RECENT DEVELOPMENTS RE: FIDUCIARY DUTY
IN THE ZONE OF AND DURING INSOLVENCY
AND RE: DEEPENING INSOLVENCY

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I. BREACH OF FIDUCIARY DUTY

A. Credit Lyonnais And Progeny: Fiduciary Duty To Creditors In The Zone Of Insolvency

A discussion of recent developments with respect to fiduciary duties when a corporation is insolvent or in the vicinity of insolvency properly begins almost 16 years ago, with the Delaware Court of Chancery’s decision in Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., 1991 WL 27761 3 (Del. Ch. Dec. 30, 1991) (Chancellor Allen). This case grew out of a dispute between Credit Lyonnais and Pathe (together with Giancarlo Paretti, who dominated Pathe) as to who constituted the lawfully elected members of the board of MGM, 98.5% of the stock of which Pathe had purchased in a leveraged buyout on November 1, 1990. Five months later, trade creditors filed an involuntary chapter 7 bankruptcy against MGM. In return for its loan to MGM of an additional $145 million, which it needed to obtain dismissal of the involuntary bankruptcy case, Credit Lyonnais obtained a Corporate Governance Agreement regarding MGM.

Pursuant to that Agreement, significant decision-making authority was ceded by the board of directors to an executive committee consisting of Alan Ladd and Jay Kanter, who served, respectively, as CEO and COO of MGM. The Agreement provided that, when MGM and Pathe’s combined debt to Credit Lyonnais was reduced below $125 million, decision-making authority would be returned to MGM’s board, which was controlled by Paretti. Among the myriad claims involved in the case, Paretti and Pathe alleged that Ladd and his team breached their fiduciary duty to Pathe/Paretti as the 98.5% stockholder of MGM when the executive committee failed to approve the sale of certain assets proposed by Pathe/Paretti, the proceeds of which would have been used to pay down MGM’s debt to Credit Lyonnais.

1 To provide background on fiduciary duty and deepening insolvency, and with permission, I have attached as an Appendix an excellent piece entitled Potential Liability for Deepening Insolvency and Breach of Fiduciary Duty to Creditors, which was written by Robert B. Millner of Sonnenschein Nath & Rosenthal LLP for a panel on which Hon. Leif M. Clark, Michael H. Reed and I participated at the ABA Section of Litigation Annual Conference on April 11-14, 2007. This article is hereinafter referred to as “Millner.”
Pathel/Paretti alleged that the business judgment rule was not applicable because Ladd and his management team would be ousted if and when Paretti regained control of MGM and because of personal animosity between Paretti and Ladd. The court held that the actions of the executive committee were, under any test, not a breach of duty.

The court held that, because MGM was at least in the vicinity of insolvency, the members of the executive committee owed fiduciary duties to “the corporate enterprise,” “not merely the . . . residue risk bearers.” *Id.* at *34. They “had an obligation to the community of interest that sustained the corporation, to exercise judgment in an informed, good faith effort to maximize the corporation’s long-term wealth creating capacity.” *Id.* Therefore, they were “not disloyal in not immediately facilitating whatever asset sales were in the financial best interest of the controlling shareholder.” *Id.* Rather, they properly suspected that Pathel/Paretti would be “inclined to accept fire-sale prices” for the assets in order to retain control of MGM. *Id.* Therefore, it was “not disloyal for them to consider carefully the corporation’s interest in the . . . [proposed] transaction.” *Id.*

In famous footnote 55, the court elucidated the duty of directors of a corporation that is insolvent or in the vicinity of insolvency. Through a mathematical model, it demonstrated that the directors should not necessarily do what shareholders or creditors would desire, but rather should “consider the community of interests that the corporation represents.” *Id.* at 34 n.55.

Such directors will recognize that in managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right (both efficient and fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act.


The chancellor [in *Credit Lyonnais*] noted that directors and officers owe their fiduciary duties not so much for the benefit of the corporation itself as such, but rather for the benefit of the entities for whose benefit the corporation exists — its shareholders of course, but also its creditors, at least when the corporation enters the zone of insolvency. . . . The comment picked up steam over the years from a number of quarters, giving rise to the notion that directors might have a fiduciary duty not to exacerbate the firm’s insolvency, because to do so would do harm to the legitimate entitlements of the firm’s creditors, and creditors thus would have the right to sue for damages resulting from directors’ or officers’ breach of their fiduciary duties in “deepening” the firm’s insolvency.

**B. Production Resources: Vice Chancellor Strine’s Exegesis Of Credit Lyonnais And Clarification Of Fiduciary Duty In The Context Of Insolvency**

1. **Introduction: Factual And Legal Allegations**

In *Production Resources,* decided by Vice Chancellor Strine, the Delaware Court of Chancery imposed a course correction with respect to certain interpretations of *Credit Lyonnais,* while discoursing at length3 on several related issues under Delaware corporation law.

In *Production Resources,* PRG filed a complaint seeking appointment of a receiver for NCT and asserting breach of fiduciary duty claims against NCT, its directors (which included its CEO (Michael Parrella), President (Irene Lebovics) and its CFO). PRG alleged that, because NCT was insolvent, it could assert breach of fiduciary duty claims as direct (not derivative) claims and that, therefore, the exculpatory provision in NCT’s charter, which protects directors from duty of care claims, would be inapplicable.4 The defendants moved to dismiss for failure to state a claim.

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2 In *I.G. Services,* the court held that *res judicata* applied to foreclose claims brought by a trustee, who was the assignee of creditors’ claims under the debtor’s chapter 11 plan, when judgment had been entered against the chapter 11 trustee on similar claims. Relying on *North American* (discussed infra), the court held that creditors do not have direct claims for participation in directors’ breach of fiduciary duties, but can only pursue such claims derivatively.

3 The *Production Resources* opinion, as published in Atlantic 2d, is 32 pages long.

4 Del. Code. Ann. tit. 8, § 102(b)(7) (hereinafter “Del. C. § 102(b)(7)”) provides as follows:

In addition to any matters required to be set forth in the certificate of incorporation by subsection (a) of this section, the certificate of incorporation may also contain any or all of the following matters:

* * * * *

footnote continued...
NCT was “a technology and communications company that had yet to achieve profitability.” *Id.* at 778. “NCT’s primary business was to ‘design products and develop and license technologies based upon its portfolio or patents and other rights.’” *Id.* (footnote omitted). Its common stock traded on the pink sheets. PRG, which installed a computer controlled audio system for NCT in 1999, obtained a confessed judgment for approximately $2 million against NCT in early 2002, which it was still attempting to collect two years later. PRG alleged that NCT was insolvent, but continued to operate by means of capital provided by Carole Salkind, its primary creditor, which permitted NCT to pay some of its bills and its payroll. As the court explained:

The source of funding is odd in several respects, including that: (1) Salkind allegedly has no means of her own to support investments of the level she has putatively made; (2) no fewer than eight companies controlled by her family allegedly act as paid consultants to NCT; (3) her latest cash financing has been placed into a company subsidiary to avoid the claims of creditors including PRG; and (4) Salkind has personally been issued preferred debt and warrants convertible into nearly a billion shares—a number far in excess of that authorized by the NCT charter.

*Id.* at 774. “Perhaps most important,” Salkind was given security for her loans and, thus, able “to stake out a claim superior to PRG and other NCT creditors.” *Id.* Further, “[g]iven the massive number of shares pledged to her and her right to foreclose to collect the defaulted debt NCT

(footnote continued...)

(7) A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director’s duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit. No such provision shall eliminate or limit the liability of a director for any act or omission occurring prior to the date when such provision becomes effective. All references in this paragraph to a director shall also be deemed to refer (x) to a member of the governing body of a corporation which is not authorized to issue capital stock, and (y) to such other person or persons, if any, who, pursuant to a provision of the certificate of incorporation in accordance with § 141(a) of this title, exercise or perform any of the powers or duties otherwise conferred or imposed upon the board of directors by this title.
owes her, Salkind was fairly regarded as the company's de facto controlling stockholder." Id. at 774-775.5

The court noted that "NCT's own public filings reveal[ed] that it [was] balance-sheet insolvent and that it has been unable to pay several debts that came due." Id. at 775; see id. at 783-84. Further, to compromise some of those debts (including debts for rent, inventory and temporary help), it had "pledged or issued billions of shares of its stock - which trade[d] in pennies - shares far in excess of what [was] authorized by its charter. " Id.6 It had not held an annual meeting since 2001 "because, it sa[id], the company cannot afford the cost." Id. And, even though it had submitted nine versions of its S-1 to the SEC, it had not obtained approval to register certain shares it pledged to PRG and others.7 From these and other allegations, the court concluded that PRG had alleged facts that, if true, demonstrated that NCT was insolvent under the following applicable test:8

To meet the burden to plead insolvency, PRG must plead facts that show that NCT has either: 1) "a deficiency of assets below liabilities with no reasonable prospect that the business can be successfully continued in the face thereof," or 2) "an inability to meet maturing obligations as they fall due in the ordinary course of business." Here, PRG has pled facts meeting both tests. Id. at 782 (footnote omitted).9

5 PRG's complaint alleged that, "[a]s of October 31, 2003, NCT owed Salkind more than $28 million. NCT has defaulted on at least 13 convertible notes owed to her, worth more than $9 million in principle [sic] alone, and refinanced them on more unfavorable terms for NCT. Salkind is allegedly now a secured creditor, holding liens on most of NCT's tangible assets, including the stock of NCT's subsidiaries . . . . Salkind or her affiliates owned over 1.2 billion share of NCT stock on a fully converted basis." Production Resources, 863 A.2d at 780.

6 The court described this as "a business strategy or dubious legality and . . . suggestive of desperation, rather than solvency." Production Resources, 863 A.2d at 779.

7 Before the confession of judgment, NCT entered into a "resolution agreement," pursuant to which it acknowledged a debt of $1,906,221 to PRG and agreed to register 6.7 million shares of stock for the benefit of PRG.

8 The court determined that PRG had alleged facts sufficient to plead insolvency in the context of its discussion of PRG's claim for the appointment of a receiver under Del. Code Ann. tit. 8, § 291. See Production Resources, 863 A.2d at 782-84. However, it then used that determination in deciding whether PRG had stated claims against the officers and directors of NCT, an insolvent entity, for breach of fiduciary duty. See id. at 787 (resolution of the motion to dismiss breach of fiduciary duty claims "depends on a proper understanding of the nature of claims that belong to corporations and the reasons why creditors are accorded the protection of fiduciary duties when companies become insolvent").

9 It is noteworthy that, under this set of definitions, a corporation is not insolvent merely because its liabilities exceed it assets. In addition, there must be "no reasonable prospect that the business can be successfully continued in the face thereof." In Production Resources, NCT argued that "PRG has failed
PRG’s complaint pled, “[i]n a cursory manner, . . . that the defendant-directors and officers breached their fiduciary duties by grossly mismanaging the company’s finances” and paying “exorbitant salaries,” all of which “caused the company to become insolvent.” Id. at 780. The court also found that PRG had alleged facts that, if true, demonstrated that: (1) “Salkind [was] NCT’s de facto controlling shareholder[10] and that her interests [were] being inequitably favored over PRG’s and other creditors’ interests by a complicit board”; (2) due to the substantial salaries and bonuses paid to Parrella and Lebovics “during a period when NCT’s financial performance and health have been dismal and NCT has dishonored its debt to PRG . . . [and] the payments to Salkind’s family companies, there [was] a pattern of improper self-enrichment by those in control”; and (3) “Salkind’s capital infusions [had] often been put into the coffers of NCT subsidiaries precisely to frustrate the ability of PRG to collect on the debts due it from NCT [while] . . . the consideration for these putative infusions [had] allegedly been additional convertible notes of NCT itself.” Id. at 781. According to the court, the allegations of the complaint “generate[d] an aroma of fiduciary infidelity.” Id.

