2012]

STILL SOLVENT: THE THIRD CIRCUIT CONTINUES TO SUPPORT “DEEPENING INSOLVENCY” AS A VIABLE TORT CLAIM IN 
IN RE LEMINGTON HOME FOR THE AGED

ERIC Kim*

“A corporation is not a biological entity for which it can be presumed that any act which extends its existence is beneficial to it.”1

I. INTRODUCTION

Vince Lombardi, the wildly successful head coach of the 1960s era Green Bay Packers, is credited with once saying that “winners never quit and quitters never win.”2 As admirable as this old adage on perseverance may seem, directors of insolvent corporate entities face an extremely complex situation, where choosing to liquidate—or “quitting”—may often be the best option to maximize value for shareholders and creditors.3 Recently, however, some courts held directors tortiously liable for not dissolving a corporation soon enough.4 More specifically, under the theory of “deepening insolvency” many jurisdictions began to hold that directors who continue to prolong the life of an insolvent corporation can be personally liable for any damages caused as a result.5 Consequently, in juris-

* J.D. Candidate, 2013, Villanova University School of Law. I would like to thank the faculty of Villanova University School of Law for their support, my colleagues on the Villanova Law Review for their tireless efforts, and Marie and Jinchul Kim for giving me the opportunity to attend law school.

1. See Funding Corp. of N.Y. v. Dansker (In re Investors Funding Corp. of N.Y. Sec. Litig.), 523 F. Supp. 533, 541 (S.D.N.Y. 1980) (explaining how prolonging insolvent corporate entity’s existence may actually be harmful).


3. See Sabin Willett, The Shallows of Deepening Insolvency, 60 BUS. LAW. 549, 551–53 (2005) (explaining nature of insolvency and discussing how keeping corporation in existence after it has continually been insolvent or unprofitable only hurts shareholders—who are residual claimants upon liquidation—and creditors).


dictions that subscribe to deepening insolvency, creditors could use the theory to file claims against directors, officers, and anyone playing a substantial role in a business entity’s management.6

The debate on deepening insolvency has been contentious, to say the least.7 Corporate practitioners and their clients have lamented that deepening insolvency circumvents the business judgment rule and places too much liability on a corporation’s management.8 Many academics have heralded the theory as an innovative addition to corporate and bankruptcy law.9 Other commentators have predicted that deepening insolvency could lead directors to liquidate a corporation too soon.10 On the...
contrary, shareholders and creditors have generally supported the theory by arguing that it merely ensures that actions are taken to maximize corporate value.11 This disparity has extended to the courts, as the lower federal and state courts continue to disagree on the divisive theory.12 Some have held that deepening insolvency should be considered a form of damages for other torts such as negligence or malpractice.13 Others have held that deepening insolvency should be an independent tort claim.14 as a tort creates inconsistencies for directors’ and officers’ fiduciary duties of care and loyalty, which may require them to try and save an insolvent corporation with more capital (i.e., loans). See id. at 545–47 (discussing inconsistencies between deepening insolvency and fiduciary duties).


But like any novelty, deepening insolvency appeared to rapidly lose its popularity. The turning point came from the highly influential Delaware Court of Chancery (“Chancery Court”) in the case of *Trenwick America Litigation Trust v. Ernst & Young, L.L.P.*,16 where the court not only affirmatively rejected deepening insolvency as a tort claim, but actually reprimanded the Bankruptcy Court for the District of Delaware for assuming that Delaware state law would support such a conclusion.17 Subsequently, the *Trenwick* court’s decision to discard deepening insolvency led other courts to follow suit.18 Since 2006, many jurisdictions have either completely rejected the theory, or at the very least, marginalized it.19

The Third Circuit originally appeared to be a firm supporter of deepening insolvency through its expansive holding in *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co.*,20 where the court first established deepening insolvency as a viable tort claim in Pennsylvania.21 Later, the


17. See id. at 204 (“The concept of deepening insolvency has been discussed at length in federal jurisprudence, perhaps because the term has the kind of stentorous academic ring that tends to dull the mind to the concept’s ultimate emptiness.”). Furthermore, the Delaware Chancery Court stated:

*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. Even when the company is insolvent, the board may pursue, in good faith, strategies to maximize the value of the firm. As a thoughtful federal decision recognizes, Chapter 11 of the Bankruptcy Code expresses a societal recognition that an insolvent corporation’s creditors (and society as a whole) may benefit if the corporation continues to conduct operations in the hope of turning things around.*

*Id.* (opining that theories such as deepening insolvency could not impose duty to liquidate when State would like directors to put forth their utmost effort to save insolvent corporation).

18. See Wooley v. Faulkner (*In re SI Restructuring, Inc.*), 532 F.3d 355, 363 (5th Cir. 2008) (“In the Delaware Court of Chancery, the doctrine of deepening insolvency as an independent cause of action or as a theory of damages was also considered and rejected . . . .”); *Official Comm. of Unsecured Creditors of Propex, Inc. v. BNP Paribas (In re Propex, Inc.)*, 415 B.R. 321, 331 (Bankr. E.D. Tenn. 2009) (“The current state of affairs with regard to deepening insolvency, as the court sees it, is that the theory is still obscure and difficult to distinguish from existing torts . . . .”); *Christians v. Grant Thornton, L.L.P.*, 733 N.W.2d 809, 812 (Minn. Ct. App. 2007) (holding that deepening insolvency is not recognized form of corporate damage in Minnesota).

19. For a further discussion of how various state jurisdictions began to marginalize deepening insolvency, see supra note 16 and accompanying text.

20. 267 F.3d 340 (3d Cir. 2001).

21. See id. at 344 (“We conclude that ‘deepening insolvency’ constitutes a valid cause of action under Pennsylvania state law and that the Committee therefore has standing to bring this action.”). When the *Lafferty* holding first came out,
Circuit seemed to follow the Delaware Chancery Court through its holding in In re CitX Corp.\textsuperscript{22} There, the court unequivocally limited deepening insolvency to conduct involving fraud and held that the theory only applied as an independent tort and not as a form of damages.\textsuperscript{23} Many practitioners and academics viewed the CitX decision as marginalizing the holding of Lafferty, furthering the assumption that deepening insolvency would meet the same fate in Pennsylvania that it had met in Delaware.\textsuperscript{24} Nonetheless, in the recent case In re Lemington Home for the Aged,\textsuperscript{25} the Third Circuit surprised many practitioners by not only affirming the continued existence of deepening insolvency, but also vacating a dismissal of the appellant’s deepening insolvency claim, strongly suggesting that the tort still has its “teeth.”\textsuperscript{26}

many academics and practitioners viewed it as the single most influential ruling on deepening insolvency, particularly because it validated the theory as an independent cause of action in tort. See Laura Colasacco, Note, Where Were the Accountants? Deepening Insolvency As a Means of Ensuring Accountants’ Presence When Corporate Turmoil Materializes, 78 Fordham L. Rev. 793, 827 (2009) (“Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., is the pivotal case that defined deepening insolvency as an independent tort.”). Through Lafferty, the Third Circuit was the first federal circuit court to address the claim of deepening insolvency and embrace the concept of deepening insolvency as an independent tort. See Hugh M. McDonald et al., Lafferty’s Orphan: The Abandonment of Deepening Insolvency, Am. Bankr. Inst. J., Dec.–Jan. 2008, at 1, 57–58 (“However, the theory did not fully evolve until the Court of Appeals for the Third Circuit’s decision in Official Committee of Unsecured Creditors v. R.F. Lafferty & Co. Inc.”).


