

There are numerous torts a plaintiff can bring against an accountant: (1) professional malpractice; (2) negligent misrepresentation; (3) aiding and abetting; and (4) fraud. First, accountants may be liable for a claim of professional malpractice. Professional malpractice is a negligence cause of action whereby an accountant is held liable for the invasion of a legal interest caused by the accountant's negligent conduct. Like all

180. See infra notes 181–84.
181. See, e.g., Ultramares Corp. v. Touche, 174 N.E. 441, 446–48 (N.Y. 1931) (holding that an accountant cannot be held liable to a relying investor or shareholder if said accountant was not in privity with that party and did not meet additional conditions); see also, e.g., Credit Alliance Corp. v. Arthur Andersen & Co., 65 N.Y.2d 536, 545–46, 553 (1985) (reaffirming the holding of Ultramares Corp. v. Touche where a creditor claimed it relied on a negligently prepared financial statement). The Restatement (Second) of Torts, section 552, however, allows actions where there is no privity if the accountant has committed negligent misrepresentation. RESTATAMENT (SECOND) OF TORTS § 552 (1977). Further, states such as New Jersey reject the Ultramares doctrine. See H. Rosenblum, Inc. v. Adler, 461 A.2d 138, 145 (N.J. 1983) (holding that a lack of privity does not bar an action against an accountant because, absent relevant policy considerations, the reasonably foreseeable consequences of a negligent act should be actionable); see also Petrillo v. Bachenberg, 655 A.2d 1354, 1357–58 (N.J. 1995) (summarizing the relaxed privity standard in New Jersey and other jurisdictions). This debate is not important for the analysis in this Note, because the cause of action related to deepening insolvency will reside in the corporation as a whole, and the corporation is necessarily in privity with the accountant preparing the corporation's financial statements.
182. See 11 U.S.C. § 544(a)–(b) (2006) (explaining that the trustee generally assumes all the rights and privileges of the debtor, so would have standing to pursue claims on the debtor's behalf).
184. See Allou, 387 B.R. at 387 (citing Shearson Lehman Hutton Inc. v. Wagoner, 944 F.2d 114, 118 (2d Cir. 1991)).
185. In the majority of cases, the trustee in bankruptcy brings claims on behalf of the corporation under state law. See Raleigh v. Ill. Dep’t of Revenue, 530 U.S. 15, 20 (2000).
186. RESTATEMENT (SECOND) OF TORTS § 281 (1965). The Restatement (Second) of Torts lists these four elements of a negligence cause of action: (1) "the interest invaded is
professionals, accountants are held to a standard of care that dictates that they must "exercise the skill and knowledge normally possessed by members of that profession . . . in good standing in similar communities."187

The comments to the Restatement explain that the term "skill" means competence that is the result of acquired learning, special training, and experience.188 Essentially, when an accountant causes harm to someone he had a duty not to harm, and he is judged to have failed to satisfy the standard of care of most accountants in his community, he will be found liable for professional negligence.

Under New York law, an accountant may be held liable for professional malpractice.189 Accountants may be liable for negligence, bad faith, or dishonesty, but not for mere fallibility.190 Because accountants are known as skilled professionals, they are subject to liability in the practice of their profession.191 Accountants must exercise reasonable care and competence and adhere to accepted professional standards.192

iii. Negligent Misrepresentation

The Restatement explains that if an accountant supplies false information in the course of business for the guidance of others in a business transaction, she is subject to liability for the pecuniary loss caused due to justifiable reliance on the information.193 In order for liability to attach, the accountant must fail to exercise reasonable care or competence in either obtaining or communicating the information.194 Only those for whom the accountant intended to supply the information, and who use the information in a transaction for which the accountant intended the information to be used, may recover against the accountant for negligent misrepresentation.195 Further, the loss suffered must be caused through reliance upon the information.196

The comments to this rule explain, however, that when the harm results only in pecuniary loss, as often it does with misrepresentation of financial information, courts apply a more limited and restrictive view of

---

187. Id. § 299A. The comments explicitly state that this section applies to accountants. See id. § 299A cmt. b.
188. Id. § 299A cmt. a.
190. See id. at 821.
192. See id. at 506.
194. See id.
195. See id.
196. See id.
liability. The standard applied in negligent misrepresentation requires that the users of information supplied in commercial transactions be able to rely on the fact that statements are made honestly and in good faith.

Under New York law, a plaintiff can claim negligent misrepresentation only by pleading the following elements: (1) the defendant had a duty resulting from a special relationship; (2) the defendant made a false representation that he knew or should have known was incorrect; (3) the defendant knew the plaintiff would use the supplied information for a serious purpose; and (4) the plaintiff intended to and did rely upon the information to her detriment.

iv. Aiding and Abetting

Accountants may also be liable for aiding and abetting directors and officers. In order to state a claim for aiding and abetting, a plaintiff must show that the accountant knowingly assisted in defrauding investors. Generally, these claims require statutory authorization in the jurisdiction in which they are brought.

The Restatement explains that aiding and abetting liability may result from persons acting in concert with, or directing or permitting, the fraudulent conduct of another. An accountant could be liable for harm resulting from another’s tortious conduct in the following circumstances: (1) the accountant engages in the tortious conduct in concert with the other person pursuant to a common scheme; (2) he knows that the other person’s conduct constitutes a breach of duty and substantially assists or encourages the conduct; or (3) he substantially assists another in accomplishing a tortious result and his conduct is, independently, a breach of duty. The comment notes that an agreement to act in concert need not be express.

In addition to liability for aiding and abetting, in which case the accountant himself takes part in the tortious conduct, an accountant may also be liable for directing or permitting the conduct of another. Such liability arises in three situations. First, it may arise where an accountant orders or induces the conduct of another and knows or should know it is

197. See id. § 552 cmt. a. Such liability is even more restricted than liability for fraudulent misrepresentation, since there is no intent to deceive. See id.
198. See id. § 552 cmt. a.
199. See Hydro Investors Inc. v. Trafalgar Power Inc., 227 F. 3d 8, 20–21 (2d Cir. 2000).
201. See, e.g., Koutsoubos v. Casanave, 816 F. Supp. 472, 475–76 (N.D. Ill. 1993) (dismissing an aiding and abetting claim because it was not recognized by Illinois law, the governing law in the cause of action).
203. See id. § 876.
204. See id. § 876 cmt. a.
205. See id. § 877.
tortious. Second, it may arise where an accountant permits another to act upon his premises or with his instrumentalities while knowing or having reason to know that the other is acting or will act tortiously. Third, liability may arise where an accountant fails to exercise control over the conduct of another person whom he has a duty to control when that person is likely to do harm if not controlled.

Under Delaware law, to make a claim for aiding and abetting a fraud, a plaintiff must show (1) the existence of the underlying fraud, (2) the defendant’s knowledge of the fraud, and (3) the defendant’s substantial assistance to the fraud.

The recent U.S. Supreme Court case *Stoneridge Investment Partners v. Scientific-Atlanta, Inc.* reconsiders the availability of aiding and abetting liability under Rule 10b-5. The court held that shareholders could not bring derivative actions against third parties for aiding and abetting a Rule 10b-5 violation. The court eliminated such liability because a party can only be liable under Rule 10b-5 if he made a relied-upon material misstatement. The court explained that aiding and abetting liability would defeat the intention of the statute.

v. Fraud

In general, to state a claim for fraud, a plaintiff must plead (1) a false statement of a material fact, (2) knowledge or belief of the falsity by the party making it, (3) intention to induce the other party to act, (4) action in reliance on the truth of the statement, and (5) resulting damage.

The Restatement explains that an accountant may be liable for fraud if she fraudulently makes a misrepresentation of fact, opinion, intention, or law in order to induce or prevent another from acting in reliance on the statement. In general, an accountant who makes a fraudulent misrepresentation is subject to liability for the pecuniary losses caused by the justifiable reliance of those people she intended, or reasonably expected,

---

206. *Id.* § 877(a).
207. *Id.* § 877(c).
208. *Id.* § 877(d).
211. *Id.* at 768–73.
212. See *id.* at 772. This holding implies that an accountant cannot be held liable for aiding and abetting a corporate officer engaging in fraud who is charged under section 10b-5.
213. See *id.* at 776.
214. See *id.* at 771.
216. See *RESTATEMENT (SECOND) OF TORTS* § 525 (1977). The Restatement goes on to explain that a party is liable for pecuniary loss of the injured party based on the justifiable reliance by the injured party on the misrepresentation. See *id.*
to rely on the statement.\textsuperscript{217} The Restatement further explains that a plaintiff can only recover if he relies on the misrepresentation in acting, or refraining from acting, and if such reliance is justifiable.\textsuperscript{218} Importantly, the circumstances of fraud must be pled with particularity.\textsuperscript{219}

Finally, Rule 10b-5,\textsuperscript{220} promulgated under the Securities Exchange Act of 1934,\textsuperscript{221} serves as an analogical cause of action for fraud. The purpose of Rule 10b-5 is to deter and punish fraudulent statements made by or for corporations. In relevant part, Rule 10b-5 provides, “It shall be unlawful for any person, directly or indirectly . . . [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading . . . .”\textsuperscript{222} In order to successfully pursue a claim under Rule 10b-5, the SEC must show that the defendant made a material misrepresentation or a material omission as to which he had a duty to disclose in connection with the purchase or sale of securities.\textsuperscript{223} Similarly, to recover under Rule 10b-5, a private plaintiff must plead and prove (1) the defendant’s material misrepresentation or omission, (2) defendant’s scienter, (3) a connection between the misrepresentation or omission and the purchase or sale of a security, (4) reliance, (5) economic loss, and (6) causation.\textsuperscript{224}

3. Theories of Gatekeeper Liability

Although there are many viable causes of action available against accountants, as reviewed above, they often fail to prevent bad behavior. Accountants still comply with managerial fraud, allowing unreliable financial statements to enter the market. Leading scholar and professor John C. Coffee explains that increased gatekeeper liability is a way to prevent harm. Coffee explains, however, that gatekeepers fail for two main reasons: the presence of a market bubble and a lack of general deterrence.\textsuperscript{225}

\textsuperscript{217} See id. § 531. The loss must be suffered in the type of transaction in which the information would be expected to be used and the conduct of the reliant party influenced. See id.

\textsuperscript{218} See id.

\textsuperscript{219} FED. R. CIV. P. 9(b).

\textsuperscript{220} 17 C.F.R. § 240.10b-5 (2009).

\textsuperscript{221} 17 C.F.R. § 240.0-1 to .36a1-2.

\textsuperscript{222} 17 C.F.R. § 240.10b-5.

\textsuperscript{223} See U.S. S.E.C. v. Dunn, 587 F. Supp. 2d 486, 498–99 (S.D.N.Y. 2008) (quoting S.E.C. v. Monarch Funding Corp., 192 F.3d 295, 308 (2d Cir. 1999)). Because scienter is required in 10b-5 and fraud actions, plaintiffs are unlikely to make a successful claim. Further, certification of financial statements, as per the Sarbanes-Oxley Act, does not provide scienter. This may leave room for a negligence cause of action against accountants as a second option for recovery.


\textsuperscript{225} See generally Coffee, Gatekeepers, Stupid, supra note 107.
a. The Bubble Effect

Coffee suggests that, when the market is in a euphoric state, gatekeepers became temporarily irrelevant. Specifically, he argues that auditors and accountants are seemingly only important to investors when they are acting very cautiously. In a market bubble, this "caution and skepticism are largely abandoned" and auditors and accountants are viewed as unnecessary. To bolster their income during these periods, auditors and accountants seek consulting business, putting their long-term reputations on hold. This can create a dangerous environment if accountants are not fulfilling their gatekeeping role by checking the statements of directors and officers.

b. Deterrence Theory

Despite the fact that accountants may put their reputations aside to profit in a market bubble, they also have a "great deal to lose if their wrongdoing is detected." When there is a low level of accountant liability, there is a "decline in the expected liability costs" that comes with acquiescence to aggressive accounting policies proffered by corporate management. When the risk of auditor liability is decreased, and the benefits of acquiescence to aggressive corporate strategies are increased, reliability of accountants and their statements greatly drops.

Deterrence theory explains that there will be an increased rate of gatekeeper failure if litigation risks faced by accountants diminish while the benefits from acquiescing in aggressive management practices and

226. See id. at 1412. Coffee argues that in this euphoric environment of endlessly rising stock prices gatekeepers are a "nuisance to [the] management" of corporations. Id.

227. See id.

228. Id. Coffee works on the understandable assumption that auditors and accountants are "largely ignored by euphoric investors," so rational accountants become acquiescent to the aggressive strategies that companies may propose. Id.

229. Id.

230. See id. at 1413. The consulting services occur when there is a market bubble because gatekeepers, as they are less relevant, have less leverage over their clients and place a lower value on their reputation. See Coffee, Failure and Reform, supra note 122, at 323–24.

231. Professor Sung Hui Kim has proposed four reasons why gatekeepers may not act to prevent market-fraud: (1) low willingness to interdict, (2) low willingness to monitor, (3) low capacity to interdict and, (4) low capacity to monitor. See Sung Hui Kim, Gatekeepers Inside Out, 21 GEO. J. LEGAL ETHICS 411, 421–22 (2008).

232. Tomkins, supra note 37, at 1909 (emphasizing that they have an interest in their reputation beyond their individual client).


