9-1-2008

Let's Get It Straight: The Effect of Fehribach, The HA2003 Liquidating Trust, and Joyce on a Debtor's Pre-Bankruptcy Professionals and Where to Go From Here

Jamie L. Johnson
IIT Chicago-Kent College of Law

Follow this and additional works at: http://scholarship.kentlaw.iit.edu/seventhcircuitreview

Part of the Law Commons

Recommended Citation
Jamie L. Johnson, Let's Get It Straight: The Effect of Fehribach, The HA2003 Liquidating Trust, and Joyce on a Debtor's Pre-Bankruptcy Professionals and Where to Go From Here, 4 Seventh Circuit Rev. 59 (2008).
Available at: http://scholarship.kentlaw.iit.edu/seventhcircuitreview/vol4/iss1/4

This Bankruptcy is brought to you for free and open access by Scholarly Commons @ IIT Chicago-Kent College of Law. It has been accepted for inclusion in Seventh Circuit Review by an authorized editor of Scholarly Commons @ IIT Chicago-Kent College of Law. For more information, please contact dginsberg@kentlaw.iit.edu.
LET’S GET IT STRAIGHT: THE EFFECT OF
FEHRIBACH, THE HA2003 LIQUIDATING TRUST,
AND JOYCE ON A DEBTOR’S PRE-BANKRUPTCY
PROFESSIONALS AND WHERE TO GO FROM
HERE

JAMIE L. JOHNSON∗

Cite as: Jamie L. Johnson, Let’s Get It Straight: The Effect of Fehribach, The
HA2003 Liquidating Trust, and Joyce on a Debtor’s Pre-Bankruptcy Professionals
and Where to Go From Here, 4 SEVENTH CIRCUIT REV. 59 (2008), at
http://www.kentlaw.edu/7cr/v4-1/johnson.pdf.

INTRODUCTION

Many times when a business files for bankruptcy under the United
States Bankruptcy Code no assets remain for the debtor’s general
unsecured creditors.1 This lack of assets leaves the pre-bankruptcy
creditors scrambling to find someone to compensate them for their
resulting losses.2 Who might that someone be? Not the debtor’s
professionals, according to the United States Court of Appeals for the
Seventh Circuit.3

∗ J.D. candidate, May 2009, Chicago-Kent College of Law, Illinois Institute of
Technology; Eastern Illinois University, magna cum laude, B.A., May 2006.
1 See Steve Jakubowski, 7th Circuit Nixes Attempts to Hold Investment Bankers
Responsible for Matters Beyond Their Engagement Agreements, BANKRUPTCY
LITIGATION BLOG, Aug. 25, 2008,
2 See Jakubowski supra note 1.
3 See e.g., Fehribach v. Ernst & Young, LLP, 493 F.3d 905 (7th Cir. 2007)
(Rovner, I., concurring); HA2003 Liquidating Trust v. Credit Suisse Securities
Businesses have the option of outsourcing their accounting or financial advising needs to specialized firms, rather than conduct these services in-house. This Article refers to these firms as the debtor’s professionals. After filing for bankruptcy, there is no longer a need for these professionals as the bankrupt business is liquidated. This liquidation may occur in either a Chapter 7 bankruptcy proceeding—where the main goal is not to save the dying company but rather to liquidate its remaining assets and close its doors for good—or in a Chapter 11 proceeding—where the plan of reorganization may provide for liquidation. Although the bankrupt company’s pre-bankruptcy professionals are no longer employed by the debtor business, all ties between the two may not be completely severed. The trustee, stockholders, or other interested parties may try to recover from these professionals based on their alleged contribution to the business’s demise—which is similar to what occurred in three cases recently decided by the Seventh Circuit.

In *Fehribach v. Ernst & Young, LLP*, the court held that the debtor’s accounting firm was not negligent in failing to include a going-concern qualification in its audit report. Similarly, in *HA2003 Liquidating Trust v. Credit Suisse Securities (USA) LLC*, the court stated that the debtor’s investment banker was not grossly negligent in issuing a fairness opinion that used unsound financial projections. Finally, in *Joyce v. Morgan Stanley & Co.*, the Seventh Circuit Review, Vol. 4, Iss. 1 [2008], Art. 4

---


6 *Id.* at 369, 395.

7 *Fehribach*, 493 F.3d at 908; *HA2003 Liquidating Trust*, 517 F.3d at 456; *Joyce*, 538 F.3d at 799.

8 493F.3d at 909-10.

9 517 F.3d at 457.
Circuit rejected the stockholders’ attempt to hold the business’s financial advisor liable based on a fairness opinion issued in connection with the business’s proposed merger.10

The Seventh Circuit is not the only circuit court to consider the question of whether these third party professionals can be held liable, and if so under what causes of action. Other courts, in addition to the Seventh Circuit, have dealt with cases brought against these professionals under a variety of causes of action, all of which come with their own potential weaknesses.11 The causes of action that will be discussed in greater length throughout this Article are deepening insolvency and standard tort theories such as negligence and constructive fraud. While all of the above theories of liability—along with claims for breach of contract—were rejected in Fehribach, The HA2003 Liquidating Trust, and Joyce, other Circuits have taken differing views, both in considering the controversial theory of deepening insolvency and in determining whether there should be a privity requirement attached to a third party’s ability to bring a tort claim against an outside professional.12

Part I of this Article presents a brief background of what a bankruptcy filed under either Chapter 7 or Chapter 11 of the Bankruptcy Code entails, which is provided to explain why a trustee may feel the need to file suit against these pre-bankruptcy professionals. Part II of this Article examines how these professionals have fared in other circuits and lower federal courts by considering the various causes of action they have been sued under—specifically, deepening insolvency and causes of action under standard tort law. Part III of this Article provides a detailed background of Fehribach, The HA2003 Liquidating Trust, and Joyce and also examines the

---

10 538 F.3d at 802. Although Joyce was not initiated in connection with a bankruptcy proceeding, the issues decided by the court, in the author’s opinion are both similar to and will have a direct impact on the potential for liability of a debtor’s pre-bankruptcy professionals. Thus, Joyce will be discussed throughout this Article as if the losses suffered by the stockholders are equivalent to the losses suffered through bankruptcy in Fehribach and HA2003 Liquidating Trust.

11 See infra note 36, 57 and accompanying text.

12 See e.g. infra note 44, 46, 52, 62 and accompanying text.
Seventh Circuit’s reasoning and holdings in each of those cases. Finally, Part IV concludes that the Seventh Circuit’s unwillingness to hold a third-party professional liable for the mistakes of management in the aforementioned cases is a step in the right direction. However, an analytical framework for analyzing claims against these professionals is necessary, and Part IV of this Article proposes that the framework used should be analogous to the law as it pertains to lenders in the context of equitable subordination, under which, these professionals would only be held liable under strict circumstances but would not escape liability under all circumstances.

I. COMMERCIAL BANKRUPTCY UNDER THE CODE: A GENERAL OVERVIEW

A. Chapter 7 Liquidation

Chapter 7 of the United States Bankruptcy Code is what is known as “primal bankruptcy” because it reflects the most basic purpose of bankruptcy law as a response to a defaulting business. A corporation that enters a Chapter 7 proceeding will see all of its assets liquidated before it expires under state corporate law. This is in stark contrast to a case filed under Chapter 11 of the Bankruptcy Code, where the intention is to reorganize the struggling corporation so that it may hopefully emerge from the bankruptcy both leaner and with a reduced debt burden.