23. See id. at 677 (“Although we did describe deepening insolvency as a ‘type of injury,’ and a ‘theory of injury,’ we never held that it was a valid theory of damages for an independent cause of action.” (citations omitted)).

24. See Michelle M. Harner & Jo Ann J. Brighton, The Implications of North American Catholic and Trenwick: Final Death Knell for Deepening Insolvency? Shift in Directors’ Duties in the Zone of Insolvency?, 2008 ANN. SURV. BANKR. L. 1 (“The Third Circuit subsequently backed away from its position in Lafferty regarding deepening insolvency and the types of injury subject to redress in CitX Corp.”). As one commentator noted:

[T]he Third Circuit in CitX took aim at deepening insolvency and successfully limited its reach in three ways: (1) the court held that deepening insolvency may not be invoked as a theory of damages to support a malpractice cause of action; (2) the court ruled that a deepening insolvency claim cannot be sustained solely on an allegation of negligent conduct; and (3) the court ruled that Lafferty’s precedential value was limited to courts within Pennsylvania.


This Casebrief serves as an update on deepening insolvency within the Third Circuit jurisprudence and aims to give legal practitioners a guide to understanding the mechanisms of the controversial but resilient tort. Part II provides a more detailed overview of the judicial decisions that led to the development of deepening insolvency. Part III examines the holding in Lemington and how the case fits into the Third Circuit jurisprudence. Finally, Part IV analyzes the potential impact of Lemington and concludes that practitioners in Pennsylvania should continue to be aware of the deepening insolvency tort when advising directors, officers, and any professionals working for unsuccessful or insolvent corporations.

II. The Contemporary History and Development of Deepening Insolvency

A. Conceived from the Depths of Dicta

It is important to remember that deepening insolvency is not based on any bankruptcy code or statute, but rather was born from common law. As such, the exact origin of deepening insolvency is difficult to pinpoint. However, it is widely believed that the theory evolved from cases in the 1980s concerning breach of fiduciary duty claims against directors who fraudulently prolonged the life of their corporations. In

...
these cases, directors would often attempt to use the *in pari delicto* defense to argue that they could not be held liable for prolonging a corporation’s life, under any circumstances, because doing so benefited the corporation. 34 A New York district court faced such an argument in the case *In re Investors Funding Corporation of New York Securities Litigation*. 35 There, the court ruled that extending the life of a corporation is not per se beneficial. 36 Three years later, the Seventh Circuit in *Schacht v. Brown*, 37 dealt with similar facts and held that the *in pari delicto* defense did not apply because extending the life of the corporation created an adverse interest. 38 Accordingly, after the various courts began to consistently hold that lengthening the existence of an unsuccessful corporation is not necessarily good for the shareholders and creditors, the natural progression continued toward deepening insolvency. 39

**B. An Unprecedented Growth Spurt**

The idea that directors could be held liable for prolonging the life of an insolvent corporation quickly garnered the interests of creditors and trustees of bankruptcy estates. 40 Prior to deepening insolvency, unsecured creditors had very few options to recover their losses from a bankrupt cor-

---

34. See Henry S. Bryans, *Claims Against Lawyers by Bankruptcy Trustees—A First Course on the In Pari Delicto Defense*, 66 BUS. LAW. 587, 597 (2011) (“[The defense of *in pari delicto* at common law was based ‘on two premises: first, that courts should not lend their good offices to mediating disputes among wrongdoers; and second, that denying judicial relief to an admitted wrongdoer is an effective means of deterring illegality.’”). With an *in pari delicto* claim, defendants are arguing that they should not be held liable for actions that can be imputed onto the plaintiff. See *id.* at 595 (explaining mechanics of *in pari delicto* defense in bankruptcy trustee situations). In the context of corporations, a director’s actions can be imputed onto the corporation if it was done within the scope of the director’s duty and for the corporation. See *id.* at 597 (describing when director’s actions are imputed to corporation). Thus, a shareholder cannot sue a director who engaged in fraudulent activities if the fraud actually benefited the corporation. See *id.* (detailing how *in pari delicto* precludes bankruptcy trustee’s claims against directors).


36. See *id.* at 541 (discussing how corporations are not like biological entities where prolonging their existence is automatically beneficial).

37. 711 F.2d 1343 (7th Cir. 1983).

38. See *id.* at 1350 (“[F]or the corporate body is ineluctably damaged by the deepening of its insolvency, through increased exposure to creditor liability.”). The Seventh Circuit was combating the notion that a corporation cannot sue for conduct that prolonged its life, regardless of whether it was done fraudulently. See *id.* (“For each of these cases rests upon a seriously flawed assumption, i.e., that the fraudulent prolongation of a corporation’s life beyond insolvency is automatically to be considered a benefit to the corporation’s interests.”).


40. See generally David E. Gordon, Comment, *The Expansion of Deepening Insolvency Standing: Beyond Trustees and Creditors’ Committees*, 22 EMORY BANKR. DEV. J. 221
poration. Consequently, some commentators argue that deepening insolvency became rapidly popular out of necessity. Others have a more cynical view. Opponents of deepening insolvency often argue that the theory only gained traction during the early twenty-first century, when large corporate scandals such as Enron and WorldCom ignited a public outcry. Yet for whatever reason, the rapid rise of deepening insolvency is undeniable. Within a couple decades, what started out as dicta evolved into a complex cause of action and theory of damages in several jurisdictions.

Despite deepening insolvency’s initial popularity, the theory lacked the substance to be considered a bona fide tort until the Third Circuit definitively defined it as such in Lafferty. There, the court dealt with a

(discussing how deepening insolvency expanded remedies available for creditors and bankruptcy trust estates.)