234. See id. at 1409–11. Coffee explains that the risks of liability decreased during the 1990's due to a shortened statute of limitations for securities fraud, the elimination of aiding and abetting liability in securities fraud, and heightened pleading standards for securities class actions to a level above general fraud, among other things. See id. at 1409–10. Collectively, these instances all reduced the expected liability for gatekeepers. See id.
WHERE WERE THE ACCOUNTANTS?

accounting irregularities increase.\textsuperscript{235} Under Coffee’s gatekeeper model, gatekeepers are assumed to be easier to deter than directors and officers.\textsuperscript{236} This is because an accountant has less to gain from increased profits than a party with a direct stake in the proposed transaction.\textsuperscript{237}

As a general matter, one can assume that as accountants face greater liability for misstatements and omissions in financial statements, they will work harder to ensure the reliability of those statements. By increasing the accuracy of the financial statements, the accountants will decrease the risk of liability with respect to those statements. One drawback, however, of using greater gatekeeper liability to increase the reliability of financial statements is that accountants differ in both their reputations and the extent to which they are likely to be deterred by harm to their reputation.\textsuperscript{238} Therefore, certain accountants may risk paying monetary damages and being the subjects of lawsuits in order to continue potentially more profitable consulting work.\textsuperscript{239} Further, not all accountants have diverse clienteles, which would serve to make them “less susceptible to insider wrongdoing.”\textsuperscript{240}

The Enron case is a quintessential example of gatekeeper failure.\textsuperscript{241} In this case, Arthur Andersen, the auditor, complied with Enron’s wishes and engaged in loose accounting practices. Because the existing financial regulations did not explicitly prevent the corporate manipulation, Arthur Andersen was able to report an incomplete picture of Enron’s financial situation.\textsuperscript{242} If there was liability in place for such practices—practices that were negligent but not illegal or violative of GAAP standards—then the accountants might have acted with increased care, and some of the financial failures resulting in Enron’s downward spiral may have been prevented.\textsuperscript{243}

\textsuperscript{235} See Coffee, Acquiescent Gatekeeper, supra note 111, at 4–5.
\textsuperscript{236} See id. at 8.
\textsuperscript{237} See id. Unlike accountants, a CEO or CFO has a direct stake in the outcome of transactions, providing an increased incentive for them to make material misrepresentations in financial statements. See Coffee, Failure and Reform, supra note 122, at 327–28 (explaining that officers have stock options that create “perverse incentives” for short-term price maximization).
\textsuperscript{238} See Tomkins, supra note 37, at 1910.
\textsuperscript{239} See id.
\textsuperscript{240} Id. (citing Reinier H. Kraakman, Gatekeepers: The Anatomy of a Third-Party Enforcement Strategy, 2 J.L. ECON. & ORG. 53, 70–72 (1986)). Additionally, the services of third-party professionals are fairly generic, so corporations who wish to engage in wrongdoing can switch accountants quite easily. See id.
\textsuperscript{241} See supra Part I.C.1.b.
\textsuperscript{242} See Third Interim Report of Neal Batson at 35, In re Enron Corp., No. 01-16034 (Bankr. S.D.N.Y June 30, 2003); see also Jennings, supra note 134, at 217–18.
\textsuperscript{243} The auditors did not force Enron to correct their financial deficiencies and did not reveal the serious flaws in Enron’s accounting practices. A forensic accountant who reviewed the books after Enron’s bankruptcy noted that the auditors’ complicit relationship was fatal, and they did not appropriately play their role as a gatekeeper. See Andy Serwer, Dirty Rotten Numbers: Enron Has Made Us Shine a Light on the Books of America’s Public Companies, \textit{FORTUNE}, Feb. 18, 2002, at 80; see also Jennings, supra note 134, at 217–18. Arthur Andersen certified that the financials were GAAP compliant, but this did not mean the statements did not contain material misrepresentations or misleading facts. See Batson,
c. Will Gatekeeper Liability Work?

An accountant’s services are only valuable if they comply with a meaningful substantive standard, such as GAAP and other standards outlined by the AICPA. When an economic bubble bursts, reliable gatekeepers are necessary, as investors will only work with credible accountants who share their “risk-averse” view. Today, the economy is depressed, and gatekeeper reliability will be essential to increased investor confidence.

Further, accountants may decrease their liability by reducing corporate misstatements in financial reports—this makes accountants more reliable. Professor William G. Heninger studied the association between auditor litigation and abnormal financial accruals by analyzing 364 lawsuits brought by shareholders against auditors. The Heninger study shows that if managers are able to report abnormal accruals, making the financial health of the corporation appear more favorable, auditors will likely face increased litigation for failure to report the abnormalities. The study shows that if auditors want to avoid litigation, they should carefully scrutinize corporate financials. Heninger’s study shows that auditors should be held responsible for failure to curb managerial discretion over the presentation of financial statements.

Finally, auditors can serve as an essential intermediary in corporate management to prevent fraud. It is possible for auditors to intervene and refuse to certify financial statements or withdraw a certification. Even after Sarbanes-Oxley reforms, there is still room for increased liability to

 supra note 242, at 35. It seems that fear of professional malpractice liability did little or nothing to stop Arthur Andersen from complying in Enron’s scheme.

244. See Coffee, Gatekeepers, Stupid, supra note 107, at 1417.

245. See id. at 1416. Coffee says that if one accepts the bubble theory, then the market will “self-correct” once the bubble bursts, as accountants respond to the needs of skeptical investors and become reliable again. See id. The Enron era, however, has repeated itself with some of the recent economic and corporate affairs. See, e.g., Norris, supra note 8 (explaining the Refco scandal). This shows that heightened gatekeeper liability may in fact be what is needed to prevent another cycle of compliant and ineffective accounting, which has devastating effects on the economy when financial schemes fail.

246. Even in private failures, accountant failure can diminish consumer confidence in the economy. See, e.g., Michael J. de la Merced, In Madoff’s Wake, Scrutiny of Accounting Firms, N.Y. TIMES, Dec. 22, 2008, at B1. In the wake of the now infamous ponzi scheme orchestrated by Madoff Investment Securities LLC, accounting firms are being scrutinized for failures that relate to and encourage financial fraud. See id. Increased liability of the accounting profession may be key in moving forward.

247. See generally William G. Heninger, The Association Between Auditor Litigation and Abnormal Accruals, 76 ACCT. REV. 111, 113 (2001) (study that hypothesizes that auditors face increased litigation if they fail to attenuate managerial manipulation to portray a favorable impression of the firm).

248. See id. at 112.

249. See id. at 113.

250. See id. at 124.

251. See Coffee, Failure and Reform, supra note 122, at 324.

252. See id. at 324.
deter accountants from engaging in or allowing negligent or fraudulent corporate practices to slip through the cracks.\(^{253}\) Incentives must be created to ensure that accountants will engage in responsible auditing.\(^{254}\)

This Note shows that deepening insolvency is one such strategy to increase accountant liability. As a new tort without defined bounds, deepening insolvency represents potential litigation risk for accountants. If courts hold accountants responsible for deepening insolvency (and if the tort of deepening insolvency is crafted properly against accountants), then accountants will have an increased incentive to audit responsibly and report managerial fraud before it results in bankruptcy.

II. DEEPENING INSOLVENCY: THE HISTORY AND CURRENT CONFLICT

Deepening insolvency is a contested tort that could provide a successful cause of action against accountants if properly crafted. Part II.A.1 identifies the tort of deepening insolvency, describing the ways in which it provides an independent cause of action. Part II.A.2 then turns to an analysis of the relevant case law, discussing the pivotal cases in the development of the deepening insolvency tort. Next, Part II.B presents the four major interpretations of the validity of deepening insolvency as a tort in current case law. Finally, Part II.C reviews the elements and specifics of the cause of action, including the harm, the possible plaintiffs, the possible defendants, and the potential defenses.

A. The Development of Deepening Insolvency

1. General Definition

Substantial debate surrounds the existence of the tort of deepening insolvency.\(^{255}\) The U.S. Court of Appeals for the Third Circuit has twice refused to foreclose the possibility of a viable deepening insolvency cause of action.\(^{256}\) Despite this, claims of deepening insolvency have been

\(^{253}\) See id. at 336. Coffee insists that SOX is not entirely responsive to accounting irregularities caused by corporate management nor will it offset increased pressure from management. See id. at 336–37.

\(^{254}\) See Frank Partnoy, Strict Liability for Gatekeepers: A Reply to Professor Coffee, 84 B.U. L. REV. 365, 366 (2004) (arguing that reputation related incentives are not enough to ensure the good conduct of gatekeepers).


discouraged in Delaware. 257 Recently, the tort has been narrowed, and many scholars have criticized its very existence.258

Deepening insolvency is a cause of action that presumes, in certain circumstances, that it is more beneficial for a corporation to cease operations than to continue to operate and incur further debt.259 Deepening insolvency has most commonly been described as “‘an injury to the [d]ebtors’ corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life.’”260 Put in other terms, deepening insolvency embraces the concept that the progression of a corporation “from barely insolvent to irretrievably insolvent” can cause overwhelming damage to a corporate entity.261 When operation continues and harm is caused to the corporation, a cause of action for deepening insolvency may be appropriate.262

2. Cases Developing the Deepening Insolvency Claim

a. Bloor v. Dansker

The first case that recognized the concept of deepening insolvency was Bloor v. Dansker (In re Investors Funding Corp. of New York Securities Litigation),263 in the U.S. District Court for the Southern District of New York. In Bloor, an insolvent corporation’s trustee brought an action against multiple defendants—including the corporation’s directors, officers, and accountants—for fraud that led to the company’s insolvency.264 The court explained that it cannot be presumed that any act that extends the life of a corporation is beneficial.265 Further, the court rejected the argument that


258. See Sara Apel, Comment, In Too Deep: Why the Federal Courts Should Not Recognize Deepening Insolvency as a Cause of Action, 24 EMORY BANKR. DEV. J. 85, 99–100 (2008) (explaining that courts have rejected deepening insolvency on the following grounds: the nonrecognition by states of the cause of action, the effect of the business judgment rule, the lack of shareholder standing, and the defense of in pari delicto).

259. See Mahoney, supra note 255, at 995.


262. See Mahoney, supra note 255, at 995–96.

263. 523 F. Supp. 533, 536 (S.D.N.Y. 1980); see also Gold, Swinson & Reich, supra note 39, at 668.

264. See Bloor, 523 F. Supp. at 536. Here, the trustee alleged that the accountant violated both securities and state laws when performing its audit of the corporation in addition to aiding and abetting fraud. See id.

265. See id. at 541; see also Gold, Swinson & Reich, supra note 39, at 668. The court in Bloor v. Dansker (In re Investors Funding Corp. of New York Securities Litigation) did not state that prolonging corporate life was per se harmful, but it criticized the assumption that it was always a benefit. 532 F. Supp. at 541.
WHERE WERE THE ACCOUNTANTS?

fraud benefited the debtor corporation since it allowed continued operation past insolvency.266 This case made the first allusion to deepening insolvency as a concept in American jurisprudence.267

b. Schacht v. Brown

Following the Bloor decision, in Schacht v. Brown,268 the U.S. Court of Appeals for the Seventh Circuit found that prolonging a financially ailing corporation's life was, in fact, harmful.269 In Schacht, the liquidator of an insolvent insurance company alleged that the company was forced to continue operations despite its increasing debt.270 The liquidator explained that the officers and directors of the company engaged in fraudulent behavior that led to the company's demise.271 The Schacht court laid down the foundation for future development of the deepening insolvency tort cause of action by explaining that the body of a corporation is "ineluctably damaged" by the deepening of its insolvency.272

c. Lafferty

Next, Official Committee of Unsecured Creditors v. R.F. Lafferty & Co.,273 is the pivotal case that defined deepening insolvency as an independent tort. In Lafferty, the Third Circuit was the first federal circuit court to address the claim of deepening insolvency, and it was also the first court to embrace the concept of deepening insolvency as an independent tort.274 In this case, the debtor corporation filed bankruptcy after a failed ponzi scheme.275 The bankruptcy trustee sued the officers and directors of the company, as well as the professional and financial advisors of the company.276 In particular, a committee of creditors appointed by the U.S.