A corporation may find itself in a Chapter 7 proceeding either voluntarily or involuntarily. A business may choose to voluntarily file a Chapter 7 petition, enabling it to liquidate its assets in an orderly

---

14 Id. at 369.
15 Id. A plan of reorganization in a Chapter 11 proceeding can, however, provide for the liquidation of the debtor’s assets. Id. at 395.
16 Id. at 374-75.
fashion because the automatic stay will take effect. However, because of the drastic consequences of filing a Chapter 7 petition, many businesses wait until the last possible moment to file—all too often when the value of the company has already been depleted beyond saving. A business may also find itself in a Chapter 7 proceeding against its will if an involuntary petition is filed by its creditors. Involuntary petitions are rare and section 303 of the Bankruptcy Code makes them relatively difficult to file by including various requirements such as the three-creditor rule—which requires that at least three creditors join in the involuntary petition.

Once a petition is filed a trustee in bankruptcy is appointed to liquidate and administer the assets of the bankruptcy estate. Many Chapter 7 proceedings, however, are considered “no-asset” bankruptcies—meaning there is simply nothing left for the trustee to administer. This lack of assets may lead the trustee to file an action against the debtor’s pre-bankruptcy professionals in an attempt to

17 Id. at 373. The automatic stay is a legal mandate which acts as a freeze on any and all attempts to collect a debt from the debtor and all civil litigation involving the rights of the debtor. Katelyn Knight, Comment, Equitable Mootness in Bankruptcy Appeals, 49 Santa Clara L. Rev. 253, 260-61 (2009). See also 11 U.S.C. § 362 (2006).
18 WARREN & WESTBROOK, supra note 14, at 375.
19 Id.; See also 11 U.S.C. § 303 (2006).
20 WARREN & WESTBROOK, supra note 14, at 375.
21 Id. at 134. A trustee in bankruptcy is appointed by the U.S. Trustee, elected by creditors, or appointed by a judge to administer a bankruptcy estate. BLACK’S LAW DICTIONARY (8th ed. 2004). The bankruptcy estate is created with the commencement of a bankruptcy case and constitutes a legal entity separate from the debtor. The property which makes up the bankruptcy estate is protected by the automatic stay from claims of creditors and is subject to the jurisdiction of the bankruptcy court. Steve H. Federstein, Property of the Estate, in, UNDERSTANDING THE BASICS OF BUSINESS BANKRUPTCY AND REORGANIZATION 2008, at 117 (PLI Comm. Law & Practice, Course Handbook Series Order No. 14425, 2008) (Updating Author). See also 11 U.S.C. § 541 (2006).
collect more money for the estate—which, in turn, means more money for creditors.23

B. Chapter 11 Reorganization

The central focus of a Chapter 11 bankruptcy is the reorganization of the struggling debtor.24 Such reorganization can include, for example, only paying back a certain percentage of bank loans or extending the amount of time a debtor has to pay back those loans under its previous agreements.25 Ultimately, however, a number of large debtor corporations liquidate through Chapter 11 by creating a plan of liquidation when a plan of reorganization is not feasible.26 A Chapter 11 case may also be converted to a Chapter 7 to effectuate a liquidation.27

As with a Chapter 7 bankruptcy proceeding, a Chapter 11 proceeding may also be commenced by either the filing of a voluntary or involuntary petition.28 Creditors may believe it’s necessary to put a business in a Chapter 11 proceeding to obtain important financial information or allow for the supervision of the debtor without forcing it to close its doors.29 The same requirements exist under section 303 of the Bankruptcy Code for creditors attempting to push a business into a Chapter 11 proceeding as they do for Chapter 7 involuntary bankruptcies.30

Once a case is commenced under Chapter 11, if no trustee is appointed, the debtor becomes a new legal entity known as the “debtor in possession.”31 The debtor-in-possession is equivalent to the trustee

23 See Fehribach v. Ernst & Young, LLP, 493 F.3d 905, 907 (7th Cir. 2007) (Rovner, J., concurring).
24 WARREN & WESTBROOK, supra note 14, at 395.
25 Id.
26 Id.
27 Id. at 412.
28 Id. at 377.
29 Id.
31 WARREN & WESTBROOK, supra note 14, at 409.
in a Chapter 7 proceeding in terms of most of its powers and
obligations in the bankruptcy.32

The main goal of the debtor in possession is to formulate a
feasible plan of reorganization.33 A plan of reorganization can be
confirmed by the bankruptcy court even though the plan’s terms do not
provide for a distribution to general unsecured creditors, which
explains why these creditors would want to bring an action against the
debtor’s pre-bankruptcy professionals—because bringing suit against
those professionals may be the only way to find a deep-pocket to
enable them to recover on their claims.34

II. POTENTIAL CAUSES OF ACTION AGAINST THIRD PARTY
PROFESSIONALS AND THEIR VARYING TREATMENT IN THE COURTS
THROUGHOUT HISTORY

As is true in the Seventh Circuit, the law pertaining to whether a
debtor’s professionals can be held liable for a company’s plunge into
bankruptcy varies depending on which cause of action the creditors
utilize to make their case. Deepening insolvency, for example, is
controversial by nature and has been treated as an independent tort, a
tort of damages, or rejected completely depending on which court
the theory is presented to.35 For other more standard tort theories—
such as negligence and fraud—the difference between the courts
centers on the question of whether privity is a prerequisite to the

33 WARREN & WESTBROOK, supra note 14, at 609.
34 See 11 U.S.C. § 1129 (2006) (providing the requirements for confirmation of
a plan of reorganization).
35 See generally Diane F. Coffino & Charles H. Jeanfreau, Delaware Hits the
Brakes: The Effect of Gheewalla and Trenwick on Creditor Claims, 17 J. BANKR. L.
& PRAC. 1 ART. 3 (2008) (examining the rejection of deepening insolvency as an
independent tort and its contentious existence as a damages theory); Sara E. 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, 99-112 (2008)
(discussing the current state of the law regarding deepening insolvency).
assertion of a claim by a third party against an outside professional, which is determined by looking at the state law governing the action.36

A. Deepening Insolvency: Cause of Action or Damages Theory?

The theory of deepening insolvency argues that directors, officers, corporate affiliates, lenders, and third party advisors should be held liable to the corporation (for its creditors’ benefits) for their participation in deciding to continue operating financially distressed companies through borrowing rather than immediately recommending liquidation.37 In 2001, the United States Court of Appeals for the Third Circuit was the first court to recognize deepening insolvency as an independent tort in Official Committee of Unsecured Creditors v. R.F. Lafferty & Co.38 In upholding the district court’s refusal to grant the outside advisor’s motion to dismiss, the court stated that it believed the Pennsylvania Supreme Court would recognize deepening insolvency as a cause of action because the theory was becoming more universally accepted.39 The Third Circuit also reasoned that under Pennsylvania common law principles “where there is an injury, the law provides a remedy.”40 However, in rationalizing its creation of the new tort, the Lafferty court failed to cite to any specific state law on the subject.41

Not all courts, however, have recognized the concept of deepening insolvency as an independent tort.42 The theory was first

37 Coffino & Jeanfreau, supra note 35.
38 267 F.3d 340 (3rd Cir. 2001); See also Coffino & Jeanfreau, supra note 35; Apel, supra note 35, at 95.
39 Lafferty, 267 F.3d at 352; See also Coffino & Jeanfreau, supra note 35; Apel, supra note 35, at 95-96.
40 Lafferty, 267 F.3d at 351; See also Coffino & Jeanfreau, supra note 35.
41 Apel, supra note 35, at 96.
42 See Coffino & Jeanfreau, supra note 36; Russell C. Silberglied, Keep Your Deepening Insolvency Materials: Harmonizing Brown Schools with Radnor
used by the courts as a theory of damages, and while some courts rejected deepening insolvency as a cause of action, they continued to use it to form a measure of damages caused by either breach of duty or another tort. The idea of deepening insolvency as a damages theory originated in the Seventh Circuit in Schacht v. Brown, where the court rejected the proposition that a corporation could never sue to recover damages sustained through the prolongation of an insolvent corporation’s life.