(footnote continued . . .)

to allege facts that support a finding that it has ‘no reasonable prospects’ of continuing,” based on case law suggesting that “if a company can raise money to pay its bills through credit in a commercially sensible manner, then the company is not insolvent.” Production Resources, 863 A.2d at 782 (footnote omitted). The court responded:

[I]t is significant that NCT’s liabilities are nearly five times its assets. NCT had negative net tangible assets of $53.7 million and a working capital deficit of $57.1 million as of December 31, 2002. Both of these figures exceed NCT’s aggregate revenue of $41.2 million for the five years ending December 31, 2002, combined; not its net revenue, its total aggregate revenue! During the same period, NCT consistently racked up huge annual operating losses. The imposing size of the still-growing deficits NCT confronts is sufficient – at the pleading stage – to support an inference that the company has no prospects of successfully continuing. That NCT has staved off collapse by pledging billions of unauthorized and unregistered shares (of its penny stock) . . . fails to negate the inference that the company has no reasonable prospect to salvage its finances and continue as a viable going concern that meets its legal obligations. NCT’s drastic circumstances differ materially from cases where the relevant corporation’s assets and liabilities were approximately equal and where, with traditional financing, there appeared a prospect for viability.”

Id. at 783 (footnotes omitted).

10 The court stated: “In short, it is fairly inferable that Salkind, at her will, can assume practical control over NCT by either exercising her foreclosure rights in default or by converting and becoming a controlling shareholder.” Production Resources, 863 A.2d at 781.
The defendant directors’ principal defense to the breach of fiduciary duty claims was that they were barred by the corporation’s exculpatory charter provision. PRG argued that, because NCT was insolvent, its claims as a creditor for breach of duty were necessarily direct and, accordingly, were not barred by the exculpatory charter provision. PRG also argued that it had pled sufficient facts to state a claim for non-exculpated breaches of duty.

2. Reinterpretation Of Credit Lyonnais: Creditor Claims For Breach Of Fiduciary Duty Are Generally Derivative Because, Even When A Corporation Is Insolvent, The Duty Of Its Officers And Directors Is To Maximize The Value Of The Enterprise

The court directed its attention, first, to discussing whether breach of fiduciary duty claims asserted by creditors are direct or derivative, and took this opportunity to correct what it considered to be wrongheaded interpretations of Credit Lyonnais.

The court noted that, ordinarily, creditors may not allege fiduciary duty claims against corporate directors. Their legal protections lie elsewhere, e.g., in their ability to enforce contractual agreements, the law of fraudulent conveyance and bankruptcy law. “So long as the directors honor the legal obligations they owe to the company’s creditors in good faith, as fiduciaries they may pursue the course of action that they believe is best for the firm and its stockholders.” Id. at 787.

However, the court noted, this does not mean that “the directors are required to put aside any consideration of other constituencies, including creditors, when deciding how to manage the firm.” Id. That, the court said, is the lesson of Credit Lyonnais, which “clearly emphasized that directors would be protected by the business judgment rule if they, in good faith, pursued a less risky business strategy precisely because they feared that a more risky strategy might render the firm unable to meet its legal obligations to creditors and other constituencies.” Id. at 788.\footnote{The court in Production Resources cited the following explanation from Credit Lyonnais:}

The obligation of directors in that context of high risk and uncertainty, said Chancellor Allen, was not “merely [to be] the agent of the residue risk bearers” but rather to remember their fiduciary duties to “the corporate enterprise” itself, in the sense that the directors have an obligation “to the community of interest that sustained the corporation . . .” and to preserve and, if prudently possible, to maximize the corporation’s value to best satisfy the legitimate claims of all its constituents, and not simply to pursue the course of action that stockholders might favor as best for them.

court in Credit Lyonnais “emphasize[d] that directors have discretion to temper the risk that they
take on behalf of equity holders when the firm is in the ‘zone of insolvency.’” Id. Further, the
court indicated, “directors have an obligation to consider the legal duties of the firm and to avoid
consciously placing the firm in a position when it will be unable to discharge those duties.” Id.
at 788 n.52. “As the proportion of the firm’s enterprise value that is comprised of debt increases,
directors must obviously bear that in mind as a material consideration in determining what
business decisions to make.” Id.12

The court was critical of interpretations of Credit Lyonnais that converted this shield for
directors who consider the interests of creditors in making decisions about what is best for the
corporation into a sword that could be wielded by creditors against directors by alleging breach
of fiduciary duties owed to them if the corporation is in the vicinity of insolvency.13 The court
was of the view that existing legal protections available to creditors should be sufficient. “With
these protections, when creditors are unable to prove that a corporation or its directors breached
any of the specific legal duties owed to them, one would think that the conceptual room for
concluding that the creditors were somehow, nevertheless, injured by inequitable conduct would
be extremely small, if extant.” Id. at 790. Rather, in such circumstances, “directors comply with
their fiduciary duties to the firm by selecting and pursuing with fidelity and prudence a plausible
strategy to maximize the firm’s value.” Id.14

(footnote continued...)

12 The court noted, however, that there is no “magic dividing line that should signal the end to some,
most, or all risk-taking on behalf of stockholders or even on behalf of creditors, who are not
homogeneous and whose interests may not be served by a board that refuses to undertake any further
business activities that involve risk.” Production Resources, 863 A.2d at 788 n.52. Thus, the business
rule remains applicable in such situations, “provid[ing] directors with the ability to make a range of good
faith, prudent judgments about the risks they should undertake on behalf of troubled firms.” Id. (citing
Angelo, Gordon & Co. v. Allied Riser Comm. Corp., 805 A.2d 221, 229 (Del. Ch. 2002)).
13 The court singled out for criticism Committee of Unsecured Creditors v. Reliance Capital Group, Inc.
(In re Buckhead America Corp.), 178 B.R. 956, 968-69 (D. Del. 1994), and Weaver v. Kellogg, 216 B.R.
563, 582-84 (S.D. Tex. 1997).
14 Further, the court said:

When a firm is insolvent or near insolvency, the interests of its stockholders and creditors
can be starkly divergent, with the stockholders preferring highly risky strategies that
creditors would eschew. . . . Despite this divergence, I doubt the wisdom of a judicial
endeavor to second-guess good-faith director conduct in the so-called zone. Although it

footnote continued...
Nevertheless, the court noted, when a firm is insolvent, “it is settled that under Delaware law, the firm’s directors are said to owe fiduciary duties to the company’s creditors.” Id. at 790-91. However, according to the court, the fact of insolvency does not change the obligation of the directors, who “continue to have the task of attempting to maximize the economic value of the firm. That much of the job does not change. But the fact of insolvency does necessarily affect the constituency on whose behalf the directors are pursuing that end. By definition, the fact of insolvency places the creditors in the shoes normally occupied by the shareholders – that of residual risk-bearers.” Id. at 791.15

(footnote continued...)
is easy to posit extreme hypotheticals involving directors putting cash in slot machines, the real world is more likely to generate situations when directors face a difficult choice between pursuit of a plausible, but risky, business strategy that might increase the firm’s value to the level that equity holders will receive value, and another course guaranteeing no return for equity but preservation of value for creditors. Absent self-dealing or other evidence of bad faith, by what measure is a court fairly to critique the choice made through an award of damages? My reluctance to go down that road is also influenced by the reality that creditors are not monolithic and that different classes of creditors might have risk preferences that are greatly disparate, with some having interests more like stockholders.

Production Resources, 863 A.2d at 790 n.57 (citation omitted).

15 The bankruptcy court in Liquidating Trustee v. Baker (In re Amcast Industrial Corp.), 365 B.R. 91, 103-112 (Bankr. S.D. Ohio 2007), relied extensively on Production Resources in determining the scope of directors’ and officers’ fiduciary duties under Ohio law when a corporation is insolvent or in the vicinity of insolvency. See id. at 109 n.9 (“A particularly thorough and thoughtful discussion of the relationship between directors and creditors of insolvent corporations and, particularly, the protection of creditors by means of their contractual agreements, fraudulent transfer laws, and federal bankruptcy law is contained in Production Resources...”). The Amcast court concluded that, particularly in light of Ohio Rev. Code Ann. § 1701.59E, “a director has no distinct legal obligation directly to creditors, separate from the corporate entity as a whole, even when a corporation has reached the point of insolvency. Id. at 110; see id. at 105 n.6 (“In Production Resources, the Delaware Court of Chancery reemphasizes that even in insolvency, the directors’ primary fiduciary duty is to the corporate enterprise itself and as such, the directors may continue to engage in reasonable business activities that involve risk even if that course of action would not be advocated by the creditors.”). Ohio Rev. Code Ann. § 1701.59E specifically permits a director, in determining what is in the best interests of the corporation, to consider, in addition to the interests of shareholders: “(1) The interests of the corporation’s employees, suppliers, creditors, and customers; (2) The economy of the state and nation; (3) Community and societal considerations; (4) The long-term as well as short-term interests of the corporation and its shareholders...” The court analyzed and eschewed early Ohio case law indicating that, when a corporation is insolvent, directors hold the assets in trust and are required to distribute them to creditors. According to the court, this old common law concept had been “gradually supplanted or modified by statutes aimed at protecting directors on the one hand and providing [other] remedies to creditors on the other.” Id. at 109. By contrast, the court in Schnelling v. Crawford (In re James River Coal Co.), 360 B.R. 139, 180-81 (Bankr. E.D. Va. 2007, held that the “trust fund doctrine” as a common law concept retains some vitality in Virginia, albeit limited to
However, “the transformation of a creditor into a residual owner does not change the nature of the harm in a typical claim for breach of fiduciary duty by corporate directors.” *Id.* at 792. If the directors’ breach of duty injures the corporation itself, then the claim belongs to the corporation, not the creditors. “Thus, regardless of whether they are brought by creditors when a company is insolvent, these claims remain derivative, with either shareholders or creditors suing to recover for a harm done to the corporation as an economic entity and any recovery logically flows to the corporation and benefits the derivative plaintiffs indirectly to the extent of their claim on the firm’s assets.” *Id.* (footnote omitted).\(^\text{16}\)

3. **Exculpatory Charter Exclusions Apply To Creditors’ Derivative Claims For Breach Of Fiduciary Duty**

The court then went on to discuss the implications of charter exculpations under Del. C. § 102(b)(7) for derivative breach of fiduciary duty claims asserted by creditors, and held that they apply to all derivative claims, including those brought by creditors if the corporation is or becomes insolvent.\(^\text{17}\) The court also noted that section 102(b)(7) should remain applicable in chapter 11. *See id.* at 792 n.63.

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\(^\text{16}\) Following *Production Resources*, the First Circuit, in *Morley v. Ontos, Inc. (In re Ontos, Inc.)*, 478 F.3d 427, 432 (1st Cir. 2007), held that “[e]ven assuming that Ontos was in fact insolvent, … fiduciary duties are on all but rare occasions derivative of the duties owed to the [Delaware] corporation.” It affirmed the bankruptcy court’s approval of the trustee’s settlement of fiduciary duty claims over the objection of creditors who had brought suit for breach of fiduciary duty in state court and wanted to continue that litigation.