267. See Mahoney, supra note 255, at 999.
268. 711 F.2d 1343 (7th Cir. 1983).
269. See id. at 1347-48.
270. See id. at 1345.
271. See id. at 1345-46. The directors and officers, along with the accounting firm, allegedly engaged in a scheme whereby the company participated in extremely high risk business while maintaining an insufficient surplus for insurance claims. See id. at 1345.
272. See id. at 1350.
273. 267 F.3d 340 (3d Cir. 2001).
274. See Gold, Swinson & Reich, supra note 39, at 669. See generally Lafferty, 267 F.3d 340.
275. A ponzi scheme is when new money is used to pay old debts, giving the illusion of steady returns and a business organization. See Gold, Swinson & Reich, supra note 39, at 669. The scheme implodes when no new investors can be found and old investors can no longer be paid. See id.
276. See Lafferty, 267 F.3d at 344.
Trustee brought claims on behalf of the debtor corporation alleging that
third parties caused the corporation to deepen its insolvency.277

The deepening insolvency claim alleged damage to the debtor
corporation's property due to the "fraudulent expansion of corporate debt
and prolongation of corporate life."278 On behalf of the bankrupt debtor
corporation, the committee alleged that the debtor corporation was induced
to offer and sell certificates when it was already insolvent and that its debt
was expanding out of proportion with its ability to repay it.279

The Third Circuit concluded that deepening insolvency "constitutes a
valid cause of action under Pennsylvania state law."280 There were three
main justifications for upholding the cause of action: (1) extending
corporate life beyond insolvency should be actionable; (2) lower courts had
recognized such a cause of action; and (3) in Pennsylvania, where there is
an injury, there is a remedy.281 The court, however, then dismissed the case
because of the in pari delicto doctrine.282 Still, following Lafferty, a
deepening insolvency cause of action has been regularly added to the gamut
of claims brought against directors and officers, third-party professionals,
and others in bankruptcy proceedings.283

277. See id. Named in the complaint were the third-party professionals that assisted the
corporation in registering for public offering debt securities, including their accountant and a
financial services company. See id. at 345.
278. See id. at 347.
279. See id.
280. See id. at 344.
281. See Gold, Swinson & Reich, supra note 39, at 670.
282. See Lafferty, 267 F.3d at 344. In pari delicto will be discussed infra at Part II.C.5.a.
The dismissal of the cause of action diminished the ability of plaintiffs to allege claims of
deepening insolvency, because the court in Official Committee of Unsecured Creditors v.
R.F. Lafferty & Co. never outlined the elements of this cause of action.
283. See, e.g., Thabault v. Chait, 541 F.3d 512 (3d Cir. 2008) (including a claim for
deepening insolvency); Seitz v. Detweiler, Hershey & Assoc., P.C. (In re CitX Corp.), 448
F.3d 672 (3d Cir. 2006) (same); Stanziale v. Pepper Hamilton LLP (In re Student Fin. 
Corp.), 335 B.R. 539 (D. Del. 2005) (same); Silverman v. KPMG LLP (In re Allou Distribs.,
re The Brown Sch.), 386 B.R. 37 (Bankr. D. Del. 2008) (same); Schnelling v. Crawford (In 
re James River Coal Co.), 360 B.R. 139 (Bankr. E.D. Va. 2007) (same); Alberts v. Tuft (In 
Liquidation Trust v. Credit Suisse First Boston (In re Oakwood Homes Corp.), 340 B.R. 510 
(Bankr. D. Del. 2006) (same); Miller v. Dutil (In re Total Containment, Inc.), 335 B.R. 589 
(same); Collins v. Kohlberg & Co. (In re Sw. Supermarkets, LLC), 325 B.R. 417 (Bankr. D. 
Ariz. 2005) (same); Limor v. Buergler (In re Del-Met Corp.), 322 B.R. 781 (Bankr. M.D. 
Tenn. 2005) (same); Official Comm. of Unsecured Creditors v. Credit Suisse First Boston 
KPMG, 945 A.2d 132 (N.J. Super. Ct. Law Div. 2007) (same); Coroles v. Sabey, 79 P.3d 
d. CitX

In *Seitz v. Detweiler, Hershey & Associates, P.C. (In re CitX Corp.)*, the Third Circuit addressed deepening insolvency a second time, narrowing the reach of the cause of action. This case involved a failed business that had relied heavily on a financial statement given by an accountant to secure credit, even though the accounting statement was "lousy." The value of the corporation was overstated, making the corporation seem solvent when it was not. The trustee in bankruptcy sued the accounting firm for deepening insolvency. The court found that there were issues with causation, dooming the cause of action; there was no proof that the bad financial statement itself had "jeopardize[d] the company." Notably, in *CitX*, the accountants were hired to compile financial statements, rather than to complete an entire audit. The fact that the accountants conducted a compilation, but not an audit, was essential to the court's decision because the accountant did not express assurance as to the accuracy of the reporting procedures or the financial statements themselves. In fact, the compilation failed to uncover many "red flags" at the company, including the close relationship between the bookkeeper and the founder of the corporation and the facts that the corporation was bouncing checks and was insolvent, even while selling stock to the public. As a result, in part, of the financial compilations made by the accountant, the company was able to raise equity and prolong its existence, incurring millions of dollars worth of debt.

The bankruptcy trustee, standing in the shoes of the corporation, sued the accountant for deepening insolvency, malpractice, breach of fiduciary duty, and negligent misrepresentation. The court dismissed the fiduciary duty claim but granted summary judgment to the accountant on all the remaining claims.

The *CitX* court made two critical holdings with respect to deepening insolvency. First, in analyzing the deepening insolvency claims, the court found, unequivocally, that this concept cannot be used as an independent

---

284. 448 F.3d 672 (3d Cir. 2006).
285. See id.
286. See Gold, Swinson & Reich, supra note 39, at 672.
287. See id.
288. See *In re CitX Corp.*, 448 F.3d at 674.
289. See Gold, Swinson & Reich, supra note 39, at 673.
290. See *In re CitX Corp.*, 448 F.3d at 675.
292. See *In re CitX Corp.*, 448 F.3d at 675.
293. See id. at 676.
294. See id.
295. See id. To show malpractice in this case, the bankruptcy trustee was required to establish that a duty was owed to the corporation by the accountant, that the duty was breached, and that the corporation was harmed as a result of the breach. See id. at 677.
In its analysis, the CitX court upheld the Lafferty decision that deepening insolvency as an independent cause of action does in fact exist.297

The court, however, then explained that such a claim could not stand against the accountant because there was no allegation of fraudulent conduct on the part of the accountant.298 This encompasses the second critical holding of the CitX court—that mere negligence can never support a claim for deepening insolvency.299 The CitX court then expanded upon the original Lafferty opinion, which employed the language “fraudulent expansion of corporate debt” when describing the deepening insolvent injury.300 In particular, the CitX court stated that the Lafferty court intended for only those claims based on fraudulent conduct to stand in a deepening insolvency cause of action.301 The CitX decision is widely cited as drastically limiting deepening insolvency as an independent cause of action.302

e. Trenwick

Finally, the Delaware Chancery Court, in Trenwick America Litigation Trust v. Ernst & Young, L.L.P.,303 eliminated the possibility of actionable deepening insolvency for cases brought under Delaware law.304 The Delaware Supreme Court affirmed this decision.305 Since the Trenwick decision, many courts have followed suit and found that deepening insolvency is not an independent cause of action.306

In this case, the primary defendants were directors of a publicly held company. The litigation trust pled that the directors and officers, as well as outside advisors, engaged in fraud and made material misstatements of fact.307 The directors and officers were also accused of the tort of

296. See id. at 677–80. The court explained that harm or actual loss did not occur, and, further, there was no proof that insolvency was deepened based on reliance on the financial compilations, so that deepening insolvency could not be used to prove damages for the professional malpractice claim. See id.
297. See id.
298. See id. at 680.
299. See id. at 681.
300. See id. at 681 (citing Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 347 (3d Cir. 2001)).
301. See id.
302. Keilson, supra note 266 (explaining the restrictions that Seitz v. Detweiler, Hershey & Associates, P.C. (In re CitX Corp.) placed on deepening insolventy as an independent tort). See generally Mahoney, supra note 255 (detailing the decline of deepening insolventy as a tort). 
304. See id. at 204–05.
305. Trenwick, 931 A.2d 438.
306. See Gold, Swinson & Reich, supra note 39, at 679; see also infra Part II.B.4.
307. See Trenwick, 906 A.2d at 186.
deepening insolvency. The professional advisors here, including accountants and auditors, were charged with conspiring with the directors, aiding and abetting, and fraud, but, importantly, not deepening insolvency.

In analyzing the deepening insolvency claims, the court found that Delaware does not embrace a deepening insolvency cause of action as a matter of law. The court further stated that deepening insolvency is no more a cause of action than "shallowing profitability." By way of explanation, the court noted that Delaware law imposes "no absolute obligation on the board of a company that is unable to pay its bills to cease operations and to liquidate."

The court continued by saying that rejecting deepening insolvency as a cause of action does not clear directors of all liability when a corporation is insolvent. Their conduct is to be measured instead by traditional rules of fiduciary duties, rather than a new deepening insolvency standard.

The *Trenwick* court insisted that deepening insolvency is not consistent with traditional concepts of fiduciary responsibility. Based on this, the Delaware court refused to impose retroactive fiduciary obligations simply because the business strategy of the directors and officers failed. Further, the *Trenwick* court made clear that being in the zone of insolvency does not "declare open season on corporate fiduciaries" in court. Instead, the court maintained the basic duties of corporate fiduciaries to honor creditors' rights while maximizing profit for company shareholders.

The *Trenwick* decision, while explicit in its denunciation of deepening insolvency as a cause of action, was based on a case in which the complaint was weak, conclusory, and devoid of concrete facts. The plaintiff did not plead facts with particularity sufficient to imply fraud or breach of any duty.

The *Trenwick* court ultimately concluded that the plaintiffs failed to properly plead any cause of action and that, because deepening insolvency does not constitute a tort in Delaware, that claim would also be

---

308. See id. at 188.
309. See id.
310. See id. at 174.
311. See id. at 205.
312. Id. at 204.
313. See id. at 205. The court explains that plaintiffs can follow traditional paths for recourse, such as causes of action for breach of fiduciary duty and fraud. See id.
314. See id.
315. See id. at 206–07.
316. See id. at 173.
317. See id. at 174.
318. See id. at 174–75.
319. See id. at 175, 184.
320. See id. at 194. A plaintiff cannot allege that a business strategy was simply foolish and turned out badly to prove breach of a duty. See id.
The court found that each claim against the accountants was defective. These dismissals and findings were upheld on appeal in the Delaware Supreme Court.

B. The Four Conflicting Views on the Validity of Deepening Insolvency

Over the past few years, courts and commentators have expressed divergent views regarding claims of deepening insolvency. After Trenwick, the case law is divided into four distinct areas: (1) cases that allow deepening insolvency to be an independent cause of action, (2) those that use deepening insolvency as a theory of damages, (3) those that believe deepening insolvency is just another name for an already existing tort, and (4) those that discredit deepening insolvency as a concept altogether. Each of these schools of thought will be evaluated.

1. Deepening Insolvency as an Independent Cause of Action

Many cases have followed in Lafferty's footsteps and have recognized deepening insolvency as a valid, independent cause of action. Courts support Lafferty's recognition of a cause of action when damage has been done to the corporate property due to prolongation of corporate life. The

---

321. See id. at 174–75, 204.
322. See id. at 215–18. The court found that all of the aiding and abetting claims and conspiracy claims must fail because the plaintiffs did not meet the burdens in the causes of action against the directors. See id. Next, the court found that the fraud claim failed because it was not pled with particularity and because the plaintiffs could not prove reliance on the accounting statements. See id. Third, the malpractice counts failed because the advisors did not breach the professional duty of care owed to their clients because the accusations were conclusory, did not display specific deficiencies, and did not have enough factual content. See id.
325. See Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340 (3d Cir. 2001); see also Thabault v. Chait, 541 F.3d 512, 522–23 (3d Cir. 2008) (refusing to foreclose the possibility of an independent tort of deepening insolvency because it causes distinct harm to the company); Seitz v. Detweiler, Hershey & Assoc., P.C. (In re CitX Corp.), 448 F.3d 672, 680 (3d Cir. 2006); OHC Liquidation Trust, 340 B.R. at 531–32 (holding that, before the Delaware Supreme Court decided Trenwick America Litigation Trust v. Billett, deepening insolvency was a sound theory as a cause of action because it is necessary to remedy the costs of bankruptcy and of a delayed filing); Stanziale, Jr. v. Pepper Hamilton LLP (In re Student Fin. Corp.), 335 B.R. 539, 547–49 (Bankr. D. Del. 2005) (recognizing deepening insolvency cause of action for alleged wrongful expansion of corporate life in a case against an attorney); Miller v. Dutil (In re Total Containment, Inc.), 335 B.R. 589, 621–22 (Bankr. E.D. Pa. 2005) (holding, in case where deepening insolvency is alleged by trustee against all defendants, that it is an actionable claim against directors, officers, and controlling shareholders, but not against debtors and lenders); Limor v. Buerger (In re Del-Met Corp.), 322 B.R. 781, 808, 815 (Bankr. M.D. Tenn. 2005) (finding that a deepening insolvency claim is independently cognizable as long as a duty exists between the debtor corporation and the defendants); In re LTV Steel Co., 333 B.R. 397, 422–23 (Bankr. N.D. Ohio 2005) (holding that a deepening insolvency claim may apply to the lawsuit); Official Comm. of Unsecured Creditors v. Credit Suisse First Boston (In re Exide Techs,
majority of the courts that find deepening insolvency to be an independent cause of action articulate four components to the tort: (1) fraudulent or wrongful prolongation of an insolvent corporation’s life, (2) prolongation that causes the corporation to incur more debt and become more insolvent, (3) that had prolongation not occurred, the value of the business could have been realized, and (4) distinct harm is suffered by the business entity. Further, these cases often see deepening insolvency as a distinct injury that cannot be a mere theory of damages.