42. See Franklin, supra note 7, at 477–78 (detailing events such as collapse of Enron as catalyst for deepening insolvency and arguing that deepening insolvency is needed to further regulate corporate misconduct).
43. See J.B. Heaton, Deepening Insolvency, 30 J. Corp. L. 465, 500 (2005) (arguing that certain notions of deepening insolvency are “unsupported in financial economics and inconsistent with the traditional understandings and economic functions of corporate injury”); Thompson, supra note 10, at 537 (arguing that deepening insolvency should not be viable tort or theory of damages).
44. See Thompson, supra note 10, at 536 (describing public hysteria caused by Enron scandal and how this may have led to juror support of deepening insolvency).
45. See The Deepening Insolvency Risk, Memorandum (Foster Pepper P.L.L.C., Seattle, Wash.), June 1, 2006, at 1, available at http://www.foster.com/pdf/DeepeningInsolvencyRisk.pdf (“The past few years have seen an ever increasing number of reported lawsuits asserting . . . ‘deepening insolvency.’ From only 4 or 5 in the year 2000 to well over 55 in the years 2004 and 2005. Anecdotal evidence suggests that far more have been filed and not reported.”).
46. See Willett, supra note 3, at 550 (discussing rapid development of deepening insolvency). A partner at the prominent law firm, Bingham McCutchen L.L.P., Sabin Willett actually compared deepening insolvency to evolution in the following manner:

Doctrines are like life: complex organisms evolve from the most unremarkable amino acids. Within a generation of Schacht, federal courts were issuing pronouncements that “deepening insolvency” constitutes a valid cause of action under Pennsylvania state law,” and that Delaware recognizes a “tort of deepening insolvency.” In In re Exide Technologies, Inc., a court let discovery proceed on a “deepening insolvency” claim against lenders who make loans to distressed buyers. This is evolution at light speed. What was merely a failed defense in Schacht now walks on all fours and demands recognition by legal taxonomists as a fully-fledged cause of action.

Id. (emphasis added) (footnotes omitted).
47. See Gordon, supra note 43, at 224–25 (“Beginning with a 2001 decision from the Third Circuit Court of Appeals in Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., courts began to recognize deepening insolvency as an independent cause of action.”); McDonald et al., supra note 22, at 57 (“Despite the narrow
committee of unsecured creditors filing a derivative action on behalf of the debtor corporation against the board of directors. The committee’s complaint alleged violations of federal securities laws, breach of fiduciary duty, and other related claims arising from a ponzi scheme in which the defendants were fraudulently issuing corporate bonds. As a basis for these claims, and because a derivative action requires a plaintiff to allege harms inflicted on the corporation, the committee cited deepening insolvency. Although the Third Circuit ultimately affirmed the district court’s decision to dismiss the committee’s claims, the court affirmatively acknowledged deepening insolvency as an independent tort claim in Pennsylvania.

The Third Circuit based its opinion on the Seventh Circuit’s dicta in *Schacht* and predicted that the Pennsylvania Supreme Court would soon establish deepening insolvency as an independent cause of action.

Application of *Investors Funding* and *Schacht*, the concept was greatly expanded nearly two decades after *Investors Funding* by the Third Circuit in *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc.*; Thompson, supra note 10, at 538 ("Lafferty is generally recognized as the first reported case that established deepening insolvency as an independent cause of action in tort.").


49. See id. at 344 (discussing background facts from case and how it arose from collapsed ponzi scheme).

50. See id. at 349–51 (examining claims made).

51. See id. at 359 (affirming district court’s decision to grant summary judgment against appellant’s deepening insolvency claims).

52. See id. at 350 (citing Seventh Circuit as basis for rationale that deepening insolvency should be considered independent tort in Third Circuit). The Lafferty court quoted the following passage from the Seventh Circuit’s *Schacht* holding:

[C]ases [that oppose "deepening insolvency"] rest[ ] upon a seriously flawed assumption, i.e., that the fraudulent prolongation of a corporation’s life beyond insolvency is automatically to be considered a benefit to the corporation’s interests. This premise collides with common sense, for the corporate body is ineluctably damaged by the deepening of its insolvency, through increased exposure to creditor liability. Indeed, in most cases, it would be crucial that the insolvency of the corporation be disclosed, so that shareholders may exercise their right to dissolve the corporation in order to cut their losses. Thus, acceptance of a rule which would bar a corporation from recovering damages due to the hiding of information concerning its insolvency would create perverse incentives for wrong-doing officers and directors to conceal the true financial condition of the corporation from the corporate body as long as possible.

Id. (alterations in original) (quoting Schacht v. Brown, 711 F.2d 1343, 1350 (7th Cir. 1983)). Furthermore, the Lafferty court concluded that deepening insolvency was based on the fundamentally sound rationale that increasing an already insolvent corporation’s debt hurts the corporation. See id. at 349 ("First and foremost, the theory is essentially sound. . . . Even when a corporation is insolvent, its corporate property may have value. The fraudulent and concealed incurrence of debt can damage that value in several ways.").
The Third Circuit’s holding in Lafferty had a ripple effect on not only the courts in its own jurisdiction, but on other circuits as well.53 Most notably, the Bankruptcy Court for the District of Delaware cited Lafferty in holding that deepening insolvency was also a viable tort in Delaware.54 Consequently, after Lafferty, the theory grew exponentially to the point where anyone involved in deepening a corporation’s insolvency could be held liable, even creditors and lawyers.55 Furthermore, some courts began to hold that mere negligence could be enough to support a deepening insolvency claim.56 This evolution was somewhat unexpected, considering that the court in Lafferty simply found deepening insolvency to be a valid tort and still affirmed a dismissal of the plaintiff’s claims.57 Regardless, many academics and practitioners began to fear that the theory would grow too large.58

C. The Ringing Death Knell

Just when deepening insolvency gained significant momentum in the courts, the tide turned against it.59 Although many scholarly articles criti-
cized the theory, the turning point came from the Delaware Chancery Court in *Trenwick*. There, the court dealt with a holding company that had been rendered insolvent by its acquisition of too many subsidiary insurance companies negatively affected the 9/11 attacks. The plaintiffs filed claims under deepening insolvency and the Delaware Chancery Court granted the defendant’s motion to dismiss, holding that deepening insolvency was not a valid cause of action under state law. The Delaware Supreme Court promptly affirmed the Chancery Court’s ruling.

The Delaware Chancery Court’s primary concerns regarding deepening insolvency were similar to those raised by practitioners and scholars who criticized the theory. More specifically, the *Trenwick* court recognized that directors and officers of a corporation may occasionally need to take on additional debt to secure a business objective. Thus, the tort of deepening insolvency could effectively render these directors personal guarantors of these business decisions, which runs against the gambit of corporate law that seeks to give directors substantial deference in their business decisions. Other concerns were the redundancy of deepening


61. See *id.* at 175–86 (describing facts of case)

62. See *id.* at 204 (“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 ruling was part of a subsection of the opinion entitled “Delaware Law Does Not Recognize a Cause of Action for So-Called ‘Deepening Insolvency.’” See *id.*

63. See *Trenwick Litig. Trust v. Billett*, 931 A.2d 438, at ¶1 (Del. 2007) (“[T]he final judgment of the Court of Chancery should be affirmed on the basis of and for the reasons assigned by the Court of Chancery in its opinion dated August 10, 2006.”).

64. See *Trenwick*, 906 A.3d at 204–08 (explaining holding that Delaware law does not recognize tort of deepening insolvency).

65. See *id.* (hypothesizing consequences of deepening insolvency and how it would affect directors’ ability to occasionally take on more debt to save company).

66. See *id.* at 205 (“If the board of an insolvent corporation, acting with due diligence and good faith, pursues a business strategy that it believes will increase the corporation’s value, but that also involves the incurrence of additional debt, it
insolvency with similar breach of fiduciary duty and fraud claims. Ultimately, when the Delaware Chancery Court struck down deepening insolvency, many assumed the tort would fade into obscurity.