The court in *Production Resources* indicated a reluctance to extend standing to creditors to assert breach of fiduciary claims when the corporation is not insolvent, but only in the vicinity of insolvency. First, “[i]f creditors have standing to bring derivative claims in the ‘zone of insolvency,’ they will share that standing with stockholders, leading to the possibility of derivative suits by two sets of plaintiffs with starkly different conceptions of what is best for the firm.” *Production Resources*, 863 A.2d at 789 n.56. Also, since it is so difficult to determine when a firm is insolvent, much less in the vicinity of insolvency, to extend standing in the latter circumstance would inevitably lead to an expansion of situations when discovery is permitted but, ultimately, no claim can be sustained.

\(^\text{17}\) The court in *Production Resources* raised another issue, which it declined to decide, *i.e.*, whether a creditor asserting a derivative claim on behalf of an insolvent corporation has to plead demand excusal under Del. Ct. C.P.R. 23.1 and satisfy the standards of *Aronson v. Lewis*, 473 A.2d 805, 814 (Del. 1984) (“[i]n determining demand futility the Court of Chancery in the proper exercise of its discretion must decide whether, under the particularized facts alleged, a reasonable doubt is created that: (1) the directors...” *footnote continued*...
The court reasoned that this reading of section 102(b)(7) is necessary to achieve its purpose. As the court explained:

Section 102(b)(7) authorizes corporate charter provisions that insulate directors from personal liability to the corporation for breaches of the duty of care. This is an important public policy statement by the General Assembly, which has the intended purpose of encouraging capable persons to serve as directors of corporations by providing them with the freedom to make risky, good faith business decisions without fear of personal liability.

Id. at 793. The court felt that directors need the protection of section 102(b)(7) most if their risky, but good faith, business decisions result in insolvency, i.e., when creditors have standing to pursue breach of fiduciary duty claims. “In such a scenario, the statutorily-authorized defense is most valuable to directors because there is a real danger that a fact-finder, in view of hindsight bias and its knowledge of the fact that the directors’ business strategy did not pan out, will conclude that the directors have acted with less than due care, even if they did not.” Id. at 794.

In the court’s view, “§ 102(b)(7) protection [should not be] withdrawn simply because a business strategy failed, hollowing . . . much of its intended utility.” Id. The court also considered it unlikely that the Delaware legislature intended to protect creditors – which often have the ability to contract for protections and generally have no expectation that they will be able to recover their claims from corporate directors – more than shareholders. 18 “Although §102(b)(7) itself does not mention creditors specifically, its plain terms apply to all claims belonging to the corporation itself, regardless of whether those claims are asserted derivatively by stockholders or by creditors.” Id. at 793 (footnote omitted). 19

(footnote continued...) are disinterested and independent and (2) the challenged transaction was otherwise the product of a valid exercise of business judgment.”).

18 After pointing out that an exculpatory charter provision does not shield directors from liability when they “have engaged in conscious wrongdoing or in unfair self-dealing,” the court stated:

By what equitable notion should creditors who retain the right to prove that a director is liable for fraudulent conveyance, misrepresentation, tortious interference with contract or breach of other legal duties to them, or for a non-exculpated breach of fiduciary duty toward the corporation, be granted a care-based claim that the corporation itself had contractually relinquished and that may never be pressed by the stockholders of a solvent firm?

Production Resources, 863 A.2d at 795.

19 The court expressed its disagreement with cases holding that section 102(b)(7) exculpatory provisions do not apply to breach of duty of care claims pursued by bankruptcy trustees, singling out Pereira v. Cogan, 2001 WL 243537, at *9-12 (S.D.N.Y. Mar. 8, 2001) for criticism. “Since bankruptcy trustees...”
4. **Limited Scope Of Possible Direct Claims Of Creditors For Breach Of Fiduciary Duty**

The court then considered whether there are any circumstances in which directors of an insolvent corporation have and, therefore, can breach a fiduciary duty to a creditor, giving that creditor a direct claim for relief against the directors. Because of its myriad implications, the court considered this a very difficult question.

For example, the directors of an insolvent corporation must retain the right to negotiate in good faith with creditors and to strike fair bargains for the firm. To what extent should the "fiduciary" status of the directors impinge on the negotiations? Would it, for example, expose the directors to liability under principles of common law fraud for material omissions of fact to creditors in negotiations, and not simply for affirmative misrepresentations? And in precisely what circumstances would creditors be able to look directly to the directors for recompense as opposed to the firm?

*Id.* at 797.

By analogy to the shareholders’ direct claims for breach of fiduciary duty against directors of a solvent corporation, however, the court decided that there could be circumstances in which directors of an insolvent corporation could breach their direct fiduciary duty to a creditor. “Suppose that the directors of an insolvent firm do not undertake conduct that lowers the value of the firm overall, or of creditors in general, but instead take action that frustrates the ability of a particular creditor to recover, to the benefit of the remainder of the corporation’s

(footnote continued...)
pursue claims that involve conduct that reduces the value of the firm because that reduction necessarily diminishes the (already inadequate) asset pool available to satisfy claims,” they are pursuing the debtors’ claims, which are subject to the corporation’s exculpatory charter provision. *Production Resources*, 863 A.2d at 794 n.68. The court rejected the argument that the trustee actually represents creditors, who should not be bound by a charter provision to which they were not parties. The court also considered it to be inconsistent with section 102(b)(7) that exculpation provisions would apply if a corporation were solvent, but not if it were insolvent. The court noted that Bankruptcy Judge Queenan, in *Brandt v. Hicks, Muse & Co.*, 208 B.R. 288, 300, 308 (Bankr. D. Mass. 1997), held that section 102(b)(7) protected directors sued by a bankruptcy trustee “using reasoning much like that embraced here.” *Production Resources*, 863 A.2d at 794 n.68.

20 In *Dawson v. Withycombe*, 163 P.3d 1034, 1056-58 (Ariz. App. July 24, 2007), the court vacated a jury verdict against corporate directors for constructive fraud. Citing *Production Resources*, the court held that, even though “when a firm is insolvent, creditors are included in the class of persons to whom a board of directors owes a fiduciary duty[,] ... [t]he fiduciary relationship is not personal; it is derived from the corporate form, which exists for the benefit of the creditors as a class . . . .” *Id.* at 1058. From that, the court reasoned that “because the fiduciary duty was not personal to Dawson, the Board’s duty to Fitech’s creditors did not encompass a personal duty to Dawson to inform of the status of his loan.” *Id.*
creditors and of its employees.” *Id.* But, even then, the court was uncomfortable articulating a general rule. “Would that creditor have to show that the directors did not rationally believe that their actions (e.g., in trying to maintain the operations of the firm) would eventually result in the creation of value that would enable payment of the particular creditor’s claim?” *Id.* What about the line of authority, beginning with *Asmussen v. Quaker City Corp.*, 156 A. 180 (Del. Ch. 1931), holding that “the mere fact that directors of an insolvent firm favor certain creditors over others of similar priority does not constitute a breach of duty, absent self-dealing”? 863 A.2d at 791-92, 798. Is “pure self-dealing . . . the only fiduciarily-invidious reason that might justify a direct claim by a disadvantaged creditor”? *Id.*

Nevertheless, the court felt comfortable with a relatively narrow holding:

I will resolve the motion on the established principle that when a firm is insolvent, the directors take on a fiduciary relationship to the company’s creditors, combining that principle with the conservative assumption that there might, possibly exist circumstances in which the directors display such a marked degree of animus toward a particular creditor with a proven entitlement to payment that they expose themselves to a direct fiduciary duty claim by that creditor.

*Id.*

5. Application Of Legal Conclusions To The Facts Of The Case

The court then applied its legal conclusions to the allegations of the complaint.

(1) The court determined that the complaint’s allegations that the individual defendants, by “gross negligence or worse,” “totally failed to exercise appropriate oversight over NCT and its management and are directly responsible for the deplorable financial condition of the company” were derivative due care claims barred by the exculpatory charter provision, and dismissed them. *Id.* at 798.21

(2) The court also dismissed derivative due care claims based solely on the fact that the CEO and President “received substantial salaries during a period when NCT was performing poorly.” *Id.* at 799. The exculpatory charter provision protected

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21 The court also determined that these allegations failed to meet notice pleading requirements. Therefore, claims were dismissed as to the CFO, who was not a director and, therefore, not protected by the exculpatory provision. The court also noted that, under *In re Caremark International, Inc. Derivative Litigation*, 698 A.2d 959, 968 n.16 (Del. Ch. 1996), and *Gutman v. Huang*, 823 A.2d 492, 505-07 (Del. Ch. 2003), “gross negligence . . . [may] not sustain a damages judgment against independent directors for failing to oversee the affairs of the firm and to prevent wrongdoing by company officers. Rather, the plaintiff [may have to] plead facts supporting an inference of subjective bad faith.” *Production Resources*, at 799 n.80.
directors other than Parrella and Lebovics for liability. Further, PRG failed to
plead facts supporting its allegation of gross negligence, particularly given that
NCT had a compensation committee consisting of directors whose independence
was not challenged.

(3) The court refused to dismiss the claims pled with more particularity. Noting that
section 102(b)(7) does not protect directors from liability "for acts or omissions
not in good faith or which involve intentional misconduct or knowing violation of
the law" (id. at 799 n.84), the court stated:

The unusual and particularized facts surrounding the funding of
NCT through continued dealing with NCT’s de facto controlling
stockholder, Salkind, raise a sufficient inference of scienter to fall
outside the reach of the exculpatory charter provision especially
given the extreme financial distress NCT has been suffering for
several years. To wit, the complaint alleged that the NCT board
has: 1) not convened an annual stockholder meeting for several
years; 2) caused NCT to issue or pledge billions of shares more
than are authorized by its charter; 3) permitted Salkind to obtain
liens on the assets of the corporation; 4) retained no less than 8
companies affiliated with Salkind under substantial consulting
contracts while refusing to cause the company to pay its debt to
PRG; 5) placed funds from Salkind into a company subsidiary,
rather than NCT itself; and 6) paid substantially salaries and
bonuses to Parrella and Lebovics while refusing to cause the
company to pay its debt to PRG. This strange method of
proceeding is suggestive of self-interest on the part of Salkind,
Parrella, and Lebovics and of bad faith on the part of the NCT
board members who are putatively independent. It is a permissible
(and, at this stage, therefore required) inference that rational
persons acting in good faith as the directors of an insolvent firm
would not proceed in this manner.

22 The court considered the extent to which the exculpatory charter provision would protect Parrella and
Lebovics a complex question. "Equally complex is the logic of what fiduciary duties are owed by officer-
directors in connection with their own compensation packages." Production Resources, at 799 n.82. It
did not address these issues.

23 The court stated the following standard to be applied in determining whether to dismiss for failure to
state a claim:

To grant the motion . . . , it must appear with reasonable certainty that PRG would not be
entitled to the relief sought under any set of facts which could be proven to support the
action. Well-pled facts alleged in the complaint are viewed in the light most favorable to
PRG, but conclusory allegations are not accepted as true without specific factual
allegations to support them.

Production Resources, 863 A.3d at 781.
The court found that these allegations supported a non-exculpated, derivative claim for injury to the NCT.

The court also refused to “rule out the possibility that PRG [could] prove that the NCT board has engaged in conduct towards PRG that might support a direct claim for breach of fiduciary duty by it as a particular creditor.” Id. at 800. PRG had alleged that “NCT breached specific promises made to PRG and has taken steps to accept new capital in a manner that was intentionally designed to hinder PRG’s effort to obtain payment.” Id.