The Third Circuit, however, seemed to reject deepening insolvency as a damages theory and also backtracked on its Lafferty decision in In re CitX Corp. In CitX, the court considered whether the plaintiff could ask for damages based on deepening insolvency in conjunction with his underlying malpractice claim. The court noted that causation for deepening insolvency damages was difficult to prove—and was not proven by the plaintiff—and therefore, would be unlikely to be a preferred method of calculating damages. The CitX court also attempted to narrow its previous holding in Lafferty—that deepening insolvency could stand as an independent cause of action—by stating that the cause of action requires a pleading of fraud.


43 See e.g., Coffino & Jeanfreau, supra note 35, n. 65; In re Greater Southeast Community Hospital Corp. I, 353 B.R. 324, 338 (Bankr. D. D.C. 2006) (deepening insolvency was treated as it was meant to be—a theory of harm); In re Southwest Florida Heart Group P.A., 346 B.R. 897, 898 (Bankr. M.D. Fla. 2006) (deepening insolvency claim was only relevant to measure of damages and was not a cause of action standing alone); In re Flagship Healthcare, Inc., 269 B.R. 721, 728 (Bankr. S.D. Fla. 2001) (deepening insolvency may be used in negligence action as a measure of damages).

44 711 F.2d 1343, 1350 (7th Cir. 1983). See also Apel, supra note 35, at 88.

45 Seitz v. Detweiler, Hershey & Assocs., P.C. (In re CitX Corp.), 448 F.3d 672 (3d Cir. 2006). See also Silberglied, supra note 42, at 61 (CitX limited the principle that even if deepening insolvency was not an independent tort, it could be viewed as a damages theory).

46 CitX, 448 F.3d at 674.

47 Id. at 678; See also Apel, supra note 35, at 101-02.

48 CitX, 448 F.3d at 680-81. See also Apel, supra note 35, at 102.
deeming fraud as a necessary component of a deepening insolvency
claim, the Third Circuit highlighted the major flaw of the theory—
deepening insolvency simply duplicates other existing causes of
action.49

The Third Circuit’s decisions in Lafferty and CitX have been
interpreted narrowly by some federal courts in their support for
deepening insolvency as either a cause of action or a damages
theory.50 The history of the theory, however, illustrates its
controversial nature, and some federal courts have chosen to reject
deepening insolvency altogether—whether pleaded as an independent
tort or a damages theory.51 Courts choosing to reject the theory have
primarily relied on four grounds to do so: (1) the absence of state law
supporting the theory, (2) the business judgment rule, (3) a lack of
standing, and (4) in pari delicto as an affirmative defense.52

Although there is a trend toward complete rejection of the theory
of deepening insolvency, the precedent laid down in Lafferty continues
to create confusion among federal courts.53 This is especially true
because the Lafferty decision itself, while recognizing deepening

49 Coffino & Jeanfreau, supra note 35.
50 Apel, supra note 35, at 113-14. Much of the litigation over whether
deepening insolvency is a cause of action, damages theory, or neither has taken place
Chapter 7, Chapter 11, Chapter 12, and Chapter 13, 1 BKRFUND §1.7, n. 1.10
(2008).
52 Apel, supra note 35, at 99-100. The business judgment rule is the
presumption that officers and directors of a company make their business decisions
on an informed good faith basis while acting with an honest belief that they are
doing what is best for their company. Under the business judgment rule,
disinterested directors will not be subjected to liability for decisions that were proven
unwise. D.J. (Jan) Baker, John Wm. (Jack) Butler, Jr., & Mark A. McDermott,
Corporate Governance of Troubled Companies and the Role of Restructuring
Counsel, 63 BUS. LAW. 855, 857 (2008). In pari delicto means “equal fault” and, as
such, is the basis for a court’s denial of relief. BLACK’S LAW DICTIONARY (8th ed.
2004).
53 Apel, supra note 35, at 112.
insolvency as a cause of action, failed to set forth the actual elements of the claim.\textsuperscript{54} Therefore, a difference exists in what the tort of deepening insolvency actually entails even among courts recognizing the cause of action.\textsuperscript{55} Unfortunately, sorting through the muddled law relating to deepening insolvency does little to add clarity to exactly when a third party professional can be held liable for the tort or the resulting damages based on an underlying cause of action.

\textit{B. Standard Tort Theories: Privity Problems}

In a state that completely rejects the theory of deepening insolvency, there are usually a number of other causes of action a creditor may attempt to hold the third party professional liable under.\textsuperscript{56} Standard common law tort theories such as negligence and fraud are common causes of action for creditors seeking to hold an advisor or accountant liable for their losses stemming from a corporation’s liquidation.\textsuperscript{57} Historically, however, Justice Cardozo’s seminal decision in \textit{Ultramares Corp. v. Touche} made it more difficult to hold outsiders who were not in privity with the plaintiff liable under a negligence theory.\textsuperscript{58} In \textit{Ultramares}, the action for misrepresentation (both negligent and fraudulent) was brought against a third party accounting firm to recover a loss the plaintiffs allegedly suffered as a result of reliance on an audit prepared by that firm.\textsuperscript{59} The court, however, refused to find that the law should admit “to liability in an

\textsuperscript{54} Id. at 113.  
\textsuperscript{55} Id.  
\textsuperscript{56} See generally Klamann & Braud, supra note 37 (specifying the various potential causes of actions or theories a third party accountant can be held liable under).  
\textsuperscript{57} See Id. at §38. While creditors also tend to file breach of contract actions against third party professionals, those actions will not be discussed in this section but will rather only be discussed in the context of the Seventh Circuit’s decisions in \textit{Fehribach}, \textit{The HA2003 Liquidating Trust}, and \textit{Joyce}.  
\textsuperscript{58} 174 N.E. 441 (N.Y. 1931); Klamann & Braud, supra note 37, at §38.  
\textsuperscript{59} 174 N.E. at 442.
indeterminate amount for an indeterminate time to an indeterminate class” and thus held that the accounting firm was not liable.60

Many courts disfavor Ultramares, however, and stemming from that disfavor a number of varying positions have arisen concerning whether a professional can be held liable to a third party under tort theories.61