2. Deepening Insolvency as a Theory of Damages

Other courts reject deepening insolvency as an independent cause of action, but consider it a theory of damages. This line of cases explains that the additionally incurred debt, as well as other factors the court deems appropriate, can be a measure of damages recoverable by a trustee in bankruptcy for other causes of action such as breach of fiduciary duties. In *NCP Litigation Trust v. KPMG,* the Superior Court of New Jersey explained deepening insolvency as a theory of damages. In this case, the litigation trust of an insolvent corporation sued the corporation’s accountant, KPMG. The trust alleged that KPMG harmed the company due to breach of contract, negligence, negligent misrepresentation, and breach of fiduciary duty. The court stated that deepening insolvency is

---

326. See Keilson, *supra* note 266, at 980.
327. See Silverman v. KPMG LLP (*In re* Allou Distrbs., Inc.), 395 B.R. 246, 264–67 (Bankr. E.D.N.Y. 2008). The court in *Silverman v. KPMG LLP (*In re* Allou Distrbs., Inc.) explained that deepening insolvency is the prolongation of a corporation’s life beyond insolvency causing increased debt that damages the corporation. See *id.* at 264 (citing Kittay v. Atl. Bank of N.Y. (*In re* Global Serv. Group, LLC), 316 B.R. 451, 456 (Bankr. S.D.N.Y. 2004)). The court reiterated that deepening insolvency caused by inaccurate audits is enough to state a separate and cognizable injury that would withstand a motion to dismiss. See *id.* The court reviewed the decisions following *Lafferty* and explained that deepening insolvency could not be an independent theory of damages. See *id.* at 265–67.
330. See *id.* at 140–41.
331. *Id.* at 135.
332. *Id.*
harmful because it may prevent a corporation from seeking bankruptcy protections when necessary. \footnote{333} Alternatively, the court said, deepening insolvency can be damaging if it forces a company into bankruptcy by exhausting the company’s resources to repay new debts. \footnote{334} While the court insisted that deepening insolvency is not a benefit to a company, it made clear that deepening insolvency remains a question of fact as to whether or not the company is actually harmed by incurring new debt to prolong survival. \footnote{335}

The court then held that deepening insolvency is a legally cognizable harm. \footnote{336} It explained that deepening insolvency functions to support an independent cause of action, such as a negligence action, or other causes of action based on intentional conduct. \footnote{337} Deepening insolvency, under the damages theory, is a harm brought on as a result of negligent or intentional conduct. \footnote{338}

Essentially, deepening insolvency as a theory of damages simply means that when a corporation’s life is wrongfully prolonged, the resulting harm represents a means of calculating damages if the harm is accompanied by a separate, independent tort. For instance, a plaintiff that suffered from the incidental prolongation of corporate life cannot recover without showing more, such as negligence, breach of a fiduciary duty, fraud, or aiding and abetting. However, a plaintiff who suffered harm from deepening insolvency as a result of the already actionable conduct of another may recover the damages caused by the prolongation of corporate life.

Notably, even some courts that have explicitly held that deepening insolvency is not a tort have held that it is a colorable theory of damages. \footnote{339} Despite support for this theory, many courts that see deepening insolvency as an independent cause of action shun it as a theory of damages. \footnote{340}

\footnote{333} Id. at 142. Note that this theory rests on the assumption that bankruptcy is an antidote for a failing company. See id.

\footnote{334} See id. Deepening insolvency resulting in imminent bankruptcy often creates a situation in which a corporation is unable to become profitable again. See id.

\footnote{335} See id. at 143. The court reiterates that inflating a corporation’s revenue and allowing it to continue business beyond the point of insolvency is not a benefit to the company. Id. at 142. The court also made clear that the “fraudulent inducement” of a company’s survival is not a benefit. Id. at 142–43.

\footnote{336} Id. at 143.

\footnote{337} See id. at 143–44.

\footnote{338} See id. at 144.


\footnote{340} See Seitz v. Detweiler, Hershey & Assocs., P.C. (In re CitX Corp.), 448 F.3d 672, 677 (3d Cir. 2006); see also Silverman v. KPMG LLP (In re Allou Distrbs., Inc.), 395 B.R. 246, 266 (Bankr. E.D.N.Y. 2008) (explaining that deepening insolvency cannot be a theory of damages in an independent tort action and is better interpreted as a description of otherwise cognizable damages).
3. Deeping Insolvency as Another Name for an Existing Tort

Some courts, namely those overseeing litigation proceedings related to *In re Parmalat Securities Litigation*, have declined to recognize deepening insolvency as an independent cause of action, viewing the claim as simply duplicative of other tort causes of action already in existence. In deciding whether deepening insolvency could be a tort, the court in *Parmalat* explained that a tort consists of a duty, a breach, causation, and damages.

In *Parmalat*, the plaintiff alleged that the auditors should have reported that the company's liabilities outweighed its assets, which would have prevented the company from continuing to borrow money, driving the company further into debt. The court held that the defendants, the auditors, had a duty to the company and that the breach was failure to properly audit. The court reasoned that the cause of action was no more than one for professional malpractice. The court then dismissed the claim for deepening insolvency as duplicative.

4. Deepening Insolvency Is Not a Valid Cause of Action

*Trenwick* eliminated all possibility of a deepening insolvency cause of action under Delaware law. This case seemed to put an end to the theory altogether, as Delaware law controls many of the claims against directors and officers because so many businesses are incorporated in Delaware. A multitude of cases following *Trenwick* have declared that deepening insolvency is not an independent tort. There are four main reasons courts

---

341. Bondi v. Bank of Am. Corp. (*In re Parmalat Sec. Litig.*) (*Parmalat I*), 383 F. Supp. 2d 587 (S.D.N.Y. 2005); Bondi v. Grant Thornton Int'l (*In re Parmalat Sec. Litig.*) (*Parmalat II*), 377 F. Supp. 2d 390 (S.D.N.Y. 2005); see also Rafool v. Goldfarb Corp. (*In re Fleming Packaging Corp.*), Nos. 03-82408, 04-8166, 2005 WL 2205703, at *8-9 (Bankr. C.D. Ill. 2005) (explaining that, when bringing a deepening insolvency claim against directors and officers, there is a danger of redundancy and that, if the elements are essentially the same, the deepening insolvency claim would be dismissed as duplicative). See generally Sylvers, supra note 100.

342. See *Parmalat I*, 383 F. Supp. 2d at 601-02 (reasoning that damages for breach of fiduciary duties will suffice to cover damages for deepening insolvency in declining to recognize deepening insolvency as a novel tort theory).

343. See *Parmalat II*, 377 F. Supp. 2d at 419.

344. See id. at 418.

345. See id. at 419.

346. See id.

347. Id.

348. See Keilson, supra note 266, at 992.

349. This holding, however, does not extend beyond Delaware. *Trenwick* is a state court case. Actions against gatekeepers and third-party professionals may still survive when brought under the law of different states.

350. See Interstate Foods v. Lehman, No. 06 Civ. 13469(JGK), 2008 WL 4443850, at *4-5 n.2 (S.D.N.Y. Sept. 30, 2008) (concluding that deepening insolvency is not recognized under New York law as an independent cause of action and explaining that deepening insolvency should be covered by breach of fiduciary duty torts against directors and officers); Schnelling v. Crawford (*In re James River Coal Co.*), 360 B.R. 139 (Bankr. E.D.
have rejected the theory of deepening insolvency as an independent tort cause of action: (1) the absence of authorizing state law, (2) the business judgment rule, (3) lack of standing, and (4) the *in pari delicto* defense barring recovery.351

In *Official Committee of Unsecured Creditors of Vartec Telecom, Inc. v. Rural Telephone Finance Cooperative*,352 the court found that deepening insolvency would not be recognized as a tort under Texas law.353 Specifically, the court held that deepening insolvency is not an independent cause of action because it is an unnecessary addition to tort law in Texas. The court explained that it is impossible to fit deepening insolvency into a tort structure, since a tort needs duty, breach, causation, and injury.354 It further reasoned that claims against directors and officers would be duplicative, and that claims against lenders would not fit into the deepening insolvency framework because there is no duty between lender and borrower.355 Additionally, the court held that to recover for deepening

---

351. See Apel, *supra* note 258, at 99–100; see also Stanziale v. Pepper Hamilton LLP (*In re Student Fin. Corp*), 335 B.R. 539, 548 (D. Del. 2005); NCP Litig. Trust v. KPMG LLP (*NCP II*), 901 A.2d 871, 879 (N.J. 2006); Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P., 906 A.2d 168 (Del. Ch. 2006) (rejecting the deepening insolvency cause of action as to directors and officers, but not addressing it as to third-party professionals).


353. *Id.* at 644. This was a case where a committee of creditors of the bankrupt corporation sued the lender of the corporation who entered into a loan agreement with the company that resulted in the deteriorating financial condition of the company. See *id.* at 634–35.

354. See *id.* at 645.

355. See *id.*
WHERE WERE THE ACCOUNTANTS?

insolvency damages, the plaintiff must plead that the defendant committed another tort.356

Cases that support an independent tort of deepening insolvency explain that those courts that reject the tort do not understand the true nature of the harm that deepening insolvency causes.357 Those who oppose the tort argue that acquiring debt is a neutral transaction that actually helps the corporation by “increasing its ability to meet its short-term debt.”358 The court in NCP Litigation Trust explained that this theory ignores the concept of interest, and that in fact deepening insolvency can be financially devastating to certain corporations.359

C. Possible Characteristics of a Deepening Insolvency Claim

Because deepening insolvency is not settled as an independent tort, the characteristics of a successful claim are not definite. This section explores the debate over the following: (1) whether deepening insolvency creates a cognizable harm, (2) who the proper plaintiff is, (3) who the proper defendant is, (4) what the necessary elements are, and (5) the possible defenses.

1. The Harm

Deepening insolvency causes significant harm to a corporation. Courts have explained that the fraudulent and concealed accrual of debt, one of the common definitions of deepening insolvency, can lessen the value of corporate property.360 When a director or officer cooks the books, employs fraud to disguise insolvency, or enlists the help of third-party professionals to misstate the financial health of a company, this becomes an actionable tort.361 Other harms caused by deepening insolvency include legal and administrative costs of bankruptcy, operational limitations on profitability, undermining business relationships, and failed corporate confidence.362 Further, increased debt can force an insolvent company into bankruptcy, causing the corporation to incur more costs.363

It is important to note, however, that a company’s insolvency is not deepened “simply by the incurrence of new debt where the company suffers

356. See id. at 644 (explaining that using deepening insolvency as a tort collapses it into other torts).
357. See supra Part II.B.1.
359. See id. at 141 n.4.
362. See Mahoney, supra note 255, at 1001. These harms can be avoided if a corporation is dissolved in a timely manner, justifying the deepening insolvency cause of action. See id.
363. See Lafferty, 267 F.3d at 349–50. Other harms include the inability to run the business efficiently and undermining a corporation’s relationships with its business associates and customers. See id. at 350.
no loss on the loan transaction." Insolvency is deepened when the proceeds from a loan are wasted or looted or the debt is incurred in a concealed and damaging manner.

A rule that does not acknowledge the harm caused by deepening insolvency would create an incentive for directors and officers to "conceal the true financial condition of the corporation" in an effort to rebuild the corporation through further investments while preventing it from recouping damages. Cases that oppose acknowledging deepening insolvency as a valid cause of action are based on the presumption that the "fraudulent prolongation of a corporation's life beyond insolvency" is a benefit for the corporation. This is untrue in many circumstances, as the corporate body is "ineluctably damaged by the deepening of its insolvency" because exposure to creditor liability increases, among other harms.

2. The Possible Plaintiffs

Relevant literature debates which of two dominant parties may bring a claim for deepening insolvency: the debtor corporation or the creditors of the debtor corporation. This part explores the strengths and weaknesses of each possible plaintiff.

a. The Debtor Corporation

As shown above, many courts have found that a debtor corporation is injured by deepening insolvency. Therefore, the debtor corporation seems to be the most natural party to bring a deepening insolvency claim. Most courts have found that the injury to corporate property is legally distinct, allowing the debtor corporation to bring the cause of action.

365. See id. at 575. This may create a roadblock in bringing an action for deepening insolvency against an accountant. Since it is the directors and officers who waste the proceeds of a loan, it may be hard to find the accountant culpable for actually deepening the insolvency of the company.
366. See Lafferty, 267 F.3d at 350.
367. Id.
368. Id. (emphasis omitted). Opponents to this theory explain that harm may not accrue as a result of deepened insolvency if the prolonged insolvency allows the corporation to continue its operations and recover. See generally Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P., 906 A.2d 168 (Del. Ch. 2006). Therefore, the harm is not the deepening insolvency itself, but the net outcome to the corporation. See id.
369. See supra Part II.C.1.
370. See Lafferty, 267 F.3d at 348; see also infra Part II.C.5.b.
In *Lafferty*, the court found that the deepening insolvency claim belongs to the debtor corporation. Under a deepening insolvency analysis, a court does not treat the corporation and the shareholders the same; the property of the corporate debtor cannot be equated to the shareholder interest if the corporation is an independent entity. Therefore, insofar as a claim induces a corporate debtor to incur more debt, thereby damaging corporate property, the claim belongs to the corporate debtor rather than to the shareholders. It is important to remember, however, that the right may change depending on jurisdiction. The right generally belongs to the party to whom directors and officers owe a duty when a company nears or enters insolvency.

b. *The Creditors*

Litigants have argued in the alternative—that creditors should control the right to bring a deepening insolvency cause of action. Arguably, the creditors are directly impacted by deepening insolvency. When equity is drained from a corporation, the primary injury is to the creditors who were fraudulently induced to loan funds and who will not see a return on their investment. Under this reasoning, the creditors could own the claim.