In its conclusion, the court made clear that its decision did not “rest . . . in any manner on the proposition that it is a breach of fiduciary duty for the board of an insolvent company to engage in vigorous, good-faith negotiations with a judgment creditor.” Id. In fact, the court indicated, that might well be the duty of the board when there are insufficient assets to pay all creditors.

What is pled here, however, is a suspicious pattern of dealing that raises the legitimate concern that the NCT board is not pursuing the best interests of NCT’s creditors as a class with claims on a pool of insufficient assets, but engaging in . . . [H]ere there are facts pled that in days past would be deemed to have raised a claim for ‘constructive fraud.’ NCT is permitting Salkind to repeatedly expand her position as a fully secured creditor, to the detriment of PRG and other creditors in the event of liquidation. At the same time, Salkind’s family members continue to receive lucrative payments as consultants of the company, money that could be used to pay the debt owed to PRG. Meanwhile, defendants Parrella and Lebovics, two members of the four member NCT board, who Salkind likely has the practical power to displace, continue to draw substantial salaries. And Salkind’s new capital infusions are being placed into a subsidiary in order to avoid PRG’s collection efforts.

Production Resources, 863 A.2d at 786.

It is noteworthy, however, that the court left open for further consideration, as the case developed, the extent to which PRG should be left with its direct tort and contract claims, rather than direct equitable claims for breach of fiduciary duty. “It may well be . . . that upon close examination, existing principles of tort or contract law are sufficient when applied with the understanding that directors bear a fiduciary relation to creditors when the firm is insolvent.” Id. at 801. The court gave as an example the possibility that “NCT’s insolvency might influence the application of traditional torts, like common law fraud, by enabling PRG to recover for cases of material omission.” Id. at n.88.
preferential treatment of the company’s primary creditor and de facto controlling stockholder (and perhaps its top officers, who are also directors) without any legitimate basis for the favoritism.

*Id.* (footnote omitted).

**C. Cases Decided After *Production Resources* Dealing With The Limited Scope Of Direct Claims Of Creditors For Breach Of Fiduciary Duty**

Cases decided after *Production Resources* have applied the distinction the court there drew between direct and derivative creditor claims against corporate directors for breach of fiduciary duty. An example is *Big Lots Stores, Inc. v. Bain Capital Fund VII, LLC*, 922 A.2d 1169 (Del. Ch. 2006). There, in 2000, Big Lots sold its toy subsidiaries (KB Toys) to the Bain defendants and members of the subsidiaries’ management group. It received in exchange $257.1 million in cash and a deeply subordinated $45 million PIK note due in 2010. In 2002, KB Toys redeemed and repurchased its shares and paid bonuses to more than 50 managers and senior executives. “[T]he 2002 transaction constituted a liquidity event which allowed Bain and its affiliates, as private equity investors, to withdraw certain sums of money from the KB Toys businesses.” *Id.* at 1174. Big Lots’ complaint alleged that this withdrawal resulted in a 900% return in a mere 16 months. On January 14, 2004, “some 22 months after the 2002 transaction,” KB Toys filed a chapter 11 petition. *Id.*

Big Lots sued the Bain defendants and KB Toys’ directors and officers for, among other things, breach of fiduciary duty. The court dismissed the claim for lack of standing, because it was a derivative, not a direct, claim. Initially, the court looked to *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031 (Del. 2004), which articulated the following test for direct claims of stockholders: “A direct claim . . . is a claim on which the stockholder can prevail without showing an injury or breach of duty to the corporation, and one in which no relief flows to the corporation.” *Big Lots*, 922 A.2d at 1179 (footnotes omitted). The relevant questions are: “‘Who suffered the alleged harm – the corporation or the suing stockholder individually – and who would receive the benefit of the recovery or other remedy’?” *Id.* (citing *Tooley*, 846 A.2d at 1038).

Applying this test, the court looked to *Production Resources*, where the court recognized that “there might . . . be some circumstances in which ‘directors display such a marked degree of animus towards a particular creditor with a proven entitlement to payment that they expose themselves to a direct fiduciary duty claim by that creditor.’” *Id.* (citing *Production Resources*,
863 A.2d at 798). The court then contrasted *Production Resources* with the case before it in two principal ways. First, in *Production Resources*, the company was clearly insolvent, while here it was only allegedly made insolvent by the 2002 transaction. Second, the creditor in *Production Resources* had a judgment and was entitled to immediate payment, while Big Lots had a claim on a PIK note due in eight more years. "The immediacy of the *Production Resources* defendant's debt was a necessary underpinning of the court's finding that the debtor's recalcitrance might have been motivated by targeted animus towards the plaintiff." *Id.* at 1180. The court also noted that Big Lots was a sophisticated creditor that could have negotiated for protections in 2000 that could have prevented what happened to it in 2002.

Big Lots also alleged that the "defendants fraudulently induced it to refrain from interfering in the 2002 transaction by issuing . . . [a] letter assuring Big Lots that KB Holdings would continue to have consolidated net worth of above $20 million after that transaction closed." *Id.* at 1176. The court also dismissed that claim, although recognizing that other courts have treated claims by creditors for fraudulent inducement as direct claims. However, the court distinguished those cases as involving injury other than to the corporation. It also noted that claims for fraudulent inducement not to act have historically been rejected because they are too speculative.

Another case following *Production Resources* is *Mann v. GTCR Golden Rauner, L.L.C.*, 483 F. Supp. 2d 884 (D. Ariz. 2007). The court dismissed breach of fiduciary duty claims brought by former employees of LeapSource who were minority shareholders, but also had claims for unpaid bonuses and severance. Applying the rationale of *Production Resources* and *Big Lots* and the test of *Tooley*, the court determined that the plaintiffs' claims were derivative not direct. As in *Big Lots*, the plaintiffs were merely unsecured creditors with no right to immediate payment, and the allegations turned generally on the fact that LeapSource had been rendered insolvent as a result of the directors' actions and inactions. There was also no allegation of animus toward the plaintiffs, nor that they were singled out for nonpayment. Further,

[t]heir claimed injuries are not independent of the alleged injuries to LeapSource. . . . Those alleged breaches run the gamut from defendants "refus[al] to fully fund LeapSource with $65 million, as promised[" to "preventing LeapSource from meeting its budgetary and business plan objectives[",]" culminating in an allegation that defendants "plac[ed] [LeapSource] in bankruptcy liquidation." Certainly plaintiffs' claimed direct injury, not receiving their severance payments
due to LeapSource’s insolvency, is not “independent of any alleged injury” to LeapSource, as Tooley requires.

Id. at 899. Thus, the plaintiffs could not recover independently of other unsecured creditors, but should share with them if LeapSource’s bankruptcy trustee successfully pursued breach of fiduciary duty claims against the defendants.

D. **Trenwick: Vice Chancellor Strine’s Discourse On Fiduciary Duty In Or Near Insolvency, Which Was Adopted By The Delaware Supreme Court**

*Trenwick America Litigation Trust v. Ernst & Young, L.L.P.,* 906 A.2d 168 (Del.Ch. 2006), aff’d, 2007 WL 2317768 (Del. Aug. 14, 2007), like *Production Resources,* was decided by Vice Chancellor Strine in an even lengthier opinion.27 There, Trenwick engaged in an acquisition strategy that did not work out and it and its wholly-owned subsidiary, Trenwick America, ended up in chapter 11. Under Trenwick America’s plan of reorganization, a Litigation Trust was formed to pursue claims, and it filed a complaint asserting, among other things, breach of fiduciary duty claims against the former members of Trenwick’s and Trenwick America’s respective boards of directors.

The facts of the case are very complex, but the court provided the following general description of the allegations of the complaint:

All center on one idea: Trenwick’s strategy of growing by acquiring Chartwell and LaSalle was “irrational” and resulted from “gross negligence.” As a result of stupidity, the Trenwick directors, whose bidding was followed by the Trenwick America directors, put together a large insurance holding company with inadequate reserves and assets to cover the claims that were ultimately made against it. By pledging the assets of Trenwick America to cover the debt resulting from this expansion strategy, the Trenwick and Trenwick America directors injured Trenwick America by rendering it insolvent and leaving it with too few assets to satisfy its creditors. . . .

[T]he Litigation Trust alleges that the Trenwick directors breached their fiduciary duties of care and loyalty by this conduct – duties that the Litigation Trust alleges were owed to the creditors of Trenwick and its subsidiaries because Trenwick and its subsidiaries were insolvent. As a component of this breach, the Trenwick directors supposedly engaged in fraud by concealing the facts regarding the nature and effects of the expansion strategy.

26 The Delaware Supreme Court affirmed the judgment of the Court of Chancery “on the basis of and for the reasons assigned by the Court of Chancery in its opinion dated August 10, 2006.” 2007 WL 2317768 at *1.

27 The opinion of the Court of Chancery in *Trenwick* as published in Atlantic 2d is 51 pages long.
The Trenwick America directors are accused of identical conduct and conspiring with the Trenwick directors. That is, the Trenwick America directors are alleged to have injured the creditors of Trenwick America by causing its assets to be pledged to support other subsidiaries owned by Trenwick, at a time when Trenwick America was insolvent. For that reason, the Trenwick directors are alleged to have violated their fiduciary duties, because the focus of the Trenwick America board had to be solely upon making sure Trenwick America could satisfy as many of the legal claims of its creditors as possible, with the equity and owner, Trenwick, being out of the picture as a result of the corporate child’s insolvency.

Id. at 187-88 (footnote omitted). “All of the defendants . . . moved to dismiss the complaint, primarily for failure to state a claim.” Id. at 188.

First, the court determined that the Litigation Trust had standing to pursue only claims belonging to Trenwick America, and not claims belonging to its creditors. Then, it dealt with whether the Litigation Trust had stated a claim for breach of fiduciary duty against the directors of its parent, Trenwick. The court determined that it had not, for several reasons, including that “the complaint fails to plead facts supporting a rational inference that Trenwick or Trenwick America were insolvent at the time of any of the challenged transactions.” Id. at 195.

Nevertheless, the court took the opportunity to state its views on fiduciary duty in the context of insolvency. In a lengthy footnote, the court makes the following points:

(1) When a corporation becomes insolvent, “the creditors become the enforcement agents of fiduciary duties,” i.e., as the residual risk bearers, they have derivative standing to pursue breach of fiduciary claims on behalf of the corporation;

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28 The court held that, under Caplin v. Marine Midland Grace Trust Co., 406 U.S. 416, 92 S. Ct. 1678 (1972), “bankruptcy trustees and litigation trusts formed as part of reorganization plans do not have standing to bring direct claims belonging to creditors under the federal bankruptcy statute.” Trenwick, 906 A.2d at 191. It also stated that “[t]he rule articulated in Caplin holds true even in cases where a creditor has assigned her claims to a trustee or Trust . . .” Id. (citing In re Bennett Funding Group, Inc., 336 F.3d 94, 102 (2d Cir. 2003), Williams v. Cal. 1st Bank, 859 F.2d 664, 666-67 (9th Cir. 1988), and In re Gaudette, 241 B.R. 491, 499-502 (Bankr. D.N.H. 1999). There is contrary authority. See, e.g., Semi-Tech Litigation LLC v. Bankers Trust Co., 272 F. Supp. 2d 319, 323-24 (S.D.N.Y. 2003) (“[T]his Court does not find Williams persuasive. Caplin involved an effort to discern whether Congress intended trustees to exercise such a power whereas the issue both in Williams and here is whether assignments should be stripped of legal effect because the assignee is a creature of bankruptcy. . . . The Court sees no basis for treating an assignee created by, or assignments made pursuant to, a Chapter 11 plan any differently.”), aff’d, 450 F.3d 121, 123 (2d Cir. 2006) (adopted opinion of district court on issue). Harvey Miller’s paper for this conference on assigning creditor claims to litigation trusts and others should provide insight on this issue.
When the corporation is insolvent, the goals of the directors must be to “manage the enterprise to maximize its value so that the firm can meet as many of its obligations to creditors as possible”;

Whether a corporation is solvent or insolvent, the directors are permitted to make “a myriad of judgments about how generous or stingy to be to other corporation constituencies in areas where there is not precise legal obligations to those constituencies”; “this complexity [does not] diminish when a firm is insolvent simply because the residual claimants are now creditors”;

“They business judgment rule protects the directors of solvent, barely solvent, and insolvent corporations, and . . . the creditors of an insolvent firm have no greater right to challenge a disinterested, good faith business decision than the stockholders of a solvent firm.” Id. at 195 n.75.

