

Narrowing the Scope of Auditor Duties

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The tort of “deepening insolvency” refers to an action asserted by a representative of a bankruptcy estate against directors, officers, lenders, or others based on their pre-petition interactions with the debtor. 9 NORTON BANKR. L. & PRAC. 3d § 174:22. Liability under deepening insolvency has been imposed where “the defendant’s conduct, either fraudulently or even negligently, prolongs the life of a corporation, thereby increasing the corporation’s debt and exposure to creditors.” *In re LTV Steel Co., Inc.*, 333 B.R. 397, 421 (Bankr. N.D. Ohio 2005). Damages under the theory are sometimes awarded to a bankrupt corporation when, by delaying liquidation, the company incurs additional debts that would not have arisen if it had filed for bankruptcy at an earlier date. *Fehribach v. Ernst & Young LLP*, 493 F.3d 905, 908 (7th Cir. 2007). However, recovery under deepening insolvency appears to be subject to increasing limitations. Recently, in *Fehribach v. Ernst & Young LLP*, 493 F.3d 905 (7th Cir. 2007), the United States Court of Appeals for the Seventh Circuit rejected the notion that a financial auditor is obligated to investigate circumstances external to a company’s records to determine whether a going-concern qualification should be included in an audit report. The Seventh Circuit opined that the auditor is required to factor into its audit report information about external matters that it is “told by the firm or otherwise learns.” *Id.* at 911. In so holding, the Court, though not entirely casting out the theory of deepening insolvency from future consideration, arguably sent out a warning sign for future claimants in its jurisdiction that these claims are not easy to establish. In

particular, the *Fehribach* decision marks a victory for financial auditors who would otherwise be possible targets for creditors in bankruptcy.

A. Factual Background

The Chapter 7 trustee of Taurus Foods, a frozen food distribution company, filed suit against Ernst & Young, the company's financial auditor, for negligence and breach of contract because it failed to include a going-concern qualification in its audit report. The trustee argued that Ernst & Young's failure to include a going-concern qualification in the report caused the company to continue operations and incur an additional debt of \$3 million. Consequently, the trustee maintained that the company would have liquidated earlier had it been able to fully consider the increasingly perilous market forces of the frozen food industry at the time the report was issued. Due to competition in the national marketplace and rising costs of workers' compensation premiums, Taurus filed for bankruptcy. The United States District Court for the Southern District of Indiana granted Ernst & Young's motion for summary judgment, finding that the scope of its obligations as a financial auditor did not extend to the inclusion of a going-concern qualification.

On appeal, the Seventh Circuit affirmed, holding that the function of the audit report did not include the prediction of the company's future cash flow except with regard to its financial statements for the audited year. In other words, Ernst & Young was only responsible for predictions about Taurus' financials for the upcoming year insofar as they related to the numbers on the books, excluding any effects that market forces might have had upon those numbers. The auditor owed a duty of care only to its client, and although the benefits would accrue to Taurus' creditors in bankruptcy, Ernst & Young did not owe the creditors a duty of care. Though the relevant auditing standards provided that an auditor should understand the entity and its

“environment,” the auditor was not required to *investigate* external matters. *Fehribach*, 493 F.3d at 911. The contract which formed the basis of Taurus’ deepening insolvency claim against Ernst & Young only included services for financial auditing. Accordingly, consulting for business management services was beyond the scope of the agreement. *Id.* Taurus Foods had been in the frozen meat distribution business for many years, and Ernst & Young could not reasonably have known about the fluctuations in the marketplace to the same extent as its client. An accounting firm that conducts audits for businesses in a “multitude of different industries,” the court reasoned, cannot be responsible for appreciating each element of its clients’ business. *Id.* Thus, Ernst & Young was not liable for the incursion of additional debt due to Taurus’ continued operation. The claim was also barred by the relevant statute of limitations.

B. The Roots of Deepening Insolvency

Deepening insolvency was initially premised on the idea that borrowing money after a company became insolvent would cause financial harm to its shareholders. *See Schacht v. Brown*, 711 F.2d 1343, 1350 (7th Cir. 1983). However, as the *Fehribach* court noted, this concept was controversial because an insolvent company was already insolvent before further borrowing occurred, so the shareholders seemingly had nothing to lose. *Fehribach*, 493 F.3d at 908. Nonetheless, a business can face “equity” insolvency, where the corporation is unable to pay its bills on time, but is still worth more when liquidated than the sum of its liabilities. Accordingly, a business in “equity” insolvency will still be of some value to its shareholders, and a claim of deepening insolvency has at least some merit. *Id.*

A third way of characterizing deepening insolvency claims is by shifting the focus to management’s consultations with a financial auditor, such that the concealment of the corporation’s distressed status prevents it from otherwise reorganizing and surviving. *Id.* Such a

theory rises to the level of fraud, though it was not alleged in *Fehribach*. Regardless, deepening insolvency is limited in the sense that it does not create an obligation on the part of corporate management to liquidate, since management can always use business strategies or other investments to revitalize the company's cash flow. As to the types of deepening insolvency claims that are allowed, courts have set up a number of parameters.