Creditors may also try to use the recent zone of insolvency literature to propose that the duty of directors and officers expands to cover the creditors when a company is in the zone of insolvency. Recent case law in Delaware, however, raises doubt about the shifting duty.

Despite these arguments for a creditor's right to bring a deepening insolvency claim, most courts find that creditors or trustees in bankruptcy lack standing to pursue a claim on the creditor's behalf. Deepening insolvency is not a cause of action that creditors may bring on their own. The court in *CitX* explicitly closed the door for creditor claims in

---

372. See *Lafferty*, 267 F.3d at 349. The court in *CitX* also decided that the deepening insolvency claim belongs to the corporation as the party who is harmed. See Gold, Swinson & Reich, *supra* note 39, at 685.
373. See *Lafferty*, 267 F.3d at 353–54.
374. See id. at 354.
376. See *Apel*, *supra* note 258, at 93.
377. See id.
378. See Gold, Swinson & Reich, *supra* note 39, at 689. It is important to note that this is not the traditional definition of the harm in a deepening insolvency cause of action. See *supra* Part II.C.1.
379. See *supra* Part I.B.2.
380. See *supra* Part I.B.2.
381. See *Apel*, *supra* note 258, at 93–94.
382. See Gold, Swinson & Reich, *supra* note 39, at 685.
Pennsylvania and possibly the Third Circuit. Other courts have followed suit.

3. The Possible Defendants

The relevant literature debates which of three possible parties may be named as defendants in a deepening insolvency cause of action: gatekeepers and third-party professionals, directors and officers, or lenders and creditors. This part reviews each of these categories of defendants and explores which group is the ideal defendant in a deepening insolvency cause of action.

a. Gatekeepers

Many courts have allowed deepening insolvency claims against third-party professionals, such as accountants. Generally, a claim against accountants involves auditors that act in concert with directors and officers by misrepresenting the financial condition of the company. In Lafferty, the accountants and other gatekeepers were "responsible for professional opinions." The complaint alleged that they each conspired to render opinions with "multiple fraudulent misstatements and material omissions" concerning the financial condition of the corporation. The committee alleged that the professionals aided in the wrongful expansion of the corporation's debt, which ultimately forced the corporation to go into bankruptcy, creating a plausible deepening insolvency claim.

Other courts have explained that auditors should not be immunized from liability for their negligence to the corporation they were hired to audit. These courts further state that deepening insolvency is a practical way to "[hold] auditor[s] accountable for their negligence." Further, Thabault v. Chait, a case against the accounting firm PricewaterhouseCoopers LLC, does not foreclose the possibility of a deepening insolvency claim even in circumstances in which a claim for

383. See Seitz v. Detweiler, Hershey & Assocs. (In re CitX Corp.), 448 F.3d 672, 676 n.6 (3d Cir. 2006).
384. See Fehribach v. Ernst & Young LLP, 493 F.3d 905, 912–13 (7th Cir. 2007) (dismissing the suit because the auditor had no legally enforceable duty of care to the creditors).
385. See, e.g., Thabault v. Chait, 541 F.3d 512 (3d Cir. 2008); Smith v. Arthur Andersen LLP, 421 F.3d 989 (9th Cir. 2005); NCP Litig. Trust v. KPMG, 945 A.2d 132, 145 (N.J. Sup. Ct. Law Div. 2007).
388. See id.
389. See id.
390. See NCP Litig. Trust, 945 A.2d at 145.
391. Id.
392. Thabault, 541 F.3d 512.
professional malpractice has been successful. The court stated that the accountant did not disclose the insolvency of the company in an audit and negligently issued an overly favorable opinion.393

At the Thabault trial, the jury, deciding in favor of the company, found that but for the accountant’s negligence, the ultimate failure of the company would not have been definite.394 The defendants contended that when a plaintiff references deepening insolvency or injury to corporate property, recovery is not permissible in a mere negligence action.395 The court explained that this is incorrect and that when a plaintiff is injured, he may recover damages in accordance with state law.396

The Thabault court defined deepening insolvency as “injury to the [d]ebtors’ corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life.”397 The court explained that the harm caused by deepening insolvency may be avoided if the corporation is dissolved, when appropriate, instead of kept afloat with bogus debt.398 Holding accountants responsible for deepening insolvency could be a way to ensure this, legitimizing deepening insolvency claims against accountants.

Recall that, in CitX, the court did not find that the accountant’s audit harmed the corporation because the immediate result of the audit was increased capital and reduced debt.399 In Thabault, on the other hand, the audit had an immediate, negative consequence on the company.400 Even though the complaint in Thabault did not allege deepening insolvency as a cause of action, the court explained that New Jersey’s sister states have allowed deepening insolvency damages and that there have even been courts in New Jersey that have found deepening insolvency to be a legally cognizable harm caused by accountants.401 Therefore, to make a successful claim against accountants, the result of their audit or financial preparations must be harmful.

The Parmalat bankruptcy is another situation in which the court explained deepening insolvency claims against accountants. The court stated that the company’s ability to maintain its debt arrangement was

393. See id. at 515–16.
394. See id. at 516.
395. See id. at 520.
396. See id.
398. See id.
399. See id. at 520–21. Had the ultimate harm been linked to the audit, it is possible that the court may have found for the corporation in a deepening insolvency action against the accountants.
400. See id. at 522.
401. See id. (citing NCP Litig. Trust v. KPMG, 945 A.2d 132, 140 (N.J. Super. Ct. Law Div. 2007)).
dependent upon the company’s ability to guarantee its debt in order to obtain additional financing.\textsuperscript{402} Parmalat relied on “representations that Parmalat was financially healthy.”\textsuperscript{403} The trustee in this case claimed that the auditors misled the corporation by issuing unqualified opinions of the company’s financial statements.\textsuperscript{404}

In this case, however, the court did not address the deepening insolvency cause of action against the accountants, because the plaintiffs failed to allege that the company was injured by the accountant’s work when they were induced to incur debt.\textsuperscript{405} The court stated that incurring debt when a company is already insolvent does not deepen the company’s insolvency.\textsuperscript{406} If the company’s ability to pay its debts does not worsen, then its insolvency is not deepened, and an actionable claim against accountants will not accrue.\textsuperscript{407}

b. Directors and Officers

While a case has been made for deepening insolvency against accountants and other third-party professionals, many claims of deepening insolvency have been brought against directors and officers. In fact, most cases and analyses focus on suits against directors and officers.\textsuperscript{408} Indeed, in the seminal \textit{Lafferty} case, the debtor and its principals were defendants in the deepening insolvency cause of action.\textsuperscript{409} Cases against directors and officers explain that these principals, in a breach of their fiduciary duty to the corporation, have fraudulently prolonged the life of a corporation beyond insolvency.\textsuperscript{410} It is important to note that bringing a deepening insolvency cause of action against directors and officers will be difficult, absent a showing of fraud or conflict of interest, because the directors and officers are protected by the business judgment rule.\textsuperscript{411}

\textsuperscript{403} Id. at 566.
\textsuperscript{404} See \textit{id.} at 567–68. The auditors knew or should have known that the company’s financial condition was overstated and acted improperly in issuing its audit opinions. \textit{See id.} at 568.
\textsuperscript{405} See \textit{id.} at 573.
\textsuperscript{406} \textit{See id.} at 573–74.
\textsuperscript{407} \textit{See id.} at 574.
\textsuperscript{408} See \textit{Keilson, supra} note 266, at 975 (explaining that the recent trend is to include a deepening insolvency cause of action against directors and officers).
\textsuperscript{409} \textit{See id.} at 978.
\textsuperscript{410} \textit{See Franklin, supra} note 386, at 454–62 (explaining deepening insolvency against directors and officers). \textit{See generally} Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340 (3d Cir. 2001) (explaining that a deepening insolvency claim can be brought against directors and officers due to their fraudulent expansion of corporate life).
\textsuperscript{411} \textit{See Gold, Swinson & Reich, supra} note 39, at 693–94.
Lenders are also a possible target defendant in a deepening insolvency cause of action. The case for lender liability is a difficult one to make because lender law explains that the lender has no independent duty to the borrower.\textsuperscript{412} Many courts have disallowed deepening insolvency claims against lenders.\textsuperscript{413}

There are two primary problems with using deepening insolvency against a lender: (1) a loan cannot deepen a company’s insolvency because the money supplied equals the debt attained; and (2) the way directors and officers spend the money, rather than the borrowing, produces insolvency.\textsuperscript{414}

The claims in \textit{Kittay v. Atlantic Bank of New York}\textsuperscript{415} exemplify these problems. The court explains that a lender who extends credit, even if it knew or should have known it would not be repaid or that the loan could result in insolvency, does not commit deepening insolvency.\textsuperscript{416} A lender cannot be the defendant in a deepening insolvency claim because, even if it makes an imprudent loan, it does not amount to a tort; a third party is not legally prohibited from extending credit to an insolvent entity.\textsuperscript{417}

Some courts, however, have allowed these actions against lenders to proceed. A creditor who lends money in order to gain control of a corporation and then push it deeper into insolvency may be responsible for such a tort.\textsuperscript{418} Other courts have agreed.\textsuperscript{419}

\subsection*{4. The Elements}

The majority of courts that allow deepening insolvency to be an independent cause of action find the following elements vital to a successful case: prolongation of an insolvent company’s life coupled with either a

\begin{itemize}
\item \textsuperscript{412} \textit{See id.} at 698–99.
\item \textsuperscript{413} \textit{See Kittay v. Atl. Bank of N.Y. (In re Global Serv. Group, LLC), 316 B.R. 451, 459 (Bankr. S.D.N.Y. 2004) (refusing to allow a deepening insolvency claim to proceed against a lender for lack of a tort); Bondi v. Bank of Am. Corp. (\textit{In re Parmalat Sec. Litig.}) \textit{(Parmalat I)}, 383 F. Supp. 2d 587, 602 n.74 (S.D.N.Y. 2005) (discouraging deepening insolvency actions against lenders); see also Nisselson v. Ford Motor Co. (\textit{In re Monahan Ford Corp. of Flushing}), 340 B.R. 1, 39–40 (Bankr. E.D.N.Y. 2006) (refusing to allow trustee to bring a successful deepening insolvency action against lender unless the claim included more than simply prolonging the company’s life).}
\item \textsuperscript{414} \textit{See id.} at 459.
\item \textsuperscript{415} \textit{Kittay}, 316 B.R. at 456.
\item \textsuperscript{416} \textit{See id.} at 459.
\item \textsuperscript{417} \textit{See id.} at 458–59.
\item \textsuperscript{418} \textit{See Official Comm. of Unsecured Creditors v. Credit Suisse First Boston (\textit{In re Exide Techs.}, Inc.), 299 B.R. 732, 751–52 (Bankr. D. Del. 2003).}
\item \textsuperscript{419} \textit{See OHC Liquidation Trust v. Credit Suisse First Boston (\textit{In re Oakwood Homes Corp.}), 340 B.R. 510, 532 (Bankr. D. Del. 2006) (stating that the plaintiffs had alleged sufficient harm against lender defendants to plausibly support a deepening insolvency claim).}
\end{itemize}
separate tort or the breach of a separate duty.\footnote{420} No court, however, has ever explicitly articulated the elements.\footnote{421} Even in Lafferty, the pivotal deepening insolvency case, the court did not set forth the elements of the cause of action.\footnote{422}

There is much debate over the requisite mental state needed to state successfully a deepening insolvency claim. The debate turns on whether a defendant’s actions must be fraudulent or intentional, or if mere negligence or gross negligence will suffice. Those who argue in favor of a fraud standard base their argument on the language used in Lafferty that the tort itself must be the fraudulent prolongation of corporate life.\footnote{423} The Lafferty opinion employed the term “fraudulently” throughout.\footnote{424}

Cases that propose negligence as the proper standard explain that financial hardship as a result of deepened insolvency is what must be proven to find liability.\footnote{425} Further, in a case against an accountant, misrepresentation, whether intentional or not, led to a cognizable harm when it caused deepened insolvency.\footnote{426} Finally, the court in Gouiran Holdings, Inc. v. DeSantis, Prinzi, Springer & Shall,\footnote{427} upon which the Lafferty court based much of its reasoning, did not dismiss claims that alleged incurrence of unmanageable debt based on negligently prepared financial statements.\footnote{428}

5. The Possible Defenses to Deepening Insolvency

There are two dominant defenses to a successful deepening insolvency cause of action: \textit{in pari delicto} and lack of standing. This part will explore how these two defenses work and whether they are likely to be successful.