The court also held that “a wholly-owned subsidiary [in that case, the Litigation Trust] may [not] sue the directors of its parent corporation on the premise that their improvident business strategies ultimately led to the bankruptcy of the subsidiary.” Id. at 197. Rather, the subsidiary’s creditors could protect themselves through contractual provisions or the law of fraudulent transfer, which would also be available to the trustee/debtor in possession in the subsidiary’s bankruptcy case.

The court then dealt explicitly with whether the Litigation Trust had stated a claim for breach of fiduciary duty against Trenwick America’s directors. In that regard, it noted that, a solvent, wholly-owned subsidiary’s directors “are obligated only to manage the affairs of the subsidiary in the best interests of the parent and its shareholders” (id. at 200 (citing Anadarko Petroleum Corp v. Panhandle E. Corp., 545 A.2d 1171, 1174 (Del. 1988) (citing Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971)) – “even . . . if the Trenwick America board took actions that made Trenwick America less valuable as an entity.” 906 A. 2d at 201. Because the Litigation Trust’s complaint failed to plead insolvency adequately, “[t]he reality that the parent’s strategy ultimately turned out poorly for itself and its subsidiaries does not buttress a claim by the subsidiary that the subsidiary’s directors acted culpably in implementing the parent’s prior wishes.” Id. at 202. The court then noted that, “[a]t most, one might conceive that the directors of a wholly-owned subsidiary owe a duty to the subsidiary not to take action benefiting a parent corporation that they know will render the subsidiary unable to meet its legal obligations.” Id. at 203 (citing as an example of a case that so held, In re Scott Acquisition. Corp., 344 B.R. 283, 286-90 (Bankr. D. Del. 2006), which itself relied heavily on Production Resources). However,
the court declined to decide whether such a claim would or should exist, or whether the subsidiary should have to rely on fraudulent transfer laws in such circumstances.

E. **North American: No Derivative Creditor Claims For Breach Of Fiduciary Duty Unless The Corporation Is Insolvent, And No Direct Creditor Claims For Breach Of Fiduciary Duty Even If The Corporation Is Insolvent**

In *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 2007 WL 2317768 (Del. May 18, 2007), NACEPF asserted a direct claim against certain directors of Cleanwire Holdings, Inc. for breach of fiduciary duty. NACEPF held certain spectrum licenses and, together with other unrelated entities with similar licenses (collectively, “Alliance”), had a contract with Cleanwire under which Cleanwire had the right to obtain rights to the licenses as then-existing leases expired or were terminated. According to the complaint, the defendant directors represented Goldman Sachs & Co. on Cleanwire's board, and were able to control Cleanwire, which was either insolvent or in the vicinity of insolvency, because Goldman was its sole source of funding. NACEPF alleged that the defendant directors used this power to favor Goldman’s agenda, thereby breaching its duties to NACEPF, as a creditor of Cleanwire, by “not preserving the assets of Cleanwire for [the] benefit . . . of its creditors when it became apparent that Cleanwire would not be able to continue as a going concern and would need to be liquidated,” and by “holding on to NACEPF’s . . . license rights when Cleanwire would not use them, solely to keep Goldman[’s] . . . investment ‘in play.’” *Id.* at *3. In support, the complaint alleged that, beginning in June 2002, when the market for wireless spectrum collapsed, Cleanwire negotiated with members of the Alliance to terminate its obligations to them and, by threatening to file for bankruptcy, reached settlements with the other members of the Alliance, paying them over $2 million. With NACEPF as the sole remaining member of the Alliance, Cleanwire went out of business in October 2003.

The defendant directors moved to dismiss the complaint for failure to state a claim. Thus,

the Court of Chancery was confronted with two legal questions: whether, as a matter of law, a corporation’s creditors may assert direct claims against directors for breach of fiduciary duties when the corporation is either: first, insolvent or second, in the zone of insolvency.
Id. at *4 (emphasis in original).29 The Court of Chancery dealt with these issues by "assum[ing] arguendo that a direct claim for a breach of fiduciary duty to a creditor is legally cognizable in the context of actual insolvency," but determined that NACEPF’s complaint did not satisfy the pleading requirements of Production Resources and Big Lots. Id. at *8. Therefore, it dismissed NACEPF’s complaint.30

The Delaware Supreme Court affirmed the Court of Chancery’s judgment, but for somewhat different reasons. It adopted two positions of the Court of Chancery below and in Production Resources. First, "no direct claim for breach of fiduciary duties may be asserted by the creditors of a solvent corporation that is operating in the zone of insolvency." Id. at *7. Second, "[w]hen a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the bests interests of the corporation for the benefit of its shareholder owners.” Id. Thus, the Supreme Court affirmed the Court of Chancery’s dismissal of NACEPF’s complaint “to the extent that it attempts to assert a direct claim for breach of fiduciary duty to a creditor while Clearwire was operating in the zone of insolvency.” Id. The court also confirmed that, when a corporation is insolvent, creditors, “as the residual beneficiaries of any increase in value,” have standing to

29 Citing Production Resources and other cases, the Court of Chancery held that insolvency, for these purposes, is either "a deficiency of assets below liabilities with no reasonable prospect that the business can be successfully continued" or "an inability to meet maturing obligations as they call due in the ordinary course of business." North American, 2007 WL 2317768, at *5. It also determined that NACEPF had alleged sufficient facts to support the conclusions that Clearwire (a) operated in the zone of insolvency for at least a substantial portion of the period covered by the motion to dismiss, and (b) was insolvent for at least a portion of the period following execution of the Alliance contract.

30 The Court of Chancery, in North American Catholic Educational Programming, Inc. v. Gheewalla, 2006 WL 2588971 (Del. Ch. Sept. 1, 2006) (Vice Chancellor Noble), held that: (a) creditors have no direct right of action against directors for breach of fiduciary duty if the corporation is in the zone of insolvency, but not insolvent (id. at *11-13); and (b) if the corporation is insolvent, a creditor may have a direct breach of fiduciary claim, but only if (i) the creditor holds a claim that is “clearly and immediately” due and payable and (ii) the director’s conduct is “invidious” and directed at the particular creditor or demonstrates a “marked degree of animus” toward the creditor (probably involving self-dealing) (id. at *13-18). The court derived the test for direct claims from Production Resources and Big Lots (discussed supra), and found that NACEPF failed it “because the pleadings neither identify an entitlement to payment that is clearly and immediately due nor do they permit a reasonable inference to that effect.” Id. at *16. The court declined to decide whether creditors can sue derivatively for breach of fiduciary when a corporation is merely in the zone of insolvency, although it noted that “principles underlying [derivative standing] are arguably compatible with its application in the zone of insolvency.” Id. at *11-12.
maintain derivative actions for breach of fiduciary duty against directors on behalf of the corporation. *Id.*

However, the Delaware Supreme Court also held that creditors never have direct claims for breach of fiduciary duty against a corporation’s directors – not even if the corporation is insolvent and the special circumstances described in *Production Resources* and cases following it pertain.\(^3\) The impetus for this decision was the need for “more precise conceptual line drawing.” \(^3\) *Id.* at *8* (citing *In re Walt Disney Co. Derivative Litigation*, 906 A.2d 27, 65 (Del. 2006)).

Recognizing that directors of an insolvent corporation owe direct fiduciary duties to creditors . . . would create uncertainty for directors who have a fiduciary duty to exercise their business judgment in the best interest of the insolvent corporation. To recognize a new right for creditors to bring direct fiduciary claims against those directors would create a conflict between those directors’ duty to maximize the value of the insolvent corporation for the benefit of all those having an interest in it, and the newly recognized direct fiduciary duty to individual creditors. Directors of insolvent corporations must retain the freedom to engage in vigorous, good faith negotiations with individual creditors for the benefit of the corporation. Accordingly, we hold that individual creditors of an insolvent corporation have no right to assert direct claims for breach of fiduciary duty against corporate directors. Creditors may nonetheless protect their interest by bringing derivative claims on behalf of the insolvent corporation or any other direct nonfiduciary claim . . . that may be available for individual creditors. \(^3\) *Id.* at *8* (emphasis in original; footnote omitted). The “other direct nonfiduciary claims” to which the Delaware Supreme Court referred are claims based on tort law or contractual law, “fraud and fraudulent conveyance law, implied covenants of good faith and fair dealing, bankruptcy law, general commercial law and other sources of creditors rights.” \(^3\) *Id.* at *6*.

Thus, under Delaware law, directors have no fiduciary duties to creditors if a corporation is in the “zone of insolvency.” Further, the settled principle that directors owe fiduciary duties to

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\(^3\) In the recent case of *Christians v. Grant Thornton, L.L.P.*, 733 N.W.2d 803, 809 (Minn. Ct. App. 2007), the court cited *North American* and *Production Resources* in deciding that claims against an accounting firm for “deepening-insolvency damages” based on auditor malpractice and breach of contract belonged to the insolvent corporation, not its creditors. Similarly, in *Official Committee of Unsecured Creditors v. Foss (In re Felt Manufacturing Co.)*, 2007 WL 2177690, *8* (Bankr. D.N.H. July 27, 2007), the court relied on *North American* and *Production Resources* in deciding that claims for breach of fiduciary duty against officers and directors, including claims for breach of duty to creditors, belonged to the corporation and could be pursued by the committee on behalf of the chapter 11 estate of the corporation.
creditors when a corporation is insolvent\textsuperscript{32} is actually very limited. It means that creditors of an insolvent corporation have the right to bring a derivative action for breach of fiduciary duty. They have no direct claim for relief for breach of fiduciary duty.

II. DEEPPENING INSOLVENCY

A. \textit{CitX: Third Circuit Decides That, Under Pennsylvania Law, A Claim For Deepening Insolvency Must Be Based on Fraudulent Conduct And May Not Be Based On Mere Negligence, And Deepening Insolvency Is Not A Proper Measure Of Damages For Other Torts}

The Third Circuit’s recent decision in \textit{Seitz v. Detweiler, Hershey & Assocs., P.C. (In re CitX Corp.)}, 448 F.3d 672 (3d Cir. 2006), is an important recent development regarding deepening insolvency. It is particularly important because it was the Third Circuit that decided \textit{Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc.}, 267 F.3d 340 (3d Cir. 2001), which is generally cited for the proposition that deepening insolvency is a valid cause of action under Pennsylvania law. See, e.g., \textit{CitX}, 448 F.3d at 677. \textit{CitX} also involved the application of Pennsylvania law.