Shortly after the Delaware Chancery Court published its opinion in *Trenwick*, the Third Circuit started to backtrack on its expansive *Lafferty* holding through its decision in *CitX*. There, the Third Circuit dealt with a bankruptcy trustee suing a debtor’s accounting firm for professional malpractice and deepening insolvency. The *CitX* holding had three significant effects: (1) it unequivocally rejected deepening insolvency as a theory of damages for claims such as professional malpractice or breach of fiduciary duty, (2) it limited the definition of deepening insolvency to acts of fraud, and (3) it explicitly limited deepening insolvency’s applicability to Pennsylvania.

The *CitX* holding appeared to signal the beginning of the end for deepening insolvency in Pennsylvania and the Third Circuit in general, perhaps more so than the *Trenwick* holding from Delaware. After *Lafferty* does not become a guarantor of that strategy’s success.

The idea of giving deference to the business decisions of corporate managers—such as directors and officers—comes from the business judgment rule, a common law tenet widely followed by many state jurisdictions. See Robert Sprague & Aaron J. Lyttle, *Shareholder Primacy and the Business Judgment Rule: Arguments for Expanded Corporate Democracy*, 16 STAN. J. BUS. & FIN. 1, 8 (2010) (reviewing history of business judgment rule). There are a number of reasons why courts employ the business judgment rule, but the overall focus is to maximize wealth. See id. (“Scholars argue that ‘[w]ealth is maximized when corporations are run by directors who know that their decisions will be reviewed by investors, by analysts, by stockholders, and by business partners—but not by the courts.’” (quoting David Rosenberg, *Galactic Stupidity and the Business Judgment Rule*, 32 J. CORP. L. 301, 303 (2007))).

67. See *Trenwick*, 906 A.2d at 205 (explaining that deepening insolvency is redundant to other claims that shareholders can bring against directors and officers of corporation). The Delaware Chancery Court then clarified that just because deepening insolvency is not a valid claim, it does not mean it is giving directors more leeway for misconduct. See id. (“The rejection of an independent cause of action for deepening insolvency does not absolve directors of insolvent corporations of responsibility. Rather, it remits plaintiffs to the contents of their traditional toolkit, which contains, among other things, causes of action for breach of fiduciary duty and for fraud.”).

68. See Harner & Brighton, *supra* note 27, at 1 (explaining effect of *Trenwick* decision as signaling end for deepening insolvency).

69. See Seitz v. Detweiler, Hershey & Assocs. (*In re CitX Corp.*), 448 F.3d 672, 681 (3d Cir. 2006). For a discussion on how the Third Circuit limited its holding in *Lafferty* through its holding in *CitX*, see *supra* note 27 and accompanying text.

70. See *In re CitX* at 674–77 (discussing facts of case). In *CitX*, the Third Circuit dealt with a bankruptcy trustee suing an accounting firm that was alleged to have provided the financial statements used to fraudulently procure investor funds and prolong the life of a corporation that was clearly insolvent. See id. (reviewing contextual background facts).

71. See Mahoney, *supra* note 27, at 1009 (describing significance of *CitX* decision and how it limited expansive holding of *Lafferty*).

72. See Fehribach v. Ernst & Young L.L.P., 493 F.3d 905, 908–09 (7th Cir. 2007) (using *Trenwick* and *CitX* holdings to support conclusion that deepening insolvency is not valid independent claim); Joseph v. Frank (*In re Troll Commc’ns*,
ferty, many viewed the Third Circuit as the harbinger of deepening insolvency, so when the court essentially limited Lafferty’s holding only a few years later, it was an unexpected development. 73 In fact, numerous publications were released in response to the CitX decision, most of which predicted deepening insolvency’s decline. 74 Nevertheless, the Third Circuit did not overtly strike down deepening insolvency in Pennsylvania and the tort survived, albeit in what many assumed to be a deteriorated state. 75

III. THE THIRD CIRCUIT REVIVES DEEPENING INSOLVENCY IN THE LEMINGTON DECISION

In the years after CitX, deepening insolvency was greatly marginalized. 76 Directors, officers, accountants, and lawyers breathed a collective sigh of relief as almost everyone predicted that the CitX holding would

L.L.C.), 385 B.R. 110, 121–22 (Bankr. D. Del. 2008) (citing CitX in context of invalidating deepening insolvency as independent cause of action in Delaware). The Troll decision is in stark contrast to the decision by the same court only a few years prior in In re Exide Techs., Inc., which evidences the extremely volatile nature of deepening insolvency in federal courts. See Official Comm. of Unsecured Creditors & R2 Invs., LDC v. Credit Suisse First Bos. (In re Exide Techs., Inc.), 299 B.R. 732, 752 (Bankr. D. Del. 2003) (holding that Delaware law would support deepening insolvency as independent cause of action).

73. See Jo Ann J. Brighton, Deepening the Blows Against Deepening Insolvency?, AM. BANKR. INST. J., Sept. 2006, at 24, 24 (“CitX has dealt quite a blow to the theory of deepening insolvency.”). In fact, a few days after the Third Circuit came out with its holding in CitX, the United States Bankruptcy Court for the Southern District of New York, applying Delaware law, dismissed a deepening insolvency claim on the basis that CitX explicitly limited the tort to Pennsylvania law. See Official Comm. of Unsecured Creditors of Verestar, Inc. v. Am. Tower Corp. (In re Verestar, Inc.), 343 B.R. 444, 476 (Bankr. S.D.N.Y. 2006) (“And even more recently the Third Circuit . . . went out of its way to observe, ‘nothing we said in Lafferty compels any extension of the doctrine beyond Pennsylvania.’” (quoting In re CitX Corp., 448 F.3d 672, 680 n.11 (3d Cir. 2006))).

74. See Brighton, supra note 76, at 24 (describing reaction to CitX); Mahoney, supra note 27, at 1017 (arguing that CitX decision limited Lafferty court’s expansive holding).

75. See CitX, 448 F.3d at 673 (discussing holding of case where Lafferty precedent is not overruled but limited).

76. See McDonald et al., supra note 22, at 61 (“As the development of the deepening insolvency theory indicates and recent decisions make clear, deepening insolvency cannot exist as a theory of liability—either as a freestanding cause of action or theory of damages—without undermining existing legal doctrines.”). Only a few years ago and prior to CitX, it appeared that deepening insolvency would become the tort of choice for unsecured creditors of bankruptcy corporations. See Mahoney, supra note 27, at 1018 (“Five years ago, trustees’ and creditors’ committees seemed poised to plunder the deep pockets of corporations’ auditors, directors and lenders under an emerging theory of liability known as deepening insolvency.”). However, since the CitX decision, the future of deepening insolveny appeared to be in doubt. See id. at 1018–19 (“In its recent CitX decision, the Third Circuit drastically narrowed the misguided expansion of deepening insolvency by predicating deepening insolvency on fraud, emphatically rejecting deepening insolvency as a measure of damages and limiting the precedential scope of Lafferty to Pennsylvania.”).
render deepening insolvency a feeble tag-along tort at best.\textsuperscript{77} Nevertheless, such comfort proved to be premature.\textsuperscript{78} Through its recent holding in \textit{Lemington}, the Third Circuit explicitly clarified two important points: (1) absent an en banc decision that overrules \textit{CitX} and \textit{Lafferty}, deepening insolvency is still a viable claim in Pennsylvania, and (2) while the tort is still a viable claim, it will be readily enforced.\textsuperscript{79}