\footnote{420} See Mahoney, \textit{supra} note 255, at 1008; \textit{see also} Keilson, \textit{supra} note 266, at 980 (explaining that most courts list fraudulent or wrongful prolongation, increased insolvency, decreased value, and harm of shareholders that is independent from that of creditors, as the essential elements of the deepening insolvency tort).
\footnote{421} See Gold, Swinson & Reich, \textit{supra} note 39, at 698.
\footnote{422} See OHC Liquidation Trust, 340 B.R. at 533; \textit{see also} Gold, Swinson & Reich, \textit{supra} note 39, at 674.
\footnote{423} See Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 351 (3d Cir. 2001); \textit{see also} Seitz v. Detweiler, Hershey & Assoc., P.C. (\textit{In re} CitX Corp.), 448 F.3d 672 (3d Cir. 2006) (refusing to recognize a negligence standard for deepening insolvency); OHC Liquidation Trust, 340 B.R. at 534 (requiring plaintiff to show fraudulent conduct in a deepening insolvency action); Stanziale v. Pepper Hamilton LLP (\textit{In re} Student Fin. Corp.), 335 B.R. 539, 548 (D. Del. 2005) (finding that a debtor must allege that a deepening insolvency defendant defrauded the debtor).
\footnote{424} See Lafferty, 267 F.3d at 344, 350, 351, 360.
\footnote{426} See Smith v. Arthur Andersen LLP, 421 F.3d 989 (9th Cir. 2005).
\footnote{427} 165 B.R. 104.
\footnote{428} \textit{See id.} at 106 (deciding a claim based on negligently prepared financial statements).
WHERE WERE THE ACCOUNTANTS?

a. In Pari Delicto

The *in pari delicto* doctrine is pled as a defense in virtually every deepening insolvency action. The doctrine of *in pari delicto* states that a plaintiff cannot assert a claim against a defendant if the plaintiff bears some fault for the claim. The viability of this defense depends on whether or not the wrongdoing can be imputed to the debtor corporation in a deepening insolvency cause of action. Where wrongdoing is imputed, *in pari delicto* bars the action.

Generally, an agent’s fraud can be imputed to the principal, here the corporation, and would bar an action against a third party by the principal. The rationale for imputation of fraud breaks down in scenarios involving corporate audits because liability is more intricate. Imputation is generally governed by state law, and, as in the *Lafferty* case, imputation would attach from an officer to the corporation where the officer committed fraud (1) in the course of his employment and (2) for the benefit of the corporation.

There are some exceptions to the *in pari delicto* defense. First, the adverse-interest exception states that fraud will not be imputed if the “officer’s interests were adverse to the corporation” and thus did not act in the corporation’s benefit. The *Thabault* court explained that when the

---


430. See *Lafferty*, 267 F.3d at 354; see also *Thabault v. Chait*, 541 F.3d 512, 526 (3d Cir. 2008). The court in *Thabault v. Chait* cited *Lafferty* in explaining that, to impute the wrongdoing of a corporate officer, the wrongdoing must occur in the course of employment and for the benefit of the company. See id. at 527. The *Thabault* court further stated that a plaintiff may not assert a claim against a defendant if that plaintiff is at fault for that claim. See id. at 526.

431. See *Lafferty*, 267 F.3d at 355.

432. See id.

433. See Gold, Swinson & Reich, supra note 39, at 690.


435. See id. at 879–80. In *NCP Litigation Trust v. KPMG LLP* the court decided that imputation does not bar the trustee for the bankrupt corporation from suing the auditor for alleged negligence. See id. The court explained that imputation was designed to protect an innocent party from being sued. See id. at 882. Therefore, allowing an auditor to use the imputation defense to get off the hook for alleged negligent conduct, or worse, does not serve the purpose of the imputation doctrine. See id.

436. See *Lafferty*, 267 F.3d at 358.

437. See id. at 359.
fraudulent conduct is motivated by interests that are adverse to those of the corporation, the officer’s wrongdoing is not imputed.\footnote{Thabault v. Chait, 541 F.3d 512, 527–28 (3d Cir. 2008) (finding that the doctrine of \textit{in pari delicto} did not bar recovery against an accountant).} This exception is subject to the additional sole actor exception, which provides that the conduct of an agent who is the sole representative of a corporation is imputable to the corporation regardless of the corporation’s interests.\footnote{Lafferty, 267 F.3d at 359. This exception applies when the agent who commits fraud is the sole shareholder of the corporation. See id. at 359–60 (citing Mediators, Inc. v Manney (\textit{In re Mediators}), 105 F.3d 822, 827 (2d Cir. 1997)).}

In a deepening insolvency cause of action, imputation will be governed by whether the debtor is deemed to have participated in the wrongdoing based on the actions of the debtor’s management. For example, in \textit{Lafferty}, \textit{in pari delicto} worked to bar a viable cause of action because the debtor corporation was solely owned and operated.\footnote{Lafferty, 267 F.3d at 359–60 (citing Mediators, Inc. v Manney (\textit{In re Mediators}), 105 F.3d 822, 827 (2d Cir. 1997)).} Thus the agent’s fraudulent conduct was imputed to the corporation despite it being adverse to the interests of the corporation.\footnote{See Lafferty, 267 F.3d at 360.}

Further, in \textit{Parmalat}, the court held that the \textit{in pari delicto} doctrine did bar the complaint because it alleged that Bank of America and Parmalat acted jointly to manipulate the finances and overstate the company’s earnings and equity.\footnote{Bondi v. Bank of Am. Corp. (\textit{In re Parmalat Sec. Litig.} (\textit{Parmalat I}), 383 F. Supp. 2d 587, 596 (S.D.N.Y. 2005). The court further explained that the attribution of wrongdoing to a few corporate officers of Parmalat did not prevent the application of the doctrine because the insiders were acting for the company and the transactions with Bank of America were designed to conceal the insolvency of the company and continue to raise financing. See id. at 596–98.}

Another exception to this defense is equity. In the \textit{Lafferty} case, the court explained that \textit{in pari delicto} would be barred if an inequitable result would come from its application.\footnote{See id. at 596–98.} For example, in \textit{NCP} the court concluded that a claim concerning negligence may be brought against a company’s auditors if they allege the audit damaged the company.\footnote{See Lafferty, 267 F.3d at 360.}

In allowing this claim, the court did not allow the auditors to assert a successful \textit{in pari delicto} defense.\footnote{See id. at 596–98.}

It is important to remember the application of \textit{in pari delicto} applies to a trustee in bankruptcy, as it would to the debtor corporation itself. A trustee in bankruptcy, like all representatives of the debtor corporation, only succeeds to the rights that the corporation possessed.\footnote{See Lafferty, 267 F.3d at 360.}

Therefore, \textit{in pari delicto} is analyzed as if the trustee (or committee) were the corporation itself, with no fewer or greater rights, privileges, or immunities.\footnote{See id. at 360.}
b. Lack of Standing

Standing is an essential element in any cause of action. Standing can be established as long as the state law recognizes the cause of action, in cases governed by state law, and if federal law recognizes the cause of action for cases governed by federal law. Lafferty explains that standing requires the plaintiff, himself, to bear an injury that is more than "merely illusory." This issue is similar to the question of who may bring a cause of action for deepening insolvency. The debate circles around whether the claim belongs to the debtor corporation or to the creditors. It depends on who is harmed. Importantly, courts have found that deepening insolvency does create harm. The standing issue was broken down in Lafferty, where the court explained that a corporation, but not creditors, sustains direct and discrete injuries as a result of deepening insolvency.

Most courts find that the corporation has standing to pursue claims, but not the creditors. Notably, in Trenwick, the trustee asserted that it had standing to bring claims for both the debtor corporation and the creditors of the debtor corporation. The court found that the trustee may pursue only those claims belonging to the debtor corporation, but had no standing to pursue claims on behalf of the creditors.

Further, in Parmalat, the trustee for the corporation asserted a deepening insolvency claim against the lender. The bank alleged that Bondi, the representative of the debtor, did not have standing because all of the claims belonged to the creditors and not the debtor corporation. The court explained that this was wrong, and that, in fact, a Chapter 11 trustee may only assert claims of the debtor corporation and not those belonging to the creditors. Further, it is important to note that deepening insolvency claims, if brought on behalf of the debtor’s estate, can only be brought in bankruptcy under Bankruptcy Code § 541, since that provision deals with the debtor’s estate.

448. See id. at 348.
449. See id.
450. See supra Part II.C.2.
451. See Lafferty, 267 F.3d at 349. In this pivotal case, the court decided the issue of whether deepening insolvency was a valid independent tort that gave rise to a cognizable injury under Pennsylvania law. See id. Many courts agreed with Lafferty and found that deepening insolvency creates harm. See note 325 and accompanying text.
452. See Franklin, supra note 386, at 441–48; see also Lafferty, 267 F.3d at 344.
454. See id.
456. See id. at 593–94.
457. See id. at 594. Whether a claim belongs to a creditor or debtor is a matter of substantive law of the state governing the litigation. See id.
458. 11 U.S.C. § 541 (2006); see also Seitz v. Detweiler, Hershey & Assocs., P.C. (In re CitX Corp.), 448 F.3d 672, 676 n.6 (3d Cir. 2006).
Most courts have found that the creditor does not suffer direct and distinct harm from deepening insolvency, and that this harm is placed on the debtor corporation. Therefore, the trustee in bankruptcy will generally have standing only to pursue a deepening insolvency claim on behalf of the debtor.\textsuperscript{459}

In the end, courts and commentators must further define deepening insolvency as an independent claim in order for it to be used successfully as a tort claim against accountants. Deepening insolvency lacks concrete structure due to how courts have developed it. Namely, the \textit{Lafferty} court did not define the elements to a successful deepening insolvency claim. Thus, bringing a claim for deepening insolvency has been a game of trial and error for plaintiffs. This Note proposes one concrete structure for pursuing successful deepening insolvency claims against accountants.

III. DEEPENING INSOLVENCY IS A VIABLE CAUSE OF ACTION AGAINST ACCOUNTANTS

This Note proposes that the imposition of greater costs on gatekeepers, particularly accountants, will be an effective means of curtailing negligent and complicit conduct that may harm corporations and lead to accountant liability. If a deepening insolvency cause of action is established for the negligent preparation of financial statements, it would deter this practice and, at the same time, increase the reliability of financial statements. Often, negligent preparation of financial statements stems from acquiescence in managerial fraud. If the accountants can be deterred, corporations as a whole will be safer and more reliable. The argument proceeds as follows. Part III.A shows that deepening insolvency is, in fact, a valid, independent cause of action. Then, Part III.B describes the elements of a successful deepening insolvency claim against an accountant.

A. Deepening Insolvency Is Valid as an Independent Cause of Action

Deepening insolvency is a valid, independent cause of action. First, it cannot be argued that deepening insolvency never results in a cognizable harm.\textsuperscript{460} The \textit{Bloor} case initially illustrated that prolonging a corporation's life is not a presumed benefit.\textsuperscript{461} When a corporation's life is extended by increasing its insolvency in an effort to prolong its existence and possibly restore its viability, harm may result.\textsuperscript{462} As seen in \textit{Schacht}, prolonging the life of a financially ailing corporation does indeed cause harm.\textsuperscript{463}
The harm caused by deepening insolvency can have devastating effects on a corporation. Namely, deepening insolvency may cause a corporation to incur crippling debt, stifle business relationships, and destroy the possibility of recovery from equitable insolvency.\footnote{See supra notes 360–63 and accompanying text.} When such harm is demonstrated, a corporation should have a remedy.

The Third Circuit has upheld deepening insolvency as an independent cause of action.\footnote{See Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340 (3d Cir. 2001); see also Seitz v. Detweiler, Hershey & Assocs., P.C. (In re CitX Corp.), 448 F.3d 672 (3d Cir. 2006).} Many courts have followed suit.\footnote{See supra note 325.} In fact, all of the “Big Five” cases that developed and defined deepening insolvency are still good law. Lafferty and CitX have not been overturned, and they are the key cases that promote the independent tort theory.\footnote{While other courts may have disagreed with these holdings, the U.S. Court of Appeals for the Third Circuit has not expressly rejected a deepening insolvency cause of action.}

The justifications that Lafferty initially proffered for the validity of deepening insolvency as an independent tort still ring true today. The harm caused to a corporation is real. Today, corporations are no less susceptible to the inappropriate extension of corporate life, and may even be more so in today’s troubling economic times. As Lafferty asserted, where there is a harm, there too should be a remedy.\footnote{See Lafferty, 267 F.3d at 344.} The CitX court confirmed the holding that deepening insolvency is an independent tort and not a mere means of calculating damages.\footnote{In re CitX Corp., 448 F.3d at 677–80.}

Despite its criticisms, deepening insolvency remains a valid tort in many jurisdictions. While the court in Trenwick criticized the Lafferty holding, it did not overrule it. Trenwick applies to only those suits brought under Delaware law. Though it seems that Delaware law will govern the majority of cases, due to the disproportionate number of Delaware incorporations, this is not the case. Delaware law may govern suits regarding directors’ and officers’ duties, but it does not always govern suits against accountants and other gatekeepers because their primary place of business is not normally in Delaware.

Further, those cases that adopt the Trenwick logic are premised on multiple flawed assumptions. Importantly, the four main reasons that deepening insolvency is rejected as an independent cause of action are weak.\footnote{For a review of these justifications, see supra notes 348–59 and accompanying text.} Cases proffer that deepening insolvency cannot be an independent cause of action due to (1) a lack of authorizing state law; (2) a lack of standing; (3) the in pari delicto defense; or (4) the business judgment rule.\footnote{See Apel, supra note 258, at 99–100.} First, a lack of authorizing state law may be reason not to impose liability for a specific cause of action, but it is not reason to foreclose the
possibility of development of such a cause of action. This is circular logic that implies that since something does not yet exist, it cannot be created.