In \textit{CitX}, “[a]n insolvent internet company involved in an illegal Ponzi scheme used its financial statements, compiled by its accounting firm, to attract investors.” \textit{Id.} at 674. The bankruptcy trustee sued the accountant for malpractice and deepening insolvency. The district court granted summary judgment for the defendant, and the Third Circuit affirmed.

The court first addressed the malpractice claim, specifically the requirement that the professional’s act caused harm to the debtor. The trustee alleged harm “in the form of ‘deepening insolvency’ – that Detweiler ‘dramatically deepened the insolvency of CitX, and wrongfully expanded the debt of CitX and waste of its illegally raised capital, by permitting CitX to incur additional debt by virtue of the compilation statements prepared and relied upon by third parties.” ” \textit{Id.} at 677. Thus, the court had “to decide whether deepening insolvency is a viable theory of damages for negligence” (\textit{id.} at 677) – and it concluded that it is not.\textsuperscript{33} According to

\textsuperscript{32} See Production Resources, 863 A.2d at 790-91 (“When a firm has reached the point of insolvency, it is settled that under Delaware law, the firm’s directors are said to owe fiduciary duties to the company’s creditors.”) (citing Geyer v. Ingersoll Publications Co., 621 A.2d 784, 787 (Del. Ch. 1992).

\textsuperscript{33} The court also indicated that deepening insolvency would not be a valid theory of damages for any cause of action, such as fraud. \textit{CitX}, 448 F.3d at 677 n.8. Accord, \textit{Christians v. Grant Thornton, L.L.P., supra}, 733 N.W.2d at 810-12. In \textit{Christians}, the chapter 7 trustee of Technimar Industries, Inc. sued the corporation’s auditor for malpractice and breach of contract, claiming that the company was harmed by the deepening insolvency that resulted from Grant Thornton’s erroneous audited financial statements.

\textit{footnote continued...}
the Third Circuit, its decision in *Lafferty* was that, under Pennsylvania law, deepening insolvency is a valid cause of action, not that it is a “valid theory of damages for an independent cause of action. *Id.*”

(footnote continued...)

Among other things, the court held that “deepening insolvency is not a recognized form of corporate damage in Minnesota.” *Id.* at 812. First, the court pointed out that “[d]eepening insolvency has its origins in the doctrine of *in pari delicto.*” *Id.* at 810. In *Schacht v. Brown*, 711 F.2d 1343, 1350 (7th Cir. 1983), “the Seventh Circuit considered whether the resulting extension of the corporation’s life was beneficial in connection with applying the test for imputation/*in pari delicto* that the improper acts of officers or directors must at least partially benefit the corporation. *Christians*, 733 N.W.2d at 810. “The court held that the mere prolongation of a corporation’s life did not necessarily equate to corporate benefit because ‘the corporate body is ineluctably damaged by the deepening of its insolvency, through increased exposure to creditor liability.’” *Id.* (citing *Schacht*, 711 F.2d at 1350). Second, the court noted that, while several jurisdiction recognized deepening insolvency as a measure of damages, others had not. Further, “[e]ven those jurisdictions . . . have done so only in theoretical terms.” *Id.* at 810-11. Third, citing Sabin Willet, *The Shallows of Deepening Insolvency*, 60 Bus. Law. 549 (2005), and *CitX*, among other cases, the court reasoned that traditional damage measures are sufficient to redress harm from tort or contract claims, and that the mere addition of unpayable loans, standing alone, does not harm a corporation.

We are persuaded that permitting deepening-insolvency damages would needlessly replicate and consequently confuse the current measure of damages for auditor-malpractice actions. Once the deepening-insolvency theory is stripped of the additional-loans component, we are unable to discern what recoverable harms the concept captures that ordinary measures of damages in auditor-malpractice and breach-of-contract claims do not.

*Id.* at 811 (citations omitted). Principally because the trustee/plaintiff’s evidence of damages was speculative, he was denied any possible recovery other than recovery of auditor’s fees paid.

By contrast, the court in *Liquidating Trustee v. Baker (In re Amcast Industrial Corporation)*, supra, 365 B.R. at 119 n.19 – albeit without referring to *CitX* or any other case – stated that “the concept [of deepening insolvency], may be useful as a measure of damages for breach of fiduciary duty or commission of an actionable tort.” As discussed *infra*, the court in *Amcast* held that “Ohio courts would not recognize deepening insolvency as an independent cause of action.” *Id.* at 119.

34 However, the Third Circuit in *CitX* did state that “‘[w]here an independent cause of action gives a firm a remedy for the increase in its liabilities, the decrease in fair asset value, or its lost profits, then the firm may recover, without reference to the incidental impact upon the solvency calculation.’” *CitX*, 448 F.3d at 678 (citing Sabin Willett, *The Shallows of Deepening Insolvency*, 60 Bus. Law. 549, 575 (2005)). The court also noted that “deepening insololvency as a measure of damages merely replicates malpractice damages.” *CitX*, 448 F.3d at 678 n.9.

This aspect of *CitX* was relied on by the United States District Court for the Western District of Pennsylvania in Official Committee of Unsecured Creditors of Allegheny Health, Education & Research Foundation v. PricewaterhouseCoopers, L.L.P., 2007 WL 141059 (W.D. Pa. Jan. 17, 2007). There, the Committee, on behalf of AHERF’s bankruptcy estates, sued PwC for professional negligence, breach of contract and aiding and abetting breaches of fiduciary duty by AHERF’s management. It seems that AHERF’s management kept two sets of books, and provided the materially misstated financial statements to PwC for audit. PwC did not discover the improprieties, however, and issued “clean opinions,” because of what the Committee alleged were violations of “numerous core auditing standards.” *Id.* at *3*-4. As a result, AHERF was able to acquire several hospitals, educational institutions, research facilities and

footnote continued...
Further, the court decided that the accountants did not cause whatever harm occurred. “Assuming . . . that Detweiler’s financial statements allowed CitX to raise over $1,000,000, that did nothing to ‘deepen’ CitX’s insolvency. It did the opposite.” Id. “The crux, then, is the claim that the $1,000,000 equity investment allowed CitX to exist long enough for its management to incur millions more in debt.” Id. at 6577-78. Thus, it was management’s decisions how to use the investment— not the fact of the investment—that caused the debtor harm. The court also found that there was no probative evidence “that anyone extended credit to CitX in reliance on the financial statements compiled by Detweiler.” Id. at 680. Therefore, the trustee failed to establish that the accountants caused any harm to CitX.

(footnote continued...) medical practices, in what the Committee contended was an ill-advised and badly-managed strategy. The Committee contended that PwC’s “negligence allowed the financial condition of AHERF to continue into insolvency, and prevented the timely implementation of measures to reverse the decline of AHERF’s financial condition, [and] . . . that AHERF was damaged by [PwC] to the ‘full extent of [the] insolvency, which amount is in excess of $1 billion’.” Id. at *4.

PwC moved for summary judgment, which was granted on in pari delicto grounds. However, the court also dealt with PwC’s contention that it was entitled to summary judgment “because the Committee seeks to recover damages that are similar to a deepening insolvency measure of damages which are precluded under CitX.” Id. at *5. The court refused to grant PwC summary judgment because the Committee had alleged independent causes of action (i.e., professional negligence, breach of contract and aiding and abetting breach of fiduciary duty) that “give AHERF a ‘remedy for the increase in its liabilities, the decrease in fair asset value, or its lost profits,’” citing and quoting CitX. AHERF, 2007 WL 141059, at *7. The court in AHERF also noted that PwC had not argued in its motion for summary judgment that “the Committee failed to offer sufficient proof of harm or damages,” but stated that it nonetheless had “serious concerns regarding the Committee’s measure of damages,” which, together with the issue of harm, would be “left for another day.” Id. at *6 & n.10.

35 Citing CitX, the court reiterated this point in Official Committee of Unsecured Creditors v. Tennenbaum Capital Partners, LLC (In re Radnor Holdings Corp), 353 B.R. 820 (Bankr. D. Del. 2006):

[S]tock investments like TCP’s $25 million preferred stock investment lessen insolvency rather than increasing it. . . .

Moreover, . . . the making of a loan similarly does not increase insolvency; it increases liabilities (the amount of the loan) and assets (the cash provided by the loan) in the same amount.

Id. at 842 (citations omitted). Any increase is insolvency depends not on the availability of the funds, but on how management uses the money.

This point was also articulated in Christians v. Grant Thornton, L.L.P., supra, 733 N.W.2d at 813 (citing Sabin Willet, Shallows of Deepening Insolvency, 60 Bus. Lawyer 549, 554-55 (2005), for the proposition that “additional debt will never harm a corporation because loans are balance-sheet neutral; every addition to a corporation’s liabilities is offset by an equal addition to the corporation’s assets.” 36 The Oklahoma Court of Civil Appeals reached the same conclusion in Commercial Financial Services, Inc. v. J.P. Morgan Securities, Inc., 152 P.3d 897 (Okla. Civ. App. 2006). There, a corporation sued its

(footnote continued...)
The court then turned to the trustee's cause of action for deepening insolvency. There was no evidence of fraud on the part of the accountant, so the issue was whether negligence could support a claim for deepening insolvency. The court noted that the Ninth Circuit, in *Smith v. Arthur Andersen LLP*, 421 F.3d 989, 995 (9th Cir. 2005), grounded a claim for deepening insolvency on misrepresentation that was not necessarily intentional and that, in *Lafferty*, it had cited a case (*Gouiran Holdings, Inc. v. DeSantis, Prinzi, Springer, Keifer & Shall (In re Gouiran Holdings, Inc.)*, 165 B.R. 104, 107 (E.D.N.Y. 1994)) that suggested that negligence would be sufficient. Nevertheless, the court stated that “Lafferty holds only that fraudulent conduct will suffice to support a deepening-insolvency claim under Pennsylvania law” and found “no reason to extend the scope of deepening insolvency beyond Lafferty’s limited holding.” *Id.* at 681.

**B. Trenwick: Delaware Does Not Recognize A Cause of Action For Deepening Insolvency**

*Trenwick America Litigation Trust v. Ernst & Young, L.L.P.,* supra, 906 A.2d 168 (Del. Ch. 2006), aff’d, 2007 WL 2317768 (Del. Aug. 14, 2007) (Supreme Court adopted opinion of Court of Chancery), is the most important “recent development” regarding deepening insolvency. In its complaint in that case, the Litigation Trust alleged that:

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*footnote continued...*

investment banker for professional negligence and breach of fiduciary duty and requested damages measured by deepening insolvency. Citing *CitX*, the court held that “[d]eeper insolvency” is not a recognized measure of damages in Oklahoma and that “CFS has failed to allege that Chase was the proximate cause of compensable injury.” *Id.* at 900. Therefore, it affirmed the trial court’s decision granting the investment banker summary judgment.

37 The court held that, in bankruptcy, deepening insolvency is a section 541 cause of action, not a section 544 claim. See *CitX*, 448 F.3d at 676 n.6.

38 The court also pointed out that it could not “revisit the correctness of [Lafferty’s] interpretation of Pennsylvania law” because only the Third Circuit en banc can overrule a precedential decision. See *CitX*, 448 F.3d at 680 n.11.