A number of courts have rejected what is known as the strict privity rule espoused in Ultramares and have instead taken the position advocated by the Restatement (2d) of Torts §552.62 The Restatement’s view has been embraced by as many as nineteen states, and is now considered the majority view.63 This view provides that a third party to a contract can recover for losses suffered as a result of misinformation if that third party is part of a narrow group that the misinformer knows its client will channel the information to as part of a particular business transaction or a substantially similar business transaction.64

60 Id. at 444.
61 Klamann & Braud, supra note 37, at §38.
63 Barrie, 625 So.2d at 1013.
64 Id. at 1014. Section 552 of the Restatement (2d) of Torts provides:
(1) One who, in the course of his business, profession, or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information. (2) Except as stated in Subsection (3), the liability in Subsection (1) is limited to loss suffered (a) by the person or one or more of a limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it; and (b) through reliance upon it in a transaction that he intends the information to influence or knows that the recipient so intends or in a substantially similar transaction. (3) The liability of one who is under a public duty to give the information extends to the loss suffered by any of the class of persons for whose benefit the duty...
In contrast, the minority view is referred to the “akin to privity” view. This restrictive view extends liability for economic loss only if the defendant is in a relationship with the plaintiff that is deemed “akin to privity.” This rule stemmed from the Ultramares decision and a modification of that rule in Credit Alliance Corp. v. Arthur Andersen & Co., requiring “linking conduct” on the defendant’s part. The scope of the defendant’s duty as defined by the “akin to privity” rule depends on both the defendant’s state of mind and the parties’ mutual expectations in the underlying contract. The minority rule differs from the majority rule in that it requires the precise identity of the third party to be foreseen by the defendants, while the majority view only requires that a narrow group—not the precise membership of that group—be foreseen by the defendants.

Lastly, courts willing to take an expansive view on the privity question adhere to the foreseeability rule when determining potential professional liability to third parties. Under this rule, third parties can recover “to the extent that damages incurred by non-clients are reasonably foreseeable.” Therefore, liability can be extended to all reasonably foreseeable plaintiffs who suffered an economic loss based on an actual and justifiable reliance on a negligent misrepresentation; thereby doing away with the notion of privity altogether. At least three courts follow the foreseeability view in determining potential liability for professionals to third party plaintiffs.

is created, in any of the transactions in which it is intended to protect them. Restatement (Second) of Torts §552 (1977).

65 Barrie, 625 So. 2d at 1013.
66 Id.
67 Id. See 483 N.E.2d 110 (1985).
68 Barrie, 625 So.2d at 1013.
69 Id. at 1014.
70 Id. at 1013.
71 Id.
III. THE SEVENTH CIRCUIT’S TAKE ON PROFESSIONAL LIABILITY AS SET FORTH IN ITS RECENT DECISIONS

A. Fehribach v. Ernst & Young

Fehribach v. Ernst & Young LLP was initiated with the filing of an adversary complaint by the trustee in bankruptcy against the debtor’s accounting firm. The complaint alleged causes of action for both negligence and breach of contract for the accounting firm’s failure to include a going-concern qualification in the audit report the firm had prepared for the debtor, Taurus Foods, Inc. Taurus Foods was a small distributor of frozen meats and other foods before it was forced into an involuntary bankruptcy by three of its creditors. In October of 1995, Ernst & Young, acting in its capacity as auditor for Taurus Foods, prepared an audit report for Taurus’s 1995 fiscal year, which ran from January 1994 through January 1995. In that report, Ernst & Young indicated that there was no “substantial doubt” that Taurus’s business was capable of continuing as a going concern until at least January of 1996.

In May of 1996, Taurus’s principal banker, Bank One, became alarmed at the company’s financial condition and transferred the account to an office specializing in risky loans. After the account was transferred, the new office began imposing greater restrictions on Taurus, and its financial deterioration continued at an increased pace.
In an effort to rescue the company from its demise, the Chief Financial Officer began to defraud Bank One by inflating the company’s sales and accounts receivable in the daily reports Taurus was required to present to the bank.\textsuperscript{79} Shortly after the fraud was exposed, Taurus was pushed into a Chapter 7 liquidation.\textsuperscript{80}

In filing its complaint against Ernst & Young, the trustee alleged that the auditor was negligent in failing to include a going-concern qualification in the audit report for the 1995 fiscal year.\textsuperscript{81} Using expert evidence, the trustee argued that had the going-concern qualification been included in the report, the owners of the company (who also acted as the managers) would have realized the company could not survive and would have immediately liquidated.\textsuperscript{82} An earlier liquidation, the trustee claimed, would have avoided the cost of operating under Bank One’s restrictions—to the tune of $3 million dollars.\textsuperscript{83} Ernst & Young moved for summary judgment in the United States District Court for the Southern District of Indiana, which was granted on its behalf.\textsuperscript{84} The trustee then appealed to the Seventh Circuit.\textsuperscript{85}

Judge Richard A. Posner wrote the court’s opinion in \textit{Fehribach}, which was decided by the Seventh Circuit on July 17, 2007.\textsuperscript{86} The alleged claims of negligence and breach of contract were governed by Indiana’s Accountancy Act of 2001.\textsuperscript{87} The Seventh Circuit classified the trustee’s theory of damages in the case as one based on the controversial “deepening insolvency” theory.\textsuperscript{88} While recognizing that the theory of deepening insolvency could be invoked in certain

\textsuperscript{79} \textit{Id.} Taurus’s Chief Financial Officer, Lisa Corry (who was also the daughter of one of Taurus’s owners) was convicted of fraud and sentenced to prison. \textit{Id.} at 908 (citing United States v. Corry, 206 F.3d 748 (7th Cir. 2000)).
\textsuperscript{80} \textit{Id.}
\textsuperscript{81} \textit{Id.}
\textsuperscript{82} \textit{Id.}
\textsuperscript{83} \textit{Id.}
\textsuperscript{84} \textit{Id.} at 907.
\textsuperscript{85} \textit{Id.}
\textsuperscript{86} \textit{Id.} at 905.
\textsuperscript{87} \textit{Id.} at 907.
\textsuperscript{88} \textit{Id.} at 908.
cases—such as in a case where the management worked with the outsider to conceal the corporation’s decrepit financial status—the court noted that it did not make sense to hold a third party liable under the theory when the third party invested in the firm to keep it going and the investment was misused by management.89

The court also reconciled this case with its recognition of the deepening insolvency damages theory in its earlier decision in Schacht v. Brown.90 In that case, the court formulated the theory of deepening insolvency based on the notion that an insolvent corporation’s shareholders would be harmed through additional borrowing.91 “A puzzling suggestion,” the court reasoned, “because by hypothesis a company harmed by deepening insolvency was insolvent before the borrowing spree, so what had the shareholders to lose?”92 The court did recognize that a corporation could be insolvent in the traditional sense—as by being unable to pay its debts as they become due—but could still be worth more liquidated than the total of its liabilities so as to remain valuable to the shareholders—precisely the scenario the court assumed possible in Schacht.93

The court went on to say that Fehrribach was different than other cases that could provide for damages based on deepening insolvency, because once Taurus became insolvent the owners lost their entire investments.94 Thus, there was nothing left for them to lose, and the only people that could be harmed by prolonging the corporation’s life were the creditors.95 Under Indiana law, which follows the privity rule of Ultramares, creditors without any contractual relationship to the auditor—which was the case with Taurus’s creditors—cannot file suit against the third party auditor.96 The court recognized that Taurus could sue Ernst & Young, because it was the corporation that had the