\section*{A. The Facts Surrounding the Revival}

\textit{Lemington} Home for the Aged ("\textit{Lemington}"), a non-profit corporation, operated a nursing home considered to be a historic landmark in Pittsburgh, Pennsylvania.\textsuperscript{80} Mary Peck Bond, the daughter of a local abolitionist, founded the home in 1877 to care for the swelling population of destitute and elderly African Americans in the city.\textsuperscript{81} From this modest beginning, the home expanded and continued its operations in Pittsburgh for over a century, becoming the oldest elderly care facility in the country by 2005.\textsuperscript{82} Nevertheless, starting in the 1980s, the home was beset with financial and managerial problems.\textsuperscript{83} By 1999, \textit{Lemington} operated at a loss and became completely insolvent.\textsuperscript{84} To compound the financial

\textsuperscript{77} See Third Circuit Limits Scope of Liability for "Deepening Insolvency", \textit{BANKR. BULL.} (Weil, Gotshal & Manges L.L.P., New York, N.Y.), Aug., 2006, available at http://www.weil.com/news/pubdetail.aspx?pub=8572 ("Accordingly, it is encouraging that the Third Circuit rejected the opportunity to expand \textit{Lafferty}, and instead chose to limit \textit{Lafferty}'s reach. While the Third Circuit in \textit{CitX} did not elaborate on its rationale for limiting causes of action of deepening insolvency to situations where, as in \textit{Lafferty}, the defendants engaged in intentional fraud, it is likely that the court observed the possible perils that would befall failing companies from the widespread acceptance of a stand-alone cause of action of deepening insolvency arising from mere negligence. Instead, plaintiffs must prove liability under traditional theories, such as negligence and malpractice. It is also significant that the Third Circuit, one of the foremost proponents of recognizing a cause of action of deepening insolvency, decided to limit the types of conduct that could lead to deepening insolvency liability. Other courts may once again follow the Third Circuit's lead and limit the types of conduct that could lead to deepening insolvency liability.").

\textsuperscript{78} For a discussion on how a few large law firms reacted to the \textit{Lemington} holding, see supra note 29 and the accompanying text.


\textsuperscript{80} See id. at 285 (discussing history of \textit{Lemington} elderly care home).

\textsuperscript{81} See id. (examining factual context of case).

\textsuperscript{82} Rick Stouffer, \textit{Lemington Home for the Aged Files for Bankruptcy}, PITTSBURGH TRIB. LIVE (Apr. 14, 2005), http://www.pittsburghlive.com/x/pittsburghtrib/s_323974.html ("The Lemington Center is acknowledged as the nation’s oldest continuously operating African-American-sponsored long-term care facility for the elderly.").

\textsuperscript{83} See \textit{Lemington}, 659 F.3d at 285–87 (discussing how financial condition of \textit{Lemington} deteriorated starting in 1980s).

\textsuperscript{84} See id. (addressing facts of case).
problems, in 2004 two members of the home died in circumstances that suggested neglect.85

The committee of unsecured creditors (appellant) alleged that the board of directors for Lemington had contemplated bankruptcy after these deaths, but did not actually file until over a year later.86 During this time, the directors investigated options such as loans and mergers, but everything fell through and bankruptcy appeared to be a foregone conclusion.87 Between January and March of 2005, Lemington’s board met to discuss future plans for bankruptcy and how to handle the home in the meantime.88 In these meetings, the board decided to stop admitting new patients to the home and enacted a plan to transfer the home’s principal charitable asset to Lemington Elder Care, a sister facility.89 Lemington’s board of directors all simultaneously served on the board for Lemington Elder Care.90 Eventually, Lemington filed for bankruptcy in April, 2005.91 For purposes of appellant’s deepening insolvency claims, the crucial fact was that Lemington’s board definitively decided to file for bankruptcy in January, 2005, but operated the home at a deficit before actually filing in April, 2005—a delay of four months.92

After Lemington failed to come up with a buyer during a bankruptcy conference held on June 23, 2005, the bankruptcy court ordered the

85. See id. at 286–87 (discussing two negligence related deaths that occurred in Lemington). The court gave the impression that from the year 1999 forward, the Lemington home was in utter disarray, stemming primarily from their chief administrator being completely unqualified for the position. See id. (“In 2001, a study funded by the Pittsburgh Foundation recommended that the Board replace Causey with a ‘qualified, seasoned nursing home administrator’ . . . .”). Furthermore, the Chief Financial Officer for Lemington failed to keep any accurate financial records. See id. (“In December of 2002, Defendant James Shealey became the Home’s Chief Financial Officer. Shealey failed to maintain a general ledger, and the Home’s financial and billing records were in deplorable condition.”).

86. See id. at 286 (discussing how Lemington’s chief administrator suggested bankruptcy in 2004, one year earlier than when board decided to actually file for bankruptcy).

87. See id. at 287 (“At its meeting on January 6, 2005, the Board considered options in case a proposed merger with the University of Pittsburgh Medical Center did not occur. The Board considered two options: bankruptcy and restructuring.”).

88. See id. (discussing background facts of case and specifically when Lemington’s Board met to discuss bankruptcy and future plans).

89. See id. (“[N]otes from a Board meeting held on March 15, 2005 indicate discussion of plans to transfer the Home’s principal charitable asset, the Lemington Home Fund, held by the Pittsburgh Foundation, to Lemington Elder Care, an affiliated entity.”).

90. See id. at 285 (describing how Lemington’s board members were all members of another board for affiliated corporation).

91. See id. at 288 (“On April 13, 2005, the Home filed a voluntary Chapter 11 petition in the United States Bankruptcy Court for the Western District of Pennsylvania.”).

92. See id. at 287 (discussing how Board did not file for bankruptcy until April 2005).
The appellants filed an adversarial proceeding against Lemington’s board and officers, alleging breach of fiduciary duties and deepening insolvency. Subsequently, the joint defendants filed for summary judgment and the district court granted the motion, holding that the business judgment rule applied to preclude the plaintiff’s breach of fiduciary duty claims. The district court also found that the appellants failed to allege enough facts suggesting fraud to have a viable deepening insolvency claim, and even if they did allege sufficient facts, the in pari delicto defense precluded the claim as well.