It is noteworthy that in *AHERF* (discussed *supra*), the Committee did not assert a claim for deepening insolvency against PwC, even though Pennsylvania law applied and the Third Circuit in *Lafferty* held that deepening insolvency was a valid cause of action in Pennsylvania. This may have been because of the Third Circuit’s holding in *CitX* that deepening insolvency could not be predicated on negligence, as opposed to fraud.

39 *Trenwick*, as it pertains to breach of fiduciary duty in the zone of or during insolvency, is discussed in detail *supra* at I.D.

40 It is noteworthy that the court in *Trenwick* commended – but did not adopt – the Third Circuit’s decision in *CitX*. See *Trenwick*, 906 A.2d at 206 n.105.
Trenwick America's former directors "fraudulently concealed the true nature and extent of Trenwick America's financial problems by expanding the amount of debt undertaken by Trenwick America";

The directors "knew that Trenwick America would not be able to repay this increased debt, but fraudulently represented to creditors and other outsiders that the debt would be repaid";

They thereby "prolonged the corporate life of Trenwick America and increased its insolvency, until Trenwick America was forced to file for bankruptcy"; and

This resulted in damages to Trenwick America, "to be proven at trial." Id. at 204.

The Court of Chancery dismissed this claim for relief, holding that, under Delaware law, there is no "independent cause of action for deepening insolvency." Id. at 205. The court reasoned that such a cause of action would be inconsistent with Delaware law regarding breach of fiduciary duty.

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 does not become a guarantor of that strategy's success. That the strategy results in continued insolvency and an even more insolvent entity does not in itself give rise to a cause of action. Rather, in such a scenario the directors are protected by the business judgment rule. To conclude otherwise would fundamentally transform Delaware law.

... If a plaintiff cannot state a claim that the directors of an insolvent corporation acted disloyally or without due care in implementing a business strategy, it may not cure that deficiency simply by alleging that the corporation became more insolvent as a result of the failed strategy.

Id. 42

41 The Court foreshadows this result with its introductory remark: "The concept of deepening insolvency has been discussed at length in federal jurisprudence, perhaps because the term has the kind of stentorious academic ring that tends to dull the mind to the concept's ultimate emptiness." Trenwick, 906 A.2d at 204.


As examples of such wrong-headed cases, the Court singled out Official Committee of Unsecured Creditors v. R.F. Lafferty, 267 F.3d 340 (3d Cir. 2001); OHC Liquidation Trust v. Credit Suisse First
This holding derives consistently from the Trenwick court's conception of fiduciary duty, i.e., that the duty does not undergo a fundamental transformation when the corporation is insolvent. "The directors continue to have the task of attempting to maximize the economic value of the firm." Id. at 205 n.104 (citing Production Resources, 803 A.2d at 791 (decided by the same Court of Chancery judge)). Insolvency merely "act[s] as an important contextual fact in the fiduciary duty metric. In that context, our law already requires the directors of an insolvent corporation to consider, as fiduciaries, the interests of the corporation's creditors." Trenwick, 906 A.2d at 205.

C. Cases Decided After The Court Of Chancery’s Decision In Trenwick Re: Deepening Insolvency

Following the Court of Chancery's decision in Trenwick, courts in other jurisdictions have joined those finding that there is no independent cause of action for deepening insolvency under the laws of various states. Thus, in Schnelling v. Crawford (In re James River Coal Co.), 360 B.R. 139, 177-180 (Bankr. E.D. Va. 2007), the court reasoned that "the Supreme Court of

(footnote continued...)


43 The Court provides the following colorful explanation:

[T]he fact of insolvency does not render the concept of “deepening insolvency” a more logical one than the concept of “shallowing profitability.” That is, the mere fact that a business in the red gets redder when a business decision goes wrong and a business in the black gets paler does not explain why the law should recognize an independent cause of action based on the decline in enterprise value in the crimson setting but not in the darker one. If in either setting the directors remain responsible to exercise their business judgment considering the company’s business context, then the appropriate tool to examine the conduct of the directors is the traditional fiduciary duty ruler.

Trenwick, 906 A.2d at 205.

44 Following Trenwick, the court in Official Committee of Unsecured Creditors v. Tennenbaum Capital Partners LLC (In re Radnor Holdings Corp.), supra, 353 B.R. at 842, refused to countenance an adversary proceeding that was “tried . . . as if it were a ‘deepening insolvency’ case,” even though none of the claims for relief in the complaint were called deepening insolvency.

[S]imply calling a discredited deepening insolvency cause of action by some other name does not make it a claim that passes muster. . . . [T]he Trenwick opinion made quite clear that under Delaware law, a board is not required to wind down operations simply because a company is insolvent, but rather may conclude to take on additional debt in the hopes of turning operations around.

Id.
Virginia would not adopt this new independent tort.” *Id.* at 180.\(^{45}\) Similarly, the bankruptcy court in *Amcast*, 365 B.R. at 115-19, held that “Ohio courts would not recognize deepening insolvency as an independent cause of action.” *Id.* at 119.\(^{46}\)

The Seventh Circuit, in *Fehribach v. Ernst & Young LLP*, 2007 WL 2033734 (7\(^{th}\) Cir. July 17, 2007), cited the Court of Chancery’s opinion in *Trenwick*, as well as the Third Circuit’s opinion in *CitX*, with approval. In *Fehribach*, the chapter 7 trustee for Taurus Foods, Inc., sued its auditor for negligence and breach of contract for failing to include in its audit report a going-concern qualification. The district court granted summary judgment to E&Y, which the Seventh Circuit affirmed, even though “[t]he trustee presented expert evidence that Ernst & Young was negligent in failing to include a going-concern qualification in its audit report . . . and that if it had done so the owners of Taurus . . . would immediately have liquidated [the company],

\(^{45}\) In addition to the Court of Chancery’s opinion in *Trenwick*, the court in *James River Coal* also cited with approval the *Global Services* and *Greater Southeast Community Hospital* opinions (cited in note \(^{30}\), supra). The court held that to recognize the tort of deepening insolvency would “fundamentally transform Virginia law.” *James River Coal*, 360 B.R. at 179.

Virginia law does not require a financially challenged company to abruptly wind up its business affairs and liquidate its assets. The Board of Directors must remain free to exercise its good faith business judgment that will allow it to pursue strategies the board views as sound to turn the company around.

* * * *

The inability to state a claim that the directors of an insolvent corporation breached the fiduciary duty they owed to the corporation and its creditors cannot be remedied by alleging that the corporation became more insolvent as a result of a failed business strategy . . . .

The harms sought to be remedied by the Trustee’s claim of deepening insolvency necessarily must be addressed under his claim for breach of fiduciary duty.

*Id.* at 179-180

\(^{46}\) The court in *Amcast* discussed the uncertain development of deepening insolvency after the Third Circuit’s decision in *Lafferty*, noting that, although some courts have considered it a viable cause of action, it “has found no published decision awarding damages to a plaintiff based on a deepening insolvency cause of action.” *Amcast*, 365 B.R. at 116 & n.16. “Significantly, a growing number of courts regard deepening insolvency with skepticism.” *Id.* Ultimately, the court was persuaded by the reasoning of the Delaware Court of Chancery in *Trenwick*. It rejected deepening insolvency as an independent cause of action because: (a) it “is redundant of traditional causes of action recognized under Ohio law”; (b) to the extent it is not redundant, but “heighten[s] or change[s] a fiduciary’s obligations when a corporation is underwater, the claim destroys the fundamental principles of corporate responsibility and the protections of the business judgment rule”; and (c) it “is in direct conflict with traditional concepts of corporate law that allow an insolvent businesses to continue operating in hopes of maximizing profits and turning its financial situation around rather than immediately ceasing operations and liquidating.” *Id.* at 118-19.
a v e r t i n g  c o s t s  o f  s o m e  $3  m i l l i o n  t h a t  t h e  c o m p a n y  i n c u r r e d  a s  a  r e s u l t  o f  i t s  c o n t i n u e d  o p e r a t i o n 
under  t h e  r e s t r i c t i o n s  i m p o s e d  b y  [i t s  s e c u r e d  l e n d e r]  a n d  o t h e r  a d v e r s i t i e s .”  I d .  a t  1 .
Nevertheless,  t h e  S e v e n t h  C i r c u i t  h e l d ,  t h e  t r u s t e e ’ s  c l a i m  f a i l e d  b e c a u s e  E & Y  h a d  n o t  v i o l a t e d 
a u d i t i n g  s t a n d a r d s  i n  f a i l i n g  t o  p r e d i c t  T a u r u s ’ s  d e m i s e  b a s e d  o n  t h e  i n f o r m a t i o n  m a d e  a v a i l a b l e 
t o  i t  b y  t h e  c o m p a n y .  F u r t h e r ,  t h e  c l a i m  w a s  b a r r e d  b y  I n d i a n a ’ s  o n e - y e a r  s t a t u t e  o f  l i m i t a t i o n s 
b e c a u s e  m a n a g e m e n t  w a s  a w a r e  o f  t h e  p r o b l e m  m o r e  t h a n  a  y e a r  b e f o r e  T a u r u s ’ s  b a n k r u p t c y 
f i l i n g .

T h e  S e v e n t h  C i r c u i t  d i s c u s s e d  d e e p e n i n g  i n s o l v e n c y  b e c a u s e  “[t] h e  t r u s t e e ’ s  d a m a g e s 
c l a i m  [w a s]  b a s e d  o n  t h e  t h e o r y  o f  ‘ d e e p e n i n g  i n s o l v e n c y ’ ”  ( i d .  a t  *2) .  T h e  c o u r t  s a i d :

[A]s  e x p l a i n e d  i n  T r e n w i c k . . . ,  t h e  t h e o r y  m a k e s  n o  s e n s e  w h e n  i n v o k e d  
t o  c r e a t e  s t a b i l i t y  d u t y  o f  p r o m p t  l i q u i d a t i o n  t h a t  w o u l d  p u n i s h  c o r p o r a t e 
management  f o r  t r y i n g  i n  t h e  e x e r c i s e  o f  i t s  b u s i n e s s  j u d g m e n t  t o  s t a v e  o f f  a 
declaration  o f  b a n k r u p t c y ,  e v e n  i f  t h e r e  w e r e  n o  i n d i c a t i o n  o f  f r a u d ,  b r e a c h  o f 
fiduciary  d u t y ,  o r  o t h e r  c o n v e n t i o n a l  w r o n g d o i n g .  N o r  w o u l d  i t  d o  t o  f i x  l i a b i l i t y
on  a  t h i r d  p a r t y  f o r  l e n d i n g  o r  o t h e r w i s e  i n v e s t i n g  i n  a  f i r m  a n d  a s  r e s u l t  k e e p i n g
i t  g o i n g ,  w h e n  “m a n a g e m e n t  . . . m i s u s e d  t h e  o p p o r t u n i t y  c r e a t e d  b y  t h a t
investment . . . .  [T]hey  [m a n a g e m e n t]  c o u l d  h a v e  i n s t e a d  u s e d  t h a t  o p p o r t u n i t y
t o  t u r n  t h e  c o m p a n y  a r o u n d  a n d  t r a n s f o r m  i t  i n t o  a  p r o f i t a b l e  b u s i n e s s .  T h e y  d i d
n o t ,  a n d  t h e r e i n  l i e s  t h e  h a r m  t o  [t h e  c o m p a n y] .”  I n  r e  C i t X ,  4 4 8  F . 3 d  6 7 2 ,  6 7 8
(3d  C i r .  2 0 0 6) .