C. The "Deepening" of Precedent

A sufficient body of case law exists on the subject. The basis for such claims was articulated in *Bloor v. Danskere (In re Investors Funding Corp. of New York Securities Litig.)*, 523 F. Supp. 533 (S.D.N.Y. 1980), where the court stated that a "corporation is not a biological entity for which it can be presumed that any act which extends its existence is beneficial to it." Mere survival for a longer period of time than would have otherwise occurred does not necessarily lead to further benefits and profitability for the business. In *Bloor*, an accounting firm certified financial statements which overstated the company's income and assets, influencing third parties to invest money into the company. The company subsequently filed for bankruptcy. The mere fact that the corporation survived for a longer time before filing a bankruptcy petition did not absolve the auditor of liability for negligently reporting the company's financial condition.

Particularly, the Seventh Circuit has entertained claims of deepening insolvency as a cause of action standing alone, rather than exclusively as a measure of damages. The court in *Schacht v. Brown*, 711 F.2d 1343 (7th Cir. 1983), dismissed a claim alleging that, due to fraud on the part of the directors of an insolvent insurance company, the company continued to operate while it was already insolvent, and its profitable business was destroyed, causing significant financial loss. Nonetheless, the court recognized that the shareholders have a right to know that

their corporation is insolvent, in case they should exercise their right to dissolve it in order to “cut their losses.” *Id.* at 1350.

More recently, the Seventh Circuit in *Maxwell v. KPMG LLP*, 520 F.3d 713 (7th Cir. 2008), rejected a claim of deepening insolvency due to a lack of causation. A financial auditor was employed by a company that acquired an internet consulting firm, and the debtor was the resulting entity from the merger. Alleging negligence against the auditor, the trustee claimed that the auditor approved a financial statement that misstated the company’s earnings by improperly including certain revenue. The trustee maintained that the merger would not have occurred but for the improper approval of the financial statements. If properly informed, the acquiring company would have backed away from the deal. In dismissing the claim, the court found that there lacked causality between the auditor’s alleged breach of duty and the debtor’s bankruptcy. The true cause of the bankruptcy was the decline of the “dot com” market, a force over which the auditor had no control. Taking a similar approach as the *Fehribach* court, the *Maxwell* court remarked that the “auditors’ concern is with the accuracy of the company's books rather than with the demand for the company's products or services or the attractiveness of its investment opportunities.” *Id.* at 717. Based on the decisions in *Fehribach* and *Maxwell*, business advice is interpreted as being distinct from an opinion about financial soundness.

United States Bankruptcy courts appear to be in agreement with the Seventh Circuit as to deepening insolvency claims. In *In re Global Service Group, LLC*, 316 B.R. 451 (S.D.N.Y. 2004), the court found that a bank loan which had the effect of prolonging the debtor’s existence, enabling it to slide further into insolvency, did not create tort liability on the part of the lender bank. Considering allegations that the bank made a loan that it knew or should have known that the debtor could never repay, the court noted that it might have been “bad banking,” but did not

amount to a tort. *Id.* at 459. Furthermore, the managerial decision to continue operations was a matter of “business judgment,” and thus, the debtor corporation had no absolute duty to liquidate when the loan was made. Deepening insolvency was thus not a sustainable claim.

D. Necessary Limitations

The *Fehribach* decision is sound on policy grounds. Because a claim of deepening insolvency has potential for turning into a “treasure hunt” for deep-pocketed defendants, 5 NORTON BANKR. L. & PRAC. 3d § 96:5, it follows that limitations on the doctrine are probably necessary. Plaintiffs seeking to recover under deepening insolvency enjoy a “long list of potential targets,” which can include directors and officers, equity holders, lenders, financial auditors, attorneys, and more. *Id.* At first glance, this extensive list appears to provide a seemingly endless possibility for a plaintiff to find at least one third party to blame for contributing to a company’s bankruptcy. But, as previously discussed, courts have been quick to recognize that limitations must be implemented to prevent undue tort liability. As to financial auditors, the Seventh Circuit has made clear in *Fehribach* and *Maxwell* that a distinction exists between contracting for management consulting services and financial auditing. Though the two may be loosely related, the difference was found to be sharp enough such that Ernst & Young could not be responsible for the failure of Taurus Foods to avoid financial losses by liquidating at an earlier date.

The expectation that a financial auditor should be held liable for failing to investigate a going-concern qualification is impractical. Not only was Taurus a well-seasoned player in its own industry, but Ernst & Young is merely a financial auditor that cannot be expected to be familiar with the details of the marketplace for frozen foods. An auditor cannot understand the mechanics of a given industry to the same extent as its client. Though auditors often have a

“multitude” of clients as the *Fehribach* court suggested, the detailed knowledge which Taurus imputed to Ernst & Young was overreaching and unfairly accusative. Furthermore, even if Ernst & Young was able to comprehend the dynamics of the frozen food industry, it was beyond its contractual obligation to do so. The court pointed out that business consulting was simply not part of the contract between the parties. Accordingly, such an issue should have been handled at the time the original contract was formulated. If at time the contract was made, Taurus was looking for more than financial auditing services, it should have added the appropriate contractual provisions. However, since the scope of the agreement was only for auditing, Ernst & Young could not have been expected to do anything more. The court interpreted the contract accordingly.

E. Looking Toward the Future

Unless a company hires a financial auditor to provide business management services in addition to auditing services, the chance of recovery under deepening insolvency against a financial auditor appears to be slim after *Fehribach*. Though a large firm such as Ernst & Young may also be available for management consulting services, it cannot be held liable for any faults other than what is required under its contract (absent negligence), in this case being merely for a financial audit. The *Fehribach* court correctly took a prudent approach in restricting the possibility of future recoveries against financial auditors by making clear that a company must contract for business consulting services if it will later sue a third party due to a failure resulting from business judgment.