B. The Third Circuit Affirms that Deepening Insolvency Exists as an Independent Tort Claim

The Third Circuit began its discussion of the appellant’s deepening insolvency claim by acknowledging that the cause of action had not yet been recognized by the Pennsylvania state courts. However, citing its own precedent in CitX, the court set forth the necessary framework for claimants to allege deepening insolvency. More specifically, the Lemington court held that deepening insolvency exists as a tort claim in Pennsylvania when it can be proven that an injury to corporate property occurred through the “fraudulent expansion of corporate debt and prolongation of corporate life.” Reiterating the holding of CitX, the court

93. See id. at 289 (examining bankruptcy hearing).
94. See id. (describing procedural posture of case and appellant’s claims).
95. See id. at 291 (“The District Court, however, found that the business judgment rule as well as the doctrine of in pari delicto applied to shield the directors and officers from liability.”). The business judgment rule has been codified in Pennsylvania. 15 PA. CONS. STAT. ANN. § 5715(d) (West 2011) (“Absent breach of fiduciary duty, lack of good faith or self-dealing, any act as the board of directors, a committee of the board or an individual director shall be presumed to be in the best interests of the corporation.”). The purpose of the business judgment rule has been explained by the Pennsylvania Supreme Court as follows:

The business judgment rule should insulate officers and directors from judicial intervention in the absence of fraud or self-dealing, if challenged decisions were within the scope of the directors’ authority, if they exercised reasonable diligence, and if they honestly and rationally believed their decisions were in the best interests of the company. It is obvious that a court must examine the circumstances surrounding the decisions in order to determine if the conditions warrant application of the business judgment rule.


96. See Lemington, 659 F.3d at 289 (describing district court’s holding).
97. See id. at 293 (“This cause of action has not been formally recognized by Pennsylvania state courts.”).
98. See id. at 294 (citing CitX case to describe requisite elements for deepening insolvency).
99. See id. (quoting In re CitX Corp, 448 F.3d 672, 677 (3d. Cir. 2006)) (discussing state of deepening insolvency claims in Pennsylvania) (internal quotation marks omitted).
reaffirmed that mere negligence is not enough to support a deepening insolvency claim.\textsuperscript{100} Then the court proceeded to clarify the definition of “fraud,” for purposes of deepening insolvency.\textsuperscript{101}

Despite affirming the \textit{CitX} court’s holding that the tort of deepening insolvency continues in Pennsylvania, the Third Circuit’s enthusiasm for this decision was noticeably more tempered than when it first recognized deepening insolvency in \textit{Lafferty}.\textsuperscript{102} In footnote six of the opinion, the court recognized that “courts and commentators have increasingly called into question the viability of ‘deepening insolvency’ as an independent cause of action.”\textsuperscript{103} Still, the court opined that absent an en banc decision, a precedential opinion such as \textit{Lafferty} cannot be overturned.\textsuperscript{104} Additionally, the court implied \textit{Lemington} might be distinguishable from \textit{Lafferty} because the insolvent corporation in \textit{Lemington} was a non-profit, but it declined to raise the issue sua sponte.\textsuperscript{105} Such a suggestion does, however, leave the door open for future opportunities to further limit deepening insolvency claims from the expansive precedent of \textit{Lafferty}.\textsuperscript{106}

C. The Third Circuit Demonstrates that Deepening Insolvency Will Still Be Enforced

Notwithstanding the Third Circuit’s apparent acknowledgment of deepening insolvency’s debatable validity in footnote six, a closer examination of the court’s rationale for vacating the district court order strongly

\textsuperscript{100} See id. (“[A] claim of negligence cannot sustain a deepening-insolvency cause of action.”).

\textsuperscript{101} See id. (discussing deepening insolvency). For a discussion of the court’s definition of “fraud,” see infra notes 132–34 and accompanying text.

\textsuperscript{102} Compare Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 349–53 (3d Cir. 2001) (discussing rationale behind deepening insolvency to hold that Pennsylvania law supports deepening insolvency as independent cause of action), and Gregg W. Mackuse, \textit{Damages for “Deepening Insolvency”: A Defendant’s Worst Nightmare?}, 74 Pa. B. Ass’n Q. 42, 42 (2003) (“The [\textit{Lafferty}] decision can have serious consequences for corporate officers and directors as well as for third-party professionals who have dealt with a failed company. . . . The doctrine may become one of choice given the number of bankruptcies and other business failures resulting from current economic conditions.”), with \textit{Lemington}, 659 F.3d at 294 n.6 (“As Appellees have noted in their brief, courts and commentators have increasingly called into question the viability of ‘deepening insolvency’ as an independent cause of action. Even if our precedent is erroneous, however, it can only be overturned by this Court en banc.”) (citation omitted).

\textsuperscript{103} \textit{Lemington}, 659 F.3d at 294 n.6.

\textsuperscript{104} See id. (discussing what it would take to overrule \textit{Lafferty} and invalidate deepening insolvency claim in Pennsylvania).

\textsuperscript{105} See id. (“Moreover, because no party argued that the concept of deepening insolvency may not apply to, or may involve a different standard for, a non-profit corporation, we will not address that issue.”).

\textsuperscript{106} See id. (suggesting that distinctions can be drawn between regular corporations and non-profit corporations for purposes of determining deepening insolvency).
implies that the tort will be readily enforced.\textsuperscript{107} In holding that summary judgment against the appellant’s deepening insolvency claims must be vacated, the \textit{Lemington} court cited a number of specific facts.\textsuperscript{108} First, the court opined that within the four-month period from when Lemington’s board decided to file for bankruptcy and when the corporation actually filed, significant damage was caused “to the detriment of its creditors.”\textsuperscript{109} Second, the court noted the potential for fraud in the directors’ decisions to: delay the bankruptcy filing, cease admitting new patients, not disclose their financial situation to creditors, and omit key information about expenses in the post-petition operating reports required by the bankruptcy court.\textsuperscript{110} Next, the court implied that \textit{in pari delicto} did not preclude the appellant’s deepening insolvency claims because there was evidence that the board’s fraudulent actions—such as transferring Lemington’s assets to other entities—were on its own behalf, triggering the adverse interest exception to the equitable defense.\textsuperscript{111} Additionally, the court in \textit{Lemington} noted that the appellees continued to conduct business with vendors after deciding to file bankruptcy and failed to collect Medicare receivables.\textsuperscript{112}

The culmination of all of these facts led the Third Circuit to hold that—“in the light most favorable to the [appellants]”—a reasonable jury could find that the appellees committed deepening insolvency.\textsuperscript{113} But if the court in \textit{Lemington} wanted to marginalize deepening insolvency with-

\textsuperscript{107} See id. at 295 (finding district court’s summary judgment dismissal “inappropriate” because there existed “a genuine issue of material fact as to whether the directors and officers fraudulently contributed to deepening the insolvency” of Lemington Home).

\textsuperscript{108} See id. at 293–95 (examining facts of case which led to court’s holding on appellant’s deepening insolvency claims).

\textsuperscript{109} See id. at 295 (noting appellant’s allegations that Lemington board’s actions caused harm to corporation).

\textsuperscript{110} See id. at 294 (discussing how appellees omitted expenses in post-petition monthly reports to bankruptcy court).