89 Id. at 908-9.
90 Id. at 908. See also Schacht v. Brown, 711 F.2d 1343 (7th Cir. 1983).
91 Fehrribach, 493 F.3d at 908 (citing Schacht, 711 F.2d at 1350).
92 Id. at 908.
93 Id. (citing Schacht, 711 F.2d at 1348).
94 Id. at 909.
95 Id.
96 Id.
contractual relationship with the auditor.\textsuperscript{97} Realistically, the court acknowledged that any suit brought by the bankrupt Taurus would in effect be brought for the benefit of its creditors. However, rather than expressly stating the trustee lacked standing, the court decided that the trustee’s claim failed on the facts regardless of how the standing issue was resolved.\textsuperscript{98}

The fact that Taurus survived for more than a year after the audit provided by Ernst & Young was conducted was not central to the resolution of the case.\textsuperscript{99} Rather, the court categorized a going-concern qualification as a prediction, which may have to include items in the audit report that would result to foreseeable harm to the company if omitted.\textsuperscript{100} The point of an audit, the court noted, is for the auditing firm to look at the corporation’s financials, which are provided by the corporation, and make sure that they correspond to reality.\textsuperscript{101} Ernst & Young did not find any discrepancies between Taurus’s financials and its actual financial state because no such discrepancies existed.\textsuperscript{102} The court commented that Ernst & Young did fail to include a warning about the trends toward nationalization in the frozen food market but also stated that predicting Taurus’s cash flow beyond its financial statements was outside the purpose of the audit report.\textsuperscript{103} The court noted that “an auditor’s duty is not to give business advice; it is merely to paint an accurate picture of the audited firm’s financial condition, insofar as the condition is revealed by the company’s books and inventory and other sources of an auditor’s opinion.”\textsuperscript{104}

The court did note that the auditor has a duty to follow accounting standards; in other words, it must be alert to certain conditions that would prevent the company from continuing as a going concern when considered in the aggregate.\textsuperscript{105} These conditions include: negative

\begin{itemize}
\item \textsuperscript{97} Id.
\item \textsuperscript{98} Id.
\item \textsuperscript{99} Id. at 910.
\item \textsuperscript{100} Id.
\item \textsuperscript{101} Id.
\item \textsuperscript{102} Id.
\item \textsuperscript{103} Id.
\item \textsuperscript{104} Id.
\item \textsuperscript{105} Id. at 910-11.
\end{itemize}
trends, other indications of financial difficulties (defaults on loan agreements, restructuring of debt, need to seek new sources of financing, etc), internal matters such as work stoppages and other labor difficulties, and external matters that have occurred such as legal proceedings or loss of a key franchise. However, “nowhere is the auditor required to investigate external matters, as distinct from discovering them during the engagement.” Therefore, the court focused on the fact that Ernst & Young was not hired to assess the projected supply and demand for the industry, and it was impossible for Ernst & Young to know more about trends in the frozen food market than Taurus did itself. Relying on those facts, the court held that Ernst & Young was not liable to Taurus’s creditors for the losses the company suffered from the prolonged liquidation.

The court went on to note that not only was it possible to find for Ernst & Young on the merits, but the trustee’s claim was also barred by the one year statute of limitations in the Accountancy Act. Judge Rovner concurred in the opinion, stating that she would have limited the decision to whether the action was brought within the statute of limitations and would have barred the action on that issue alone.

B. The HA2003 Liquidating Trust v. Credit Suisse Securities (USA) LLC

The HA2003 Liquidating Trust v. Credit Suisse Securities (USA) LLC involved a trust’s attempt to collect—for the sake of creditors—from the debtor’s investment banker, Credit Suisse First Boston (now Credit Suisse Securities) (“Credit Suisse”). HA-LO Industries (“HA-LO”) manufactured and sold promotional products bearing

106 Id. at 911.
107 Id.
108 Id.
109 Id.
110 Id. at 911-12.
111 Id. at 913.
112 517 F.3d 454 (7th Cir. 2008).
company logos for employees and advertising purposes.\textsuperscript{113} In the 1990s, HA-LO considered expanding its business into the e-commerce realm instead of focusing solely on traditional sales methods.\textsuperscript{114} In 1999, John Kelley, HA-LO’s Chief Executive Officer decided that purchasing Starbelly.com, Inc. (“Starbelly”) was the most promising method of breaking into the e-commerce arena.\textsuperscript{115} Starbelly was a start-up company that was eating through its venture capital at a rate of $3 million per month and had yet to make a sale.\textsuperscript{116} Obviously, the proposition was risky, but Kelley had faith in Starbelly’s e-commerce system.\textsuperscript{117}

HA-LO enlisted the help of Credit Suisse as an investment banker and Ernst & Young as a business consultant in connection with its anticipated acquisition of Starbelly.\textsuperscript{118} Along with renegotiating the price of the sale and working out a pay structure to avoid placing HA-LO in violation of its loan covenants, Credit Suisse also issued a fairness opinion representing that as of the date of the opinion (January 17, 2000), “the Merger Consideration is fair to HA-LO from a financial point of view.”\textsuperscript{119} The fairness opinion issued by Credit Suisse and its engagement letter with HA-LO both specified that it had relied on—but not verified—HA-LO’s financial projections.\textsuperscript{120} Verification of the financial projections was left up to Ernst & Young, which informed Kelley that Starbelly would not generate nearly the

\textsuperscript{113} Id. at 455.
\textsuperscript{114} Id.
\textsuperscript{115} Id.
\textsuperscript{116} Id.
\textsuperscript{117} Id.
\textsuperscript{118} Id.
\textsuperscript{119} Id. at 455-56. Fairness opinions can be issued in a number of significant corporate transactions and are most often issued to a company’s board of directors when that company is selling itself or acquiring another company. Tariq Mundiya, \textit{Fairness Opinions: Courts Scrutinize the Role of Investment Banks}, 5/29/2008 N.Y.L.J. 5, (col. 1) (2008).
\textsuperscript{120} HA2003 Liquidating Trust, 517 F.3d at 456.
amount of revenue he had projected.\textsuperscript{121} Kelley, however, refused to accept the more realistic projections provided by Ernst & Young.\textsuperscript{122}

In April of 2000, HA-LO sent its shareholders a proxy solicitation, which included the fairness opinion issued by Credit Suisse. HA-LO’s investors approved the merger, and the deal was closed in May 2000.\textsuperscript{123} Shortly thereafter, HA-LO entered a tumultuous financial period triggered both by the large cash payout to Starbelly and Starbelly’s continuing losses.\textsuperscript{124} In January 2001, HA-LO entered bankruptcy.\textsuperscript{125} After HA-LO reorganized, a successor emerged, as well as a liquidating trust.\textsuperscript{126} The trust, known as HA2003 Liquidating Trust, was set up to collect from anyone associated with HA-LO’s failed transactions and to distribute the proceeds to HA-LO’s pre-bankruptcy creditors.\textsuperscript{127} The trust filed a complaint against Credit Suisse alleging the investment banker was grossly negligent in preparing its fairness opinion.\textsuperscript{128} After a bench trial in the U.S. District Court for the Northern District of Illinois, the court found that Credit Suisse was not grossly negligent in preparing its fairness opinion; the trust appealed to the Seventh Circuit.\textsuperscript{129}