Next, the second main cause of rejection of the deepening insolvency claim, a lack of standing, is not reason to reject deepening insolvency as an independent cause of action. A party may fail to have standing to bring any of the claims that are considered actionable; this does not mean that the claim cannot withstand scrutiny as an independent cause of action for a plaintiff who does indeed have standing.

Third, the business judgment rule does not provide a valid criticism to deepening insolvency as an independent tort. The business judgment rule as a means of foreclosing deepening insolvency applies only to directors and officers. The business judgment rule does not apply to, nor does it limit the liability for, the other parties who have been considered possible defendants in deepening insolvency actions such as accountants, attorneys, and other third-party professionals.

Fourth, the in pari delicto defense cannot be a confirmatory reason for rejecting deepening insolvency as an independent tort. While in pari delicto may be an affirmative defense to a claim of deepening insolvency, it does not speak to the formation of the tort itself. The fact that a plausible defense exists is not a reason to foreclose the concept of this cause of action altogether. Given that the four main blockages to a viable deepening insolvency claim are weak and merely defensive, the tort should stand as an independent cause of action.

In addition to the fact that the main criticisms of the tort are insignificant, the cases that adopt Trenwick are based on the additional flawed assumption that deepening insolvency does not create harm. Those cases that oppose the tort argue the debt acquisition is a neutral transaction, meaning a corporation incurs only that debt for which they receive credit. Further, those courts assume that this short-term debt will help a company rebuild its capital and meet its needs. This is not always the case. In situations where debt is acquired as part of a sham operation or a ponzi scheme, the corporation will not see the benefits of the debt. Further, one cannot ignore the concept of additional interest that the corporation will have to pay back.

Importantly, the Trenwick decision itself is susceptible to criticism, providing another reason why deepening insolvency should be considered an independent tort. First, the Trenwick court foreclosed the possibility of deepening insolvency as an independent tort by analyzing it against the

472. See supra notes 56–68 and accompanying text. The business judgment rule is a liability scheme that applies to directors’ and officers’ fiduciary duty of diligence and does not extend to accountants or other third-party professionals.

473. See supra notes 429–47 and accompanying text.

474. See supra notes 310–18, 358 and accompanying text.

475. See supra note 358 and accompanying text.

476. See supra note 358 and accompanying text.

Where Were the Accountants?

478. See supra notes 307, 309, 315–18.

479. See supra notes 315–18 and accompanying text.

480. See supra notes 316–18 and accompanying text.

481. See supra note 307.


483. See supra notes 393–98 and accompanying text.

484. See supra notes 342–47 and accompanying text.

485. See infra Part III.B.2.c.

Traditional fiduciary duties imposed upon directors and officers of corporations.478 The court based its holding, in substantial part, on the fact that it refused to extend the traditional rules of fiduciary duties.479 The court instead explained that deepening insolvency is simply a means of getting around the business judgment rule and that this should not be allowed.480 The court ignored the possibility of assessing deepening insolvency against other parties.481 This weakens the holding that deepening insolvency is not recognized as an independent tort. Second, the Trenwick decision was based on a pleading that was conclusory, weak, and devoid of concrete facts.482 This may have affected the court's ability to assess a new cause of action.

Finally, there is case law that explains that even if deepening insolvency were considered duplicative, it could still stand independently.483 Some case law states that deepening insolvency is duplicative and should not be certified as a new tort.484 These courts ignore the fact that deepening insolvency creates a new harm. Further, the harm caused by deepening insolvency is not adequately remedied by existing causes of action.485

Given the fact that deepening insolvency is based on case law that is valid, lucid, and well reasoned, it should stand today as an independent tort. The four main criticisms are weak and based on defenses as opposed to actual flaws in any element of the claim. Further, deepening insolvency creates a harm that necessitates a unique remedy. Despite case law that breaks down the tort against directors and officers and lenders, it remains a strong cause of action when applied to accountants and third-party professionals.

B. The Characteristics of a Successful Deepening Insolvency Claim Against Accountants

Now that deepening insolvency has been established as a valid independent tort, a debtor corporation can bring a successful claim for deepening insolvency against accountants. Courts should recognize this claim against accountants because it will promote increased reliability of financial statements and encourage accountants to report managerial fraud. Further, accountants will be liable for their negligent conduct under this independent tort. Finally, a deepening insolvency cause of action against accountants is not susceptible to the relevant defenses.
1. The Debtor Corporation Is the Proper Plaintiff

The debtor corporation should be the plaintiff in a deepening insolvency cause of action because the corporate body feels the direct harm of the tort.\textsuperscript{486} The injury to corporate property is legally distinct from that felt by any other party, namely shareholders, creditors, or individuals. It is the corporation that is forced to incur additional debt and have its insolvency deepened.\textsuperscript{487} A corporation is an independent entity and may not be equated with its shareholders, or any other party for that matter.\textsuperscript{488} Since a claim of deepening insolvency is premised on the fact that a corporate debtor is induced to incur more debt, it is the corporate property that is damaged as a result of deepening insolvency, and the corporation who owns the claim.\textsuperscript{489}

Because deepening insolvency only results in harm when the corporation is damaged, it is most likely that a debtor corporation in bankruptcy will be the plaintiff in a deepening insolvency cause of action. It should be the trustee in bankruptcy who brings a deepening insolvency cause of action on behalf of the debtor corporation.

The creditors of a bankrupt corporation should not be able to bring a claim of deepening insolvency. While a claim generally belongs to the party to whom directors and officers owe a duty when a company nears or enters insolvency, the discourse that explains that a creditor is owed a duty when a company enters insolvency has been recently criticized.\textsuperscript{490}

Further, the harm caused by deepening insolvency is peripheral to a creditor.\textsuperscript{491} The direct effect is felt by the corporation. The creditors are affected when the corporation cannot repay its debts to the creditors. If the right is given to the creditors, it confuses the purpose and harm of the cause of action. If the creditors own the claim, then the harm caused by deepening insolvency is confined to the fraudulent inducement of creditors to loan funds that will not be repaid. This ignores the multitude of other harms felt distinctly by the corporate body as a result of deepening insolvency.

2. Accountants Are the Proper Defendants

a. The Need for Increased Accountants' Liability

Since much of the criticism of deepening insolvency bases its reasoning on the business judgment rule and the defenses available to directors and

\textsuperscript{486} See supra notes 370–75 and accompanying text.
\textsuperscript{487} See supra notes 360–75 and accompanying text.
\textsuperscript{488} See supra notes 37–38 and accompanying text.
\textsuperscript{489} See supra notes 360–68 and accompanying text.
\textsuperscript{490} See supra notes 82–94 and accompanying text.
\textsuperscript{491} See supra notes 381–84 and accompanying text.
WHERE WERE THE ACCOUNTANTS?

officers, there is room and need for the deepening insolvency tort against accountants to promote reliability of financial statements.

First, the financial statements that accountants prepare are critical to the health of a corporation. Directors and officers rely on financial statements both in making decisions and in portraying the financial health of the corporation to the outside world. If accountants are not subject to adequate liability, financial statements will not be reliable as a means of accurately representing the financial condition of a corporation. This can have devastating effects for the corporation itself, as well as the market and potential investors.

Since directors and officers, acting alone, may not always pursue the best interests of the corporation, it is up to the auditors to make certain that earnings manipulation and other financial schemes are not occurring. Accountants, as gatekeepers, must disrupt the misconduct of corporate officers by withholding cooperation in a fraudulent scheme.

Accountants, however, are in business to make money and want to make their clients happy. This can result in complicit accounting where corrupt business practices are overlooked. Complicit accounting may result in a repetition of the Enron situation. Imposition of greater liability on accountants through the tort of deepening insolvency will avoid such repetition.

Further, the passage of the Sarbanes-Oxley Act evidences both the need and desire for increased accountant liability to prevent corporate fraud. While SOX increases the liability for accountants, it leaves room for increased deterrence against accountants who may engage in complicit auditing.

Section 302 of SOX increases the requirements for the CEO and CFO of corporations, who must now take increased responsibility for financial statements by certifying them. The CEO and CFO certify these financial statements to the board of directors of a corporation, meaning that the board can rely on these statements. If the board gives these, now certified, statements more weight, it is important that they are reliable. Accountant liability is critical here. If a board is receiving certified financial statements, with no reason to doubt their accuracy, and accountants have not ensured that the CEO and CFO made accurate representations, then decisions may be made that could adversely affect the corporation.

492. See supra notes 348–56 and accompanying text.
493. See supra notes 104–10 and accompanying text.
494. See supra notes 105, 107 and accompanying text.
495. See supra notes 126–30 and accompanying text.
496. See supra notes 126–27 and accompanying text.
497. See supra notes 128–30 and accompanying text.
498. See supra notes 131–40 and accompanying text; see also supra notes 241–43 and accompanying text.
499. See supra notes 141–66 and accompanying text.
500. See supra notes 154–62 and accompanying text.
b. Heightened Liability Increases Reliability

Increased accountants' liability will promote reliability of financial statements since it will deter negligent, reckless, or wrongful behavior on the part of accountants.\textsuperscript{501} Deepening insolvency provides a means for increasing accountants' liability. Allowing actions against negligent auditors will deter wrongdoing or negligence on their part in the future.\textsuperscript{502} Limitless liability for accountants is not the solution, but, merely increased liability will require an auditor to answer in court when they fail to detect fraud or manipulation on the part of directors and officers that a reasonable accountant would discover.\textsuperscript{503}

Gatekeeper theory shows that gatekeepers fail either when the economy is in a market bubble or where there is a lack of deterrence.\textsuperscript{504} Currently, the market is not in a euphoric bubble and is in fact stressed. The alternate reason, a lack of deterrence, is the likely reason for accountant failure. Therefore, increased deterrence is an appropriate means for increasing the reliability of accountants as gatekeepers.\textsuperscript{505}

The deterrence theory explains that, if the risk of litigation is low for accountants, the benefits of complying in aggressive accounting practices will outweigh the costs.\textsuperscript{506} If litigation risk increases, then accountants will engage in more reliable accounting practices. As a result, corporate financial statements will be more accurate. While not all accountants are equally deterred by increased liability,\textsuperscript{507} the prevention of even one major corporate downfall due to managerial fraud will make the increased liability worthwhile.

Deepening insolvency against accountants will deter complicit accounting. The Heninger Study shows that if auditors want to avoid litigation, they should carefully scrutinize corporate financial statements.\textsuperscript{508} The increased reliability of financial statements, due to more rigorous accounting, will help prevent companies from being forced into bankruptcy or drained of all their assets due to deepened insolvency.

c. The Causes of Action Currently Available Are Insufficient

The causes of action currently available against accountants are insufficient to fully deter accountants from complicit accounting. Recent

\textsuperscript{501} See supra notes 244--54 and accompanying text.
\textsuperscript{502} See NCP Litig. Trust v. KPMG LLP, 901 A.2d 871, 886--87 (N.J. 2006).
\textsuperscript{503} See id. at 887. For a discussion of the difference between deepening insolvency and professional malpractice, see infra Part III.B.2.c.i.
\textsuperscript{504} See supra note 225 and accompanying text.
\textsuperscript{505} See supra notes 244--54 and accompanying text.
\textsuperscript{506} See supra notes 234--37 and accompanying text.
\textsuperscript{507} See supra notes 238--40 and accompanying text.
\textsuperscript{508} See supra notes 248--49 and accompanying text.
WHERE WERE THE ACCOUNTANTS?

corporate scandals and downfalls evidence the need for increased liability. Deepening insolvency fits this need.

i. Professional Malpractice

Liability for professional malpractice, while setting a basic standard of care for accountants, will not work to deter all complicit accounting. First, complicit accounting does not fall within the liability scheme of professional malpractice. Additionally, it can be difficult for a plaintiff to meet the burden of accounting negligence since it is based on industry practice. If the standard is low, a plaintiff will not recover unless the breach was severe. For this reason, it is possible that an accountant complied in a fraudulent corporate scheme while still complying with GAAP and GAAS standards. Without a breach of these standards, a claim for professional malpractice will not accrue.

ii. Negligent Misrepresentation

Negligent misrepresentation leaves gaps that will enable accountants to be complicit in aggressive accounting schemes. Negligent misrepresentation requires that an accountant supply false information in the course of a business transaction for the guidance of others. While accountants do supply information through financial statements, it is the directors and officers, not the accountants, that often supply false information.