\textsuperscript{111} See id. at 293–94 (discussing \textit{in pari delicto} defense and adverse interest exception). The \textit{Lemington} court did not explicitly discuss the \textit{in pari delicto} defense in the context of the appellant’s deepening insolvency claim, but rather examined the equitable defense in the context of the appellant’s breach of fiduciary duty claims. See id. However, in the \textit{Lafferty} holding, the court applied \textit{in pari delicto} to affirm the district court’s summary judgment dismissal of the deepening insolvency claims as well as the breach of fiduciary duty claims. See \textit{Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co.}, 267 F.3d 340, 344 (3d Cir. 2001) (“We conclude that ‘deepening insolvency’ constitutes a valid cause of action under Pennsylvania state law . . . . However, evaluating the Committee’s claims . . . . we hold that because the Committee, standing in the shoes of the debtors, was \textit{in pari delicto} with the third parties it is suing, its claims were properly dismissed.”). Consequently, the Third Circuit implies that \textit{in pari delicto} and the adverse interest exception can run against both fiduciary duty and deepening insolvency claims. See \textit{Lemington} 659 F.3d at 293–94 (discussing adverse interest exception to \textit{in pari delicto}).

\textsuperscript{112} See \textit{Lemington} 659 F.3d at 294–95 (examining facts pertinent to deepening insolvency claim).

\textsuperscript{113} See id. at 295 (holding that summary judgment dismissal against appellant’s deepening insolvency claims should be vacated).
out completely overturning Lafferty, this case provided ample leeway to do so. This is because, as the district court held, evidence of fraudulent intent in Lemington was tenuous, especially considering that the facts did not indicate a clear motive to defraud.\footnote{See id. at 293–95 (discussing facts relevant to determining presence of fraud for purposes of deepening insolvency review); see also Official Comm. of Unsecured Creditors v. Baldwin, No. 10-800, 2010 WL 4275252, at *12 (W.D. Pa. Oct. 25, 2010) (“[P]laintiff has failed to create a material issue of fact regarding the claims of fraud. There are simply no facts by which a reasonable trier of fact could find that defendants committed or precipitated any type of fraud. At most, their actions amount to negligence . . . .”), vacated, 659 F.3d 282 (3d Cir. 2011).} Thus, unlike CitX and Lafferty, which dealt with ponzi schemes, it would have been plausible to conclude that the board of directors for Lemington was merely grossly negligent.\footnote{See Baldwin, 2010 WL 4275252, at *12 (opining that conduct of Lemington’s board, at most, amounts to gross negligence but not fraud).} This is corroborated by the fact that in many of the meetings where the allegedly fraudulent decisions took place, attendance by members of the board was less than fifty percent.\footnote{See Lemington, 659 F.3d at 287 (“Attendance at Board meetings was often below 50%.”).} In the end, however, the Lemington court faced a judicial coin-flip, with facts that could have gone equally for or against the deepening insolvency claim.\footnote{See id. at 285–96 (discussing facts of case and considerations for deepening insolvency claim).} By vacating the summary judgment order and landing on the appellant’s side, the Third Circuit strongly implied its willingness to enforce the controversial tort—sending a clear message that deepening insolvency is still alive and well.\footnote{See Watch Out Directors and Officers: Third Circuit Keeps “Deepening Insolvency” Action Alive, News (Pachulski, Stang, Ziehl & Jones L.L.P., Wilmington, Del.), Nov. 30, 2011, available at http://www.pszjlaw.com/news-97.html (discussing “return” of deepening insolvency in wake of Lemington); ALERT MEMO, supra note 29 (warning clients that deepening insolvency is back in Third Circuit); Court Finds Material Issues of Fact Regarding Breach of Fiduciary Duties and Deepening Insolvency, CR&B ALERT (Reed Smith L.L.P., Pittsburgh, Pa.) Dec. 2011, at 7, available at http://www.reedsmith.com/files/Publication/1c9b57ad-7a77-436f-94e2-42c0f58eb/Presentation/PublicationAttachment/be87dbf5f4bf-44b8-9de9-60e934cf33eb/crab1211.pdf (“[T]he case expands creditors’ abilities to hold directors and officers accountable for the mismanagement of corporations.”); INSIGHTS, supra note 29 (discussing return of deepening insolvency in wake of Lemington holding by Third Circuit).} By vacating the summary judgment order and landing on the appellant’s side, the Third Circuit strongly implied its willingness to enforce the controversial tort—sending a clear message that deepening insolvency is still alive and well.

IV. THE IMPACT OF LEMINGTON’S HOLDING ON THE CURRENT THIRD CIRCUIT JURISPRUDENCE

Following the Lemington decision, many law firms with significant practice groups or clients in Pennsylvania noted that deepening insolvency “is back.”\footnote{For a discussion of law firms that have taken notice of the Lemington decision, see supra notes 29 and 115 and accompanying text.} But as the Lemington court mentioned in footnote six, an outright reversal of Lafferty and CitX was never the expected outcome, bar-
ring an en banc decision. Thus, what is most startling about the Lemington holding is not that the Third Circuit reaffirmed the viability of deepening insolvency in Pennsylvania, but that the court actually supported a deepening insolvency claim based on the facts of the case. Consequently, Lemington is significant to the Third Circuit jurisprudence on deepening insolvency for three principle reasons. First, the holding applies the framework for a deepening insolvency claim set out by CitX. Second, it explicitly defines “fraud” for purposes of determining deepening insolvency. And finally, it gives notice to corporations and bankruptcy practitioners by providing a factual example of what is sufficient for a deepening insolvency claim to survive summary judgment in the post-CitX jurisprudence.

A. Clarifying the Framework Set Forth By CitX

Following the Lemington decision, practitioners should be aware that a successful deepening insolvency claim must prove three elements: (1) “an injury to the debtor’s corporate property” (2) caused by (3) “fraudulent expansion of corporate debt and prolongation of corporate life.” Again, the Third Circuit has reiterated that for a deepening insolvency claim, negligent actions that inadvertently prolong a corporation’s life are not enough, even if such actions cause a detriment to corporate value. Consequently, a successful claim must include factual allegations of fraud.

120. See Lemington, 659 F.3d at 295 n.6 (discussing need for en banc review to overturn precedential opinion).
123. See Lemington, 659 F.3d at 294 (examining deepening insolvency framework in post-CitX jurisprudence).
124. See id. (defining fraud for purposes of deepening insolvency).
125. See id. at 285–96 (discussing facts relevant to holding that district court’s summary judgment order against appellant’s deepening insolvency claims be vacated).
126. See id. at 294 (“[W]e stated that ‘deepening insolvency’ in Pennsylvania is defined as ‘an injury to [a debtor’s] corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life.’”).
127. See id. (maintaining that negligent actions are insufficient to prove deepening insolvency).
128. See id. (reaffirming CitX holding that element of fraud is necessary for a valid deepening insolvency claim).
B. Defining “Fraud” For Purposes of Deepening Insolvency

Although the court in CitX made it clear that fraud needed to be present in order to have a valid deepening insolvency claim, it never explicitly defined fraud. Thus, in Lemington, the court took this extra explanatory step and defined fraud as “anything calculated to deceive, whether by single act or combination, or by suppression of truth, or a suggestion of what is false, whether it be by direct falsehood or by innuendo, by speech or silence, word of mouth, or look or gesture.” This definition is taken from common law rather than statutes, and essentially holds that fraud is “any artifice by which a person is deceived to his disadvantage.” By clarifying the definition of fraud, the Lemington holding gives practitioners a better understanding what type of misconduct is necessary to successfully raise a deepening insolvency claim.