The case was decided on February 20, 2008 with an opinion issued by Chief Judge Frank Easterbrook.\textsuperscript{130} The court noted that the district court had found that it could not label the investment bank’s behavior grossly negligent because it was only doing what its contract with HA-LO required it to do.\textsuperscript{131} The district court also found that HA-LO’s Chief Executive Officer and board members knew

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{121} \textit{Id.}
\item \textsuperscript{122} \textit{Id.}
\item \textsuperscript{123} \textit{Id.; A proxy solicitation is defined as a “request that a corporate shareholder authorize another person to cast the shareholder’s vote at a corporate meeting.” BLACK’S LAW DICTIONARY (8th ed. 2004).}
\item \textsuperscript{124} \textit{HA2003 Liquidating Trust, 517 F.3d at 456.}
\item \textsuperscript{125} \textit{Id.}
\item \textsuperscript{126} \textit{Id.}
\item \textsuperscript{127} \textit{Id.}
\item \textsuperscript{128} \textit{Id.}
\item \textsuperscript{129} \textit{Id.}
\item \textsuperscript{130} \textit{Id. at 455.}
\item \textsuperscript{131} \textit{Id. at 456.}
\end{itemize}
\end{footnotesize}
everything they accused Credit Suisse of ignoring, which would make assessing damages impossible. On appeal, the Seventh Circuit reviewed these factual findings using a clearly erroneous standard, which the court concluded was not met.

Although the trust urged the court to consider whether fairness opinions were just “worthless (but expensive) paper,” the court refused to be pulled into the debate, finding that the question had no bearing on the outcome of the case. The court did state that requiring investment banks to treat fairness opinions as insurance would only raise the price of these decisions, thereby having a detrimental effect on the market. Such insurance, the court reasoned, would be cheaper when achieved through the stock market and the ability of investors to diversify their holdings. The Seventh Circuit is known for seizing the opportunity to promote the free market in its decisions, and its line of rationale discussing the “efficient market” in The HA2003 Liquidating Trust does not differ in that regard.

While the court took the chance to discuss market principles, its decision to not hold Credit Suisse liable primarily relied on the fact that the financial adviser not only acted according to normal business standards but, more importantly, had performed its contract with HA-LO to the letter. Credit Suisse relied on the numbers provided by HA-LO in formulating its fairness opinion, and though those numbers may have been wrong, Credit Suisse did not have the duty to ensure their accuracy. That task was left up to (and completed by) Ernst & Young. It was HA-LO’s choice to not provide Credit Suisse with

132 Id. at 456-57.
133 Id. at 457. The clearly erroneous standard requires that a reviewing judge have a “definite and firm conviction” that an error was committed. Dickinson v. Zurko, 527 U.S. 150 (1999).
134 HA2003 Liquidating Trust, 517 F.3d at 457.
135 Id. at 458.
136 Id.
137 Dominic J. Campisi, Representing Estate and Trust Beneficiaries and Fiduciaries, SP004 ALI-ABA 1, 10-11 (2008).
138 HA2003 Liquidating Trust, 517 F.3d at 457.
139 Id.
140 Id.
those numbers but instead to ask the investment bank to tender the fairness opinion using numbers generated by HA-LO itself.\footnote{Id.}

The trust also argued that Credit Suisse should have foreseen the end of the dot-com boom, an argument the court deemed an “appeal to hindsight.”\footnote{Id. at 458.} The court went on to say that if everyone knew the dot-com boom was ending, as the trust asserted, then Credit Suisse had no duty to revise its opinion as the trust argued it should have done.\footnote{Id.} Not only would have it been unnecessary to restate what the investing public could clearly see, but Credit Suisse was hired to deliver an opinion as of one date, which is exactly what it did.\footnote{Id.} Finally, the trust asked the court to throw out the contract between the parties and impose a separate set of duties on Credit Suisse.\footnote{Id.} The court refused to do so, citing the principle that, “[i]ntelligent adults can enforce their own standards of performance, and courts must enforce the deal they have struck.”\footnote{Id. at 459.}

The Seventh Circuit, therefore, reached the same general conclusion as in Fehribach—that the third party professional was not liable—by tailoring its focus to the contract between the parties as that contract was written.\footnote{Id.}

\textbf{C. Joyce v. Morgan Stanley & Co., Inc.}

In the last of the trilogy of cases, Joyce v. Morgan Stanley & Co., Inc., the shareholders and option holders brought suit against the business’s financial advisor for constructive fraud stemming from the advisor’s failure to address ways to hedge their risks.\footnote{538 F.3d 797 (7th Cir. 2008). Hedging entails the “use of two compensating or offsetting transactions to ensure a position of breaking even; to make advance arrangements to safeguard oneself from loss on an investment, speculation, or bet.” BLACK’S LAW DICTIONARY (8th ed. 2004).}

Edward T.
Joyce and the other plaintiffs were shareholders and option holders in 21st Century Telecom Group ("21st Century"). On December 12, 1999, 21st Century entered into a merger agreement with RCN Corporation ("RCN") whereby RCN would acquire all of 21st Century's common stock. Morgan Stanley advised 21st Century in connection with the merger. Unfortunately for the shareholders, between the date of the merger agreement and the effective date of the merger in April of 2000 RCN's stock value plummeted. The newly acquired stock ended up worthless.

The shareholders filed suit against Morgan Stanley alleging constructive fraud on the part of the financial advisor. This fraud, the shareholders claimed, stemmed from Morgan Stanley’s failure to advise them how to minimize their exposure to any potential decline in the value of the RCN stock. Morgan Stanley filed a motion to dismiss based on an alleged lack of standing, failure to state a claim, and failure to sue within the statutory limitation period, which the U.S. District Court for the Northern District of Illinois granted. The shareholders appealed to the Seventh Circuit.

Judge Diane P. Wood issued the court’s opinion in Joyce, which was decided on August 19, 2008. The decision held that debtor’s financial advisor, Morgan Stanley, could not be held liable to 21st Century’s stockholders and option holders under a constructive fraud theory. The court began by stating that the shareholders did have

---

149 Joyce, 538 F.3d at 799.
150 Id.
151 Id. Common stock is “a class of stock entitling the holder to vote on corporate matters, to receive dividends after other claims and dividends have been paid (esp. to preferred shareholders), and to share in assets upon liquidation.” BLACK’S LAW DICTIONARY (8th ed. 2004).
152 Joyce, 538 F.3d at 799.
153 Id.
154 Id. at 800.
155 Id. at 799.
156 Id.
157 Id.
158 Id. at 799.
159 Id. at 802.
standing to bring the suit because their claims were direct rather than derivative.\(^{160}\) The shareholders alleged that their losses were based on a failure to hedge rather than a drop in stock prices.\(^{161}\) 21st Century as a corporation did not suffer any loss related to the lack of hedging advice because 21st Century did not receive any RCN stock in the transaction.\(^{162}\) The court stated that while it was willing to acknowledge that the shareholders had standing to bring the action, the real issue turned on whether Morgan Stanley had a duty to give hedging advice.\(^{163}\)

Considering the issue of whether Morgan Stanley had a duty to give hedging advice was imperative to the resolution of the shareholders’ constructive fraud claims.\(^{164}\) Constructive fraud differs from actual fraud in that it does not require actual dishonesty or the intent to deceive; rather, the law imposes liability simply because of the act’s tendency to deceive.\(^{165}\) The claim of constructive fraud requires either a confidential or a fiduciary relationship between the parties.\(^{166}\) In their complaint, the shareholders asserted that they had a confidential relationship with Morgan Stanley, and that Morgan Stanley did in fact owe them a fiduciary duty.\(^{167}\) The shareholders alleged that the fairness opinion provided by Morgan Stanley constituted a breach of that fiduciary duty because it was not based on an independent investigation, it failed to address the risks associated with the transactions, and it did not identify the ways the shareholders could hedge those risks to minimize losses.\(^{168}\)

\(^{160}\) Id. at 799-800. A direct claim may be brought when the shareholder suffers a harm that is separate and distinct from the harm suffered by the corporation. The claim is derivative when the harm to the shareholder is shared by the corporation. 18 C.J.S. Corporations §485 (2008).