Further, the plaintiff would have to prove that the accountant knew or should have known that the information was false. Additionally, since the harm in many cases against accountants is pecuniary in nature, courts will apply a limited and restrictive view of liability for negligent misrepresentation. This limited view of liability makes negligent misrepresentation an inadequate remedy as a claim will rarely succeed.

iii. Aiding and Abetting

Liability for aiding and abetting will not sufficiently deter accountants in order to increase liability for financial statements in the place of deepening insolvency. First of all, for a plaintiff to make a case of aiding and abetting, proof of the underlying fraud that the accountant aided must be shown. This limits claims against accountants to those in which the corporation can show that the directors and officers engaged in fraud. Further, the recent

509. See supra notes 4–17 and accompanying text.
510. See supra notes 186–92 and accompanying text.
511. See supra notes 193–95 and accompanying text.
512. See supra note 199 and accompanying text.
513. See supra note 197 and accompanying text.
514. See supra notes 202–09 and accompanying text.
Stoneridge case places doubt on the availability of aiding and abetting causes of action under the federal securities laws.\(^{515}\)

iv. Fraud

Finally, it will be difficult for a corporation to recover for the harm caused by deepening insolvency under a fraud cause of action. In order to prove fraud, a plaintiff must show in the complaint that a defendant knowingly engaged in the acts.\(^{516}\) This limits accountants’ liability to only those cases in which they engaged in fraudulent conduct that can be proven. Accountants, however, should be held liable when their negligence and recklessness results in harm to a corporation, even if their conduct is short of fraud. Further, it is quite difficult to plead fraud since a plaintiff must plead particularized facts to support such a claim.\(^{517}\)

Regardless of whether any one of the above tort claims is sufficient to compensate for the harm caused by deepening insolvency, some courts allow redundancy in causes of action. The Thabault case allows such redundancy. The court explained that even though New Jersey already recognizes a tort in the form of malpractice or negligent auditing that could compensate for damages caused by deepened insolvency, it would not foreclose the possibility of a deepening insolvency cause of action, or theory of damages, in New Jersey.\(^{518}\) In the end, the existing remedies against accountants are inadequate in most cases. For this reason, courts should recognize deepening insolvency as an essential additional to the gamut of claims against accountants.

3. The Proper Elements to a Deepening Insolvency Claim

No court has explicitly articulated the elements of a deepening insolvency claim.\(^{519}\) Most courts that accept deepening insolvency as a tort, however, find that a colorable claim consists of prolongation of an insolvent corporation’s life through the incurrence of new debt, deepened insolvency, and breach of some duty.\(^{520}\) To plead an actionable claim against an accountant for deepening insolvency, the trustee in bankruptcy, on behalf of the debtor corporation, should allege the following elements: (1) deepened insolvency causing harm to the corporation, (2) negligent or reckless accounting, and (3) causation.

\(^{515}\) See supra notes 211–14 and accompanying text.

\(^{516}\) See supra note 215 and accompanying text.

\(^{517}\) See Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P., 906 A.2d 168, 208 (Del. Ch. 2006) (holding that fraud was not plead with particularity in a case where the plaintiff stated that the directors fraudulently concealed issues regarding reserve level, a merger, and other information that they had a duty to disclose to the plaintiff). The court goes on to describe that the plaintiff lacked specific information regarding when and how the information was specifically concealed. See id. at 210.

\(^{518}\) See Thabault v. Chait, 541 F.3d 512, 522–23 (3d Cir. 2008).

\(^{519}\) See supra notes 421–22 and accompanying text.

\(^{520}\) See supra note 420 and accompanying text.
The first element to a deepening insolvency cause of action is harm caused to the corporation by deepened insolvency. This Note will not define the exact amount by which insolvency must increase to demonstrate deepened insolvency necessary for an actionable claim. A plaintiff must also show that harm was caused to the corporation as a result of this deepened insolvency. Whether or not insolvency was deepened and the corporation was harmed should be a question of fact determined by the court on an individual basis.

The second element to a deepening insolvency cause of action is negligent or reckless accounting. The requisite mental state necessary for a defendant of deepening insolvency has been widely debated.\(^{521}\) An accountant, however, should not be held to a higher standard than negligence or recklessness. The corporation should not need to plead that an accountant knowingly engaged in fraud or knowingly allowed a corporate manager to fraudulently incur additional debt.

Generally, the argument for a fraudulent conduct standard is based on the omnipresent language “fraudulent prolongation of [corporate] life” in the \textit{Lafferty} case.\(^{522}\) The \textit{CitX} court adopted this standard and foreclosed the possibility of a negligence standard, limiting the reach of deepening insolvency claims.\(^{523}\) Deepening insolvency does not need to be based on a negligence standard because \textit{Lafferty} does not explicitly hold this and \textit{CitX} is distinguishable.

The \textit{Lafferty} court, in defining the extension of corporate life, described it as wrongful and fraudulent.\(^{524}\) The court did not go so far as to say, however, that the conduct causing this wrongful prolongation must be fraudulent.\(^{525}\) The court was likely describing the prolongation of corporate life as fraudulent and wrongful because prolongation that leads to harm to a corporation is the basis of a deepening insolvency tort. Further, the \textit{Lafferty} court based a significant part of its reasoning on \textit{Gouiran Holdings, Inc.} In that case, a claim was not dismissed despite being based on financial statements that were prepared negligently, but in no way fraudulently.\(^{526}\) This serves as further evidence that \textit{Lafferty} did not intend to extend a fraudulent standard to all claims of deepening insolvency.

Next, the \textit{CitX} case, which proposes that only fraudulent conduct may lead to wrongful prolongation of corporate life, is distinguishable. First, it misinterprets and wrongfully limits the holding of \textit{Lafferty}, as described above. Additionally, the \textit{CitX} holding was based on an accountant’s financial compilations.\(^{527}\) Financial compilations have a lower standard of

\(^{521}\) See \textit{supra} notes 423–28 and accompanying text.
\(^{523}\) See \textit{supra} notes 299–302 and accompanying text.
\(^{524}\) See \textit{Lafferty}, 267 F.3d at 351.
\(^{525}\) See generally id.
\(^{527}\) See \textit{supra} note 290 and accompanying text.
care associated with them than complete audits or financial reports. In this case, the court may have broadly stated that negligence would not suffice to make a claim of deepening insolvency, since the standard of care for the accountants was low.

Further, in claims against directors and officers, the fraudulent standard is logical, whereas in claims against accountants it is not. For directors and officers, generally negligent conduct based on reasonable determinations will be protected by the business judgment rule. Directors and officers will not be held to a lower standard than this rule imposes. Accountants, however, have been held to a lower standard in cases of deepening insolvency which explain that any misrepresentation by an accountant, whether intentional or not, leads to a cognizable harm when it causes deepening insolvency.

Additionally, if deepening insolvency is to serve as a means of increasing accountants' liability in order to prevent fraud by directors and officers, then a negligence or recklessness standard is necessary. Directors and officers often engage in fraud, earnings manipulation, and other schemes to increase revenue. Accountants are hired to monitor and support these directors and officers. It is important that complicit accounting does not occur. When accountants make negligent mistakes that result in an officer getting away with, for example, a ponzi scheme, the consequences for a corporation can be devastating.

This Note in no way proposes a strict liability standard for accountants. Instead, to accomplish the purpose of the deepening insolvency cause of action, accountants should be held liable for negligent or reckless errors. This standard increases the reliability of financial statements because it increases accountants' liability for the reasonably perceived fraudulent or misleading conduct of directors and officers.

Finally, the third element of deepening insolvency is causation. Causation will be a question of fact for a court to determine on a case by case basis. If the corporation can show that the directors and officers relied on negligently prepared financial statements in making risky decisions that harmed the company, causation should be satisfied. Further, if accountants are complicit in managerial schemes to manipulate earnings, causation again should be satisfied.

528. See supra note 291 and accompanying text.
529. See supra notes 50–68 and accompanying text.
530. See supra notes 386–407 and accompanying text. Additionally, since professional negligence does not carry a higher standard, it is logical that accountants should be held equally liable for the harms caused as a result of deepening insolvency when that harm is causally linked to a negligently prepared financial statement.
531. See supra notes 96–103 and accompanying text.
532. See supra notes 104–10 and accompanying text.
533. The Enron case is a classic example of such gatekeeper failure. See supra notes 131–40, 242–43 and accompanying text. Additionally, the Refco scandal orchestrated by corporate executives presents another case in which accountants may have stepped in and prevented some or all of the harm. See supra notes 6–16 and accompanying text.
4. Overcoming the Applicable Defenses

Deepening insolvency, when brought by a corporation against its accountant, is not susceptible to the relevant defenses. This section shows that neither standing, privity, nor in pari delicto will bar a recovery by a corporation against an accountant for the harm caused by deepening insolvency.

a. Standing and Privity Are Not at Issue

First, accountants will not be able to defend a deepening insolvency cause of action brought by a trustee in bankruptcy, on behalf of the debtor corporation, based on lack of standing or privity. Privity will never be absent since the accountant and the corporation it audits (or works for) necessarily have a business relationship that would satisfy any requirement for privity.\(^{534}\)

Next, an accountant cannot argue that the trustee in bankruptcy does not have standing to bring a claim on behalf of the debtor corporation. It is settled that a trustee in bankruptcy has standing to bring claims on behalf of a debtor corporation.\(^{535}\) In the case of deepening insolvency, the harm is properly felt by the corporation.\(^{536}\) Since the corporate body is the party that is damaged, the trustee in bankruptcy has proper standing to bring the claim for the corporation.

b. In Pari Delicto Does Not Apply

In the case of a deepening insolvency claim against an accountant, in pari delicto does not create an affirmative defense. Accountants may argue that in pari delicto is a valid defense because a corporation may not assert a claim if it bears fault for that claim.\(^{537}\) Accountants could argue that the wrongdoing of corporate officers that went undetected or unstopped by accountants and that likely played a role in the deepened insolvency should be imputed to the corporation. Imputation would be a plausible defense if it was done during the course of employment with, and for the benefit of, the corporation.\(^{538}\) It is not likely that these requirements will be met.

Imputation is susceptible to two major exceptions that come into play in a deepening insolvency case against accountants.\(^{539}\) First, the adverse-interest exception applies to such cases. In a deepening insolvency case, the corporation is harmed by the actions of the corporate officers and other

---

534. See supra note 181 and accompanying text.
535. See supra notes 183–85 and accompanying text.
536. See supra notes 370–75 and accompanying text.
537. See supra note 430 and accompanying text.
538. See supra notes 431–33 and accompanying text.
539. The adverse-interest exception, absent a sole actor, and equity are exceptions to imputation. See supra notes 437–45 and accompanying text.
parties that play a role in wrongfully prolonging its life.\textsuperscript{540} Therefore, the conduct of the corporate managers is adverse to the interests of the corporation, preventing the imputation of their wrongful conduct to the corporation.

Second, the sole actor exception may apply to deepening insolvency cases. The sole actor exception, which would impose imputation where the officer engaging in wrongdoing is the sole representative of a corporation,\textsuperscript{541} generally will not apply to the types of fraud that occur in large corporations such as Enron that this Note addresses. Because wrongful prolongation of corporate life is harmful to a corporation, \textit{in pari delicto} will not bar a claim of deepening insolvency against an accountant. Further, equity dictates that liability will attach if an inequitable result would transpire otherwise.\textsuperscript{542} Accountants should not be exonerated for engaging in negligent or complicit audits if a proper audit could have prevented harm to the corporation.

Finally, there is ample case law that shows that \textit{in pari delicto} does not bar a corporation from suing a negligent accountant for deepening insolvency.\textsuperscript{543} The \textit{NCP} case is a clear example. The \textit{NCP} court held that imputation did not bar a claim by a bankruptcy trustee against an accountant because imputation is designed to protect only an innocent party.\textsuperscript{544} Therefore, an auditor should not be allowed to use imputation as a defense to his own negligence or reckless conduct. Further, in the \textit{Thabault} case, the court explained that \textit{in pari delicto} does not prevent a corporation from recovering against a negligent auditor or accountant.\textsuperscript{545} Therefore, when brought against accountants, deepening insolvency presents a viable and important cause of action that will increase the reliability of financial statements and deter complicity in managerial fraud. Deepening insolvency can stand as an independent tort. Since a debtor corporation is uniquely harmed by wrongful prolongation of corporate life, it rightfully owns the cause of action. Accountants are ideal defendants in a deepening insolvency cause of action. Further, when brought against accountants by a debtor corporation, deepening insolvency is not susceptible to the relevant defenses. In the end, deepening insolvency should result in successful claims against accountants where their negligent audits caused harm to a corporation in the form of wrongfully prolonging corporate life.

\textsuperscript{541} See supra note 439 and accompanying text.
\textsuperscript{542} See supra notes 443–44 and accompanying text.
\textsuperscript{543} See supra notes 390–98 and accompanying text.
\textsuperscript{544} See supra note 435.
\textsuperscript{545} See \textit{Thabault} v. \textit{Chait}, 541 F.3d 512, 528 (3d Cir. 2008). The auditor negligence exception to \textit{in pari delicto} explains that a claim for negligence may be brought on behalf of a corporation against its auditors for damages that the auditor’s negligence caused. See \textit{id.} (citing \textit{NCP} Litig. Trust v. KPMG LLP, 901 A.2d 871, 882 (N.J. 2006)).
CONCLUSION

Given today's economy, reliable accounting and responsible business management will be essential to regaining confidence in corporations. Accountants, as gatekeepers, must work to prevent managerial fraud and ensure that corporations paint only an accurate picture of their financial worth. Deepening insolvency, which will increase liability for accountants, is a means of ensuring that accountants will engage in responsible accounting practices. This cause of action should be recognized as a valid, independent cause of action because there is adequate case law to support the independent tort theory, and there is room and need for increased liability against accountants. Further, the current causes of action do not adequately address the harms caused by deepening insolvency. In order to prevent managerial fraud from inflating corporate debt and pushing corporations into bankruptcy, deepening insolvency should be recognized against accountants. Deepening insolvency will encourage accountants to responsibly audit corporations and shun complicit accounting practices.
Notes & Observations