C. Providing an Example of How a Deepening Insolvency Claim Can Survive Summary Judgment

Given that summary judgment is a crucial stage in the timeline of litigation, the Lemington decision is especially important for practitioners on both sides of the docket. Prior to Lemington, the Third Circuit did not have a precedential case in which a deepening insolvency claim survived summary judgment. Even in Lafferty, the Third Circuit affirmed the district court’s summary judgment ruling against the appellant’s deepening insolvency claim for equitable defense reasons. Accordingly, there are a number of lessons to be learned from Lemington, where the appellants successively raised a deepening insolvency claim strong enough to survive summary judgment.

First, any delay after a board has officially decided to file for bankruptcy can be significant. In Lemington, the court was highly suspicious

129. See Seitz v. Detweiler, Hershey & Assocs. (In re CitX Corp.), 448 F.3d 672, 680–81 (3d Cir. 2006) (mentioning fraud as requisite for deepening insolvency claim, but not elaborating on definition of fraud for purposes of deepening insolvency).

130. See Lemington, 659 F.3d at 294 (quoting In re Reichert’s Estate, 51 A.2d 615, 617 (Pa. 1947)) (stating definition of fraud under Pennsylvania law).

131. Id. (quoting In re Reichert’s Estate, 51 A.2d 615, 617 (Pa. 1947)).

132. See id. at 285 (mentioning procedural posture of case). For a discussion on how the Lemington holding was noticed by bankruptcy and corporate law practitioners in large law firms, see supra note 121 and accompanying text.

133. See CitX, 448 F.3d at 681 (discussing holding and affirming district court’s summary judgment dismissal of appellant’s deepening insolvency claims); Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 344 (3d Cir. 2001) (affirming district court’s summary judgment reversal of appellant’s deepening insolvency claims).

134. See Lafferty, 267 F.3d at 344 (holding that appellant’s deepening insolvency claims were properly dismissed). For a further discussion of the Third Circuit’s holding in Lafferty, see supra notes 54–55 and accompanying text.

135. See Lemington, 659 F.3d at 293–94 (discussing appellee’s delay in filing for bankruptcy and implying this to be significant in determination of fraud).
of the four-month delay between the board’s decision to file bankruptcy and the actual filing date, and this became sufficient to create an inference of fraud.\textsuperscript{136} Had the corporation’s board filed for bankruptcy promptly, their liability would have most likely been limited to breach of fiduciary duty claims.\textsuperscript{137}

Next, evidence of self-dealing can be used to trigger the adverse interest exception to the \textit{in pari delicto} defense. In \textit{Lafferty}, the court affirmed summary judgment against the appellant’s deepening insolvency claims because it held that the directors’ fraudulent acts could be imputed to the corporation, and therefore, \textit{in pari delicto} applied.\textsuperscript{138} The board members for Lemington, however, did not engage in any large scale fraud through the corporation, but they did transfer the corporation’s assets to other entities under their control.\textsuperscript{139} The \textit{Lemington} court ruled that this type of fraudulent self-dealing act could not be imputed to the corporation and \textit{in pari delicto} did not apply.\textsuperscript{140}

Finally, proving fraud is the key to having a successful deepening insolvency claim. Realistically, as a non-profit corporation that had been struggling for years, Lemington’s overall value most likely did not significantly diminish because its board decided to prolong the corporation’s life by four months.\textsuperscript{141} However, the Third Circuit appeared to overlook actual damages and focused on evidence of fraud.\textsuperscript{142} For future litigation involving deepening insolvency, proving or disproving the fraud element will be crucial.\textsuperscript{143}

\begin{footnotesize}
\begin{enumerate}
\item[136.] See id. (addressing facts suggesting questions of fraud being present).
\item[137.] See id. (pointing first to delay in bankruptcy filing as evidence of fraud). Although the court discussed other factors that led it to believe fraud could be present, most of these factors arose from the board’s failure to file the bankruptcy promptly. See id. at 294 (“The Committee alleges that fraud ‘is apparent in the Board’s failure to disclose to the creditors and the Bankruptcy Court the Board’s decision made in January 2005 to close the Home and deplete the patient census, while delaying the bankruptcy filing until April 2005 . . . .’”).
\item[138.] See \textit{Lafferty}, 267 F.3d at 360 (“[W]e find that the \textit{in pari delicto} doctrine bars the Committee, standing in the shoes of the Debtors, from bringing its claims against Lafferty.”).
\item[139.] See \textit{Lemington}, 659 F.3d at 288 (noting how Lemington’s board transferred corporate assets to other entities in their control).
\item[140.] See id. at 293 (“Because the Committee has tendered sufficient evidence that the directors’ and officers’ . . . did not benefit the Home but instead benefited their own self-interest, the applicability of the ‘adverse interest’ exception presents a genuine issue of material fact. Summary judgment on this basis is therefore inappropriate.”).
\item[141.] See id. at 285–90 (discussing corporation’s financial struggles starting in 1980s and continuing until its bankruptcy in 2005).
\item[142.] See id. at 293–95 (focusing on determining fraud while reviewing appellant’s deepening insolvency claims).
\item[143.] See Magalhaes et al., \textit{supra} note 125, at 75 (characterizing fraud as “more relevant” determination in the \textit{Lemington} case).
\end{enumerate}
\end{footnotesize}
V. Conclusion

Within a decade, the Third Circuit both catalyzed and corralled the movement towards validating the tort of deepening insolvency with its decisions in Lafferty and CitX, respectively.144 The addition of the Lemington holding to the overall jurisprudence shows that the Third Circuit has, yet again, surprised practitioners in bankruptcy law. Ultimately, deepening insolvency still appears to be on the decline and only time will tell whether the decision in Lemington will have the effect of actually reviving support for the controversial theory.145 However, in Pennsylvania, as long as deepening insolvency continues to be a valid independent cause of action, the Third Circuit has made at least one thing clear—the much maligned tort will be enforced.146

144. See Jonathan Friedland, Fiduciary Duties of Insolvent Corporations—Deepening Insolvency, STRATEGIC ALTERNATIVES FOR DISTRESSED BUSINESSES § 17:18 (2012) (discussing how Lafferty holding expanded deepening insolvency and subsequent CitX decision limited it).

145. See Fawkes, supra note 124 (“While it may be a stretch to read the Third Circuit’s decision beyond the particular facts and circumstances of the Lemington Home case—particularly with respect to its holding regarding deepening insolvency . . . .”).

146. See Magalhaes et al., supra note 125, at 32 (“Contrary to many other parts of the country, the tort of ‘deepening insolvency’ appears to be alive and well in Pennsylvania.”).