\(^{161}\) Joyce, 538 F.3d at 800.

\(^{162}\) Id.

\(^{163}\) Id.

\(^{164}\) Id.

\(^{165}\) Id.

\(^{166}\) Id.

\(^{167}\) Id.

\(^{168}\) Id. at 801.
The shareholders also alleged a conflict of interest based on the fiduciary duty they claimed Morgan Stanley owed them.169 This conflict, the shareholders claimed, arose from the fact that Morgan Stanley had previously advised RCN in connection with the merger—a fact that was disclosed to the shareholders in Morgan Stanley’s engagement letter.170 Finally, rather than ask the court to find that the alleged breach of duty lie in the fairness opinion, the shareholders asked the court to look beyond the terms of that opinion (and beyond what was alleged in their complaint) to find that Morgan Stanley owed them an extra-contractual duty to provide advice relating to hedging strategies.171 The extra-contractual duty, the shareholders contended, arose out of the special circumstances surrounding the relationship between the parties. 172

The court rejected each of the above arguments made by the shareholders.173 First, the court acknowledged that 21st Century was willing to engage Morgan Stanley despite the fact that it knew the firm had previously advised RCN.174 This willingness, the court suggested, actually indicated that 21st Century was hoping a breach of fiduciary duty by Morgan Stanley would cut in its favor—as 21st admitted it hired the firm even though it knew Morgan Stanley had a substantial amount of knowledge concerning RCN’s business and capital structure.175 The court determined, however, that 21st Century’s motivations for engaging RCN were irrelevant, as the allegations that Morgan Stanley breached its duty to the shareholders were the focus of the case.176

In determining whether a breach of duty occurred, the court reasoned that even if it chose to overlook the fact that this extra-contractual duty existed, it could still find a breach of duty based on the fairness opinion.177

---

169 Id.
170 Id. Morgan Stanley discontinued providing services to RCN when it began advising 21st Century in connection with the proposed merger. Id.
171 Id.
172 Id.
173 Id. at 801-02.
174 Id. at 801.
175 Id.
176 Id.
contractual duty was not pleaded in the complaint, the shareholders could not show that special circumstances existed that would give rise to that duty.\textsuperscript{177} One necessary circumstance is that the allegedly superior party must have accepted the duty to protect the interests of the dependent party.\textsuperscript{178} The court noted that no such evidence existed to suggest that Morgan Stanley accepted this duty on behalf of the shareholders.\textsuperscript{179} In fact, Morgan Stanley’s engagement letter specified that the advisor was working only for the corporation.\textsuperscript{180} The court compared this case to \textit{The HA2003 Liquidating Trust} because “[wishing] that a different contract had been written is not a basis for liability.”\textsuperscript{181}

Finally, the court noted that it could have also upheld the district court’s judgment based on the shareholder’s failure to sue within the statutory limitations period.\textsuperscript{182} The shareholders should have been put on notice that they needed to investigate whether they were wrongfully deprived of the means needed to prevent their losses on the effective date of the merger agreement.\textsuperscript{183} Investigating whether hedging strategies were available would have taken little effort on the shareholders part, and because the standard for knowledge is objective rather than subjective, the shareholders could not claim that the statute of limitations period was triggered at the moment they learned of the availability of hedging strategies rather than the moment they learned they had experienced a loss.\textsuperscript{184}

\textsuperscript{177} \textit{Id.} at 802.
\textsuperscript{178} \textit{Id.}
\textsuperscript{179} \textit{Id.}
\textsuperscript{180} \textit{Id.}
\textsuperscript{181} \textit{Id.}
\textsuperscript{182} \textit{Id.} at 803.
\textsuperscript{183} \textit{Id.}
\textsuperscript{184} \textit{Id.}
IV. The Seventh Circuit: Headed in the Right Direction But in Need of a Straighter Path

A. Fehribach, The HA2003 Liquidating Trust, and Joyce Were Correctly Decided

The Seventh Circuit’s recent decisions in *Fehribach*, *The HA2003 Liquidating Trust*, and *Joyce* are a step in the right direction when applied to the question of how far to extend liability for a debtor’s pre-bankruptcy professionals. This trilogy indicates that the Seventh Circuit is reluctant, or even unwilling, to extend liability to these professionals absent any specific misconduct on their part.185

These decisions were careful not to shut out the possibility for professional liability based on a standing issue alone—such as whether there was privity of contract or a duty owed by the professional to a third party.186 Failing to consider the merits of these cases and disposing them on a lack of standing alone would have been nonsensical. As the court noted in *Fehribach*, Taurus, the bankrupt company, obviously had standing to sue its pre-bankruptcy professionals because of the contractual relationship it shared with those professionals.187 If Taurus would have been solvent at the time it was injured by the auditing firm’s alleged negligence any suit brought against the auditor would have been brought for the benefit of its shareholders—even though the shareholders themselves could not have sued the auditor.188 The court went on to state that while it was true that Ernst & Young had no duty to Taurus’s creditors, it did have a duty to Taurus—a duty that did not evaporate because Taurus was bankrupt, and it was its creditors who would receive the benefit from a

185 See *Fehribach* v. Ernst & Young, LLP, 493 F.3d 905 (7th Cir. 2007)(Rovner, J., concurring); *HA2003 Liquidating Trust* v. Credit Suisse Securities (USA) LLC, 517 F.3d 454 (7th Cir. 2008); *Joyce* v. Morgan Stanley & Co., 538 F.3d 797 (7th Cir. 2008).
186 See *Fehribach*, 493 F.3d at 909 (“The trustee’s claim fails nevertheless, but fails on the facts”).
187 Id. at 909.
188 Id.
successful suit. By this rationale, the court’s decision to not dispose of any of the aforementioned cases on lack of standing alone was the logical approach. Also, it should be noted that in *Fehribach* the court was dealing with the strict privity rule espoused by *Ultramares*, yet it still chose to reach a decision on the merits.

Although *Fehribach*, *The HA2003 Liquidating Trust*, and *Joyce* were decided on the merits, two of these cases—*Fehribach* and *Joyce*—could have been resolved by simply holding that the suits were not brought within the statutory limitations period. The fact that the court decided to discuss the merits of each of these cases before holding that the actions were also barred by the statute of limitations indicates that the court wanted to use these cases to espouse its general views regarding the extension of liability to outside professionals. In doing so, the court acknowledged its unwillingness to hold professionals liable for actions that were not required by their engagement letters—without shutting out the possibility that such an action could exist. The court, however, could have devised an analytical framework that would have made its inquiries into the facts of each case much simpler.