F e h r i b a c h ,  2 0 0 7  W L  2 0 3 3 7 3 4 ,  a t  * 2.  H o w e v e r ,  t h e  c o u r t  c o n s i d e r e d  t h e  c a s e  b e f o r e  i t  t o 
be  “d i f f e r e n t”  i n  t h a t ,  u n d e r  a p p l i c a b l e  I n d i a n a  l a w ,  c r e d i t o r s  a r e  n o t  p e r m i t t e d  t o  s u e  a u d i t o r s
d i r e c t l y .  I d .  T h e r e f o r e ,  i t  a d d r e s s e d  w h e t h e r  c h a p t e r  7  t r u s t e e ’ s  s u i t  a g a i n s t  t h e  a u d i t o r  f o r
n e g l i g e n c e  a n d  b r e a c h  o f  c o n t r a c t  w o u l d  n e t h e r e t h e s e i s l y  l i e ,  e v e n  t h o u g h  r e c o v e r y  w o u l d  b e n e f i t
o n l y  c r e d i t o r s ,  a n d  d e t e r m i n e d  t h a t  i t  w o u l d :  t h e  a u d i t o r ’ s  “d u t y  t o  i ts  c l i e n t ,  T a u r u s ,  . . . d o e s
n o t  e v a p o r a t e  j u s t  b e c a u s e  t h e  c l i e n t  i s  b a n k r u p t  a n d  a n y  b e n e f i t s  f r o m  s u i n g  w i l l  a c c r u e  t o  i t s
c r e d i t o r s .  I d .  a t * 3.  N e v e r t h e l e s s ,  a s  n o t e d  a b o v e ,  t h e  c o u r t  a f f i r m e d  t h e  s u m m a r y  j u d g m e n t
b e c a u s e  t h e  a u d i t o r  h a d  n o t  b r e a c h e d  i t s  d u t y  a n d  b e c a u s e  t h e  s t a t u t e  o f  l i m i t a t i o n s  h a d  r u n .

B y  c o n t r a s t ,  i n  a  c u r i o u s  o p i n i o n ,  t h e  c o u r t  i n  B u c k l e y  v .  O ’ H a n l o n ,  2 0 0 7  W L  9 5 6 9 4 7
(D.  D e l .  M a r .  2 8 ,  2 0 0 7),  c i t e d  t h e  C o u r t  o f  C h a n c e r y ’ s  o p i n i o n  i n  T r e n w i c k  f o r  t h e  p r o p o s i t i o n
that  “[i]n  D e l a w a r e ,  t h e r e  i s  n o  g e n e r a l  d u t y  t o  l i q u i d a t e  a n  i n s o l v e n t  c o m p a n y ”  ( i d .  a t  * 9),  b u t
then  i g n o r e d  t h e  T r e n w i c k  d e c i s i o n  e n t i r e l y  i n  i t s  a n a l y s i s  o f  t h e  v i a b i l i t y  o f  a  c l a i m  f o r
d e e p e n i n g  i n s o l v e n c y  u n d e r  D e l a w a r e  l a w .  S e e  i d .  a t  *7-8.  I n s t e a d ,  w i t h o u t  i n d e p e n d e n t
a n a l y s i s ,  i t  r e l i e d ,  o n  t h e  D e l a w a r e  b a n k r u p t c y  c o u r t ’ s  o p i n i o n  i n  O a k w o o d  H o m e s ,  3 4 0  B . R .  a t
5 3 1 – w h i c h  w a s  c r i t i c i z e d  i n  T r e n w i c k  ( s e e  n o t e  4 2 ,  s u p r a ) – t h a t  D e l a w a r e  w o u l d  r e c o n n e z  a
claim for deepening insolvency. The Delaware Supreme Court’s adoption of the Court of Chancery opinion in *Trenwick* proved both the *Buckley* and *Oakwood Home* courts wrong.

Like the court in *Buckley*, the court in *Official Committee of Unsecured Creditors v. Foss (In re Felt Manufacturing Co.)*, 2007 WL 2177690, at *19-20 (Bankr. D.N.H. July 27, 2007), cited but did not follow the Court of Chancery’s opinion in *Trenwick*. It, too, relied on *Lafferty* and *Oakwood* in reasoning that New Hampshire would be likely to recognize an independent cause of action for deepening insolvency.47 However, the court declined to decide the issue, finding instead that, with respect to directors, New Hampshire would not recognize a separate tort of deepening insolvency because “existing causes of action for breach of fiduciary duty and fraud against the [directors] appear to provide the Committee with adequate remedies under existing law.” *Id.* at *20. Such would not be the case with respect to claims against “outside corporate advisors.” *Id.* at 20. Therefore, a cause of action for deepening insolvency might well be sustained against them.

Less than a week before the Delaware Supreme Court affirmed and adopted the Court of Chancery’s opinion in *Trenwick*, the court in *In re Parmalat Securities Litigation*, 2007 WL 2263893 (S.D.N.Y. Aug. 8, 2007), issued an opinion dealing with deepening insolvency under New York law. *Id.* at *9. First, it stated that deepening insolvency is not viable, either as a cause of action or measure of damages, if it is based solely on incurring debt when a corporation is insolvent. “The point is that a company’s insolvency is not deepened simply by the incurrence of new debt where the company suffers no loss on the loan transaction” (*id.* at *10) because “[w]hen . . . a company borrows cash and receives the full amount of the loan, it receives an asset that directly offsets the newly incurred liability on its balance sheet” (*id.* at *9) (citing, among other authorities, *CitX*).48 However, the court indicated that damage (and presumably a claim for deepening insolvency based thereon) is possible if an insolvent corporation is fraudulently induced to incur additional debt, citing the following passage from *Lafferty*:

“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. For example, to the extent that bankruptcy is not already a certainty, the

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47 The court described the elements of that cause of action as “(1) fraud, (2) which causes the expansion of corporate debt, and (3) which prolongs the life of the corporation.” *Felt Manufacturing*, *supra* at *19* (citing *Lafferty*).

48 See note 35 and accompanying text, *supra.*
incurrence of debt can force an insolvent corporation into bankruptcy, thus inflicting legal and administrative costs on the corporation. When brought on by unwieldy debt, bankruptcy also creates operational limitations which hurt a corporation’s ability to run its business in a profitable manner. Aside from causing actual bankruptcy, deepening insolvency can undermine a corporation’s relationships with its customers, suppliers, and employees. The very threat of bankruptcy, brought about through fraudulent debt, can shake the confidence of parties dealing with the corporation, calling into question its ability to perform, thereby damaging the corporation’s assets, the value of which often depends on the performance of other parties. In addition, prolonging an insolvent corporation’s life through bad debt may simply cause the dissipation of corporate assets.”

Id. at *10 (citing Lafferty, 267 F.3d at 349-50 (citations omitted)).

Reviewing the complaint, the court determined that the plaintiffs (successors of the corporations) pled only that the prolongation of the companies’ lives in Parmalat “caused the dissipation of corporate assets.” Id.49 “In other words, plaintiffs claim that the Companies were injured in that they were induced to delay filing for bankruptcy.” Id. at *11. Then, citing Sabin Willett, The Shallows of Deepening Insolvency, 60 Bus. Law. 549, 566 (2005), the court reasoned that, if the delay caused only deferred liquidation of insolvent companies, then the companies themselves were not harmed, only their creditors, “[a]nd they . . . lack standing to recoup damages suffered by . . . the Companies’ creditors” (Parmalat, supra at *11) – thereby implying that creditors could have deepening insolvency claims for their loss. By contrast, if reorganization were deferred, “the conclusion may be different.” Id. Perhaps a company that was liquidated could have been reorganized. Perhaps a company that was reorganized “emerged from bankruptcy with a lower enterprise value than it otherwise would have as a result of being induced to delay reorganization.” Id. at 12. Nevertheless, the court dismissed the claims because neither plaintiff had alleged sufficient facts from which harm to the corporation could be gleaned, other than speculatively. For example, the court said:

49 In this regard, the court said:

Plaintiffs do not claim that defendants’ actions ultimately drove the Companies into bankruptcy. Indeed, they allege that the Companies already were insolvent by 1999 and would have filed for bankruptcy even sooner than they did had Parmalat’s true financial condition been revealed. Nor do plaintiffs allege that the Companies’ incurrence of new debt harmed their business relationships, reputations, or otherwise hindered their operations.

Parmalat, supra at *10.
Even assuming that Farmland’s estate would have been more valuable if bankruptcy protection had been sought earlier, it is far from clear that any of this additional value would have been left to Farmland, as opposed to distributed to its creditors or other interested parties. Hence, too much speculation is required to conclude that Farmland itself would have benefited from earlier bankruptcy protection.

"In sum," the court said, "while the incurrence of debt by itself cannot deepen a company’s insolvency, the Court is not prepared to conclude that it never can cause injury to an insolvent company. But plaintiffs nevertheless have failed to allege that it caused injury to the Companies in this case." Id.

III. CONCLUSION

Beginning with Vice Chancellor Strine’s 2002 tome on fiduciary duty in or in the vicinity of insolvency in Production Resources, to the Delaware Supreme Court’s opinion in North American, to its adoption of Vice Chancellor Strine’s scholarly opinion in Trenwick, there have been fairly coherent themes articulated by the Delaware courts with respect to the duties owed by directors and officers when the companies they manage are insolvent or in the vicinity of insolvency. The touchstone appears to be the conviction that, no matter what, the underlying duty of officers and directors runs to the corporation itself and is to manage the corporation in a good faith – and conflict-free – effort to maximize its value. A corollary of that is that, in an effort to maximize value for the benefit of all, officers and directors are permitted to make good faith and conflict-free judgments among the potentially conflicting interests of the corporation’s various constituencies, and are not required by fiduciary duty law to do what is independently best for shareholders or independently best for creditors under any circumstances. Therefore, the oft-cited concept that, when a corporation is insolvent, its officers and directors owe fiduciary duties to creditors means that creditors, rather than shareholders, are the residual beneficiaries and, as such, have the right to enforce the officers’ and directors’ duties to the corporation in derivative actions. And, because such actions are derivative, the business judgment rule and charter exculpations permitted by Del. C. § 102(b)(7) (and in pari delicto?) apply, even when the action is brought by creditors (or by bankruptcy estate representatives for the benefit of creditors). In order to protect officers and directors from vexatious litigation, the right to sue

50 Marshall Huebner’s paper for this conference on in pari delicto should provide insight on this issue.
derivatively accrues to creditors only when a corporation is insolvent, and not when it is merely in the vicinity of insolvency. Further, in order to make sure that officers and directors can deal with individual creditors in a good faith and conflict-free effort to maximize value, creditors have no direct right of action against officers or directors for breach of fiduciary duty, even when the corporation is insolvent. In addition, because the fiduciary duties of officers and directors are the same whether a corporation is solvent, insolvent, or in the vicinity of insolvency, there is no cause of action for deepening insolvency. Creditors have many statutory and common law rights, such as those under contract law, tort law and bankruptcy law. Those rights, together with derivative standing when a corporation is insolvent, are enough. The Third Circuit, in CitX, also recognized this to an extent when it refused to treat deepening insolvency as an independent measure of damages for other causes of action, such as professional negligence.

The impact of these decisions – particularly the Delaware Supreme Court’s very recent adoption of the Court of Chancery’s opinion in Trenwick – in other jurisdictions is not yet known. However, as the court noted in I.G. Services, 2007 WL 2229650, at *3, “[i]t seems fair to say . . . that both state and federal courts . . . are likely to give weight to [Delaware,] the court from whence creditor-initiated actions for breach of fiduciary duties have emerged.”