**B. The Three Prong Test for Equitable Subordination as a Guideline for Devising an Efficient Analytical Framework for Professional Liability Claims**

It is possible to formulate an initial analytical framework for determining whether these professionals can be held liable for the services they rendered to a debtor pre-bankruptcy—whether the suit is

---

189 *Id.*

190 *Id.*

191 493 F.3d at 911; 538 F.3d at 803.

192 *Compare HA2003 Liquidating Trust, 517 F.3d 454, 458 (7th Cir. 2008)*

(“The engagement contract says CSFB has no duty to double-check the predictions. CSFB did what it was hired to do,” with *Fehribach*, 493 F.3d at 910 (“The requirement that the auditor disclose in its report any substantial doubt it has that the firm will still be a going concern in a year expands the auditor’s duty beyond that of verifying the accuracy of the company’s financial statements”).
brought under a fraud, negligence, or deepening insolvency damages theory. Furthermore, the rule utilized should be similar to a rule applied in a different context—to the question of whether a lender’s claim can be equitably subordinated.193 In considering whether a claim can be equitably subordinated, the Seventh Circuit—as well as other circuits—follows a three-prong balancing test that considers whether: “(1) the claimant creditor has engaged in some sort of inequitable misconduct; (2) the misconduct has resulted in an injury to other creditors or an unfair advantage to the miscreant; and (3) subordination of the debt is inconsistent with the other provisions of the bankruptcy code.”194

While some courts have held that inequitable conduct is not required for subordination, such conduct is a requirement when attempting to subordinate the claims of a secured lender.195 Generally, financial lending institutions do not owe a duty to their borrowers; however, an exception to this rule exists when the lending institution exerts “dominion or control” over the debtor.196 A close relationship between the lender and the debtor is not considered sufficient; the lender must exercise enough control over the debtor to both influence corporate policy and the disposition of assets.197 Thus, a lender’s claim will not be equitably subordinated unless it is proven that the lender actually controlled the debtor.198

Applying the aforementioned rule as an initial step to determining the potential liability of a debtor’s pre-bankruptcy professionals would

193 Equitable subordination represents the power of the bankruptcy court under § 510(c) of the Bankruptcy Code to reprioritize claims in a bankruptcy case if the court determines the claimant has engaged in misconduct that either injures other creditors or confers on unfair advantage on the claimant. In re Kreisler, 2008 WL 4613880 *864, *866 (7th Cir.). See also 11 U.S.C. § 510(c) (2008).


195 Aluminum Mills, 132 B.R. at 893.

196 Id. at 894.

197 Id.

198 See id.
establish a bright line rule for creditor’s claiming they were owed duties outside of the scope of what was required in their engagement letters—professionals will not be liable for the alleged negligence unless they exercised control over the debtor that amounted to a dictatorship over corporate policy. This test would be easier to apply than and would eliminate the need for the court’s current approach of looking at each case on a fact by fact basis to determine liability for whether fairness opinions should have amended, or market trends and other external factors should have been considered, or numbers should have been verified. The test would also create a balance by ensuring that outside professionals are held accountable for their actions when exerting control over the debtor—a balance that will not be achieved by simply inquiring into whether an engagement letter required a specific action.

As further support, the proposed test falls squarely in line with the Seventh Circuit’s reasoning against finding lender liability in the context of equitable subordination. For example, in Kham & Nate’s Shoes No. 2, Inc. v. First Bank of Whiting, the court noted the general lack of cases subordinating the claims of creditors that dealt only at arm’s length with the debtor. The debtor in Kham urged the court to find that the lender’s conduct could be inequitable even though the lender had complied with all of its contractual obligations. The court rejected this argument, stating they were “not willing to embrace a rule that requires participants in commercial transactions not only to keep their contracts but also do ‘more’—just how much more resting in the discretion of a bankruptcy judge assessing the situation years later.” Surely, the rule proposed in this Article would take any discretion out of the hands of a bankruptcy judge as to whether a professional without control over the debtor was required to do

199 Of course, if the alleged negligence or breach lies within the performance of duties required by the professional’s engagement letter then the claims should be analyzed in accordance with the elements of standard tort and contract claims.

200 908 F.2d 1351, 1356 (7th Cir. 1990).

201 Id.

202 Id.
“more”—an outcome that would seem welcomed by the Seventh Circuit.

CONCLUSION

The Seventh Circuit rightfully concluded that an outside professional was not liable for the bankruptcy or financial loss of the company it advised in Fehribach, The HA2003 Liquidating Trust, and Joyce. The plaintiffs in each of these cases were only seeking, as Chief Judge Easterbrook put it, “a deep pocket to reimburse investors for the costs of managers’ blunders.” These plaintiffs brought suit against the professionals based on claims for breach of contract, negligence, constructive fraud, and under the deepening insolvency damages theory—all common theories of liability that professionals are sued under throughout other circuit and lower federal courts. The Seventh Circuit did not expressly state that the third party plaintiffs lacked standing to bring any of the claims; rather, the court decided each case on the merits. In doing so, the court rejected each claim brought against the professionals in all three cases on a fact by fact basis.

The court’s failure to outline a general analytical framework in any of its decisions, however, will surely lead to the exercise of judicial direction as to whether these professionals can be held liable. A clear rule is necessary to simplify the liability question for these professionals in the Seventh Circuit as well as in the other circuit courts and lower federal courts. The imperativeness of such a rule is especially apparent in the current economic climate—where management in a number of industries has been blamed for their respective industry’s collapse or potential collapse. If these

203 HA2003 Liquidating Trust v. Credit Suisse Securities (USA) LLC, 517 F.3d 454, 457 (7th Cir. 2008).
industries do fail, there is always the possibility that their creditors will go after the outside professional advisors as a means of recovery. A clear cut rule delineating when these advisors can be held liable would eliminate the need for the federal courts to examine each case on a fact by fact basis to determine what actions, if any, the advisor could have taken on behalf of the struggling business and whether they were actually obligated to take those actions irrespective of whether their engagement letters required it.

The rule used for determining when these professionals can be held liable should be similar to the rule applied to the question of whether a secured lender’s claim can be equitably subordinated. In other words, plaintiffs alleging that a professional should have done more to warn them about the financial condition of the business the professional advised should first be required to prove that the professional exercised control over the debtor. Such a rule would not only ensure that professionals performing their contractual duties to the letter would not be held liable by third parties seeking a deep pocket, but it would also balance the detrimental effects of holding that a professional is not liable for actions not required by their engagement letter when that professional was exercising actual control over the debtor.

2008, http://www.huffingtonpost.com/2008/10/06/lehmans-golden-parachutes_n_132258.html (“culture of entitlement” among Lehman management); Peter Whoriskey, AIG Spa Trip Fuels Fury on Hill, WASHINGTON POST, Oct. 8, 2008, available at http://www.washingtonpost.com/wp-dyn/content/article/2008/10/07/AR2008100702604_pf.html (a week before former AIG CEO told investors company was confident in their valuation methods, Pricewaterhouse Coopers, AIG’s auditor, had warned them that they could have a material weakness in that area).