

## MEMORANDUM

To: National Bankruptcy Conference's Ad Hoc Capital Markets Committee  
From: Bruce A. Markell  
Date: March 14, 2003  
Re: Preliminary Thoughts on Federalizing Fiduciary Duties to Creditors

---

This memorandum sets forth some preliminary thoughts on whether fiduciary duties to creditors arising upon insolvency (or upon achievement of the "zone" of insolvency). I preface these remarks with the general observation that it strikes me that the concept that debtors can ever owe fiduciary duties to contractual creditors is both empty and pernicious. It is empty in that I am not sure what actions it reaches not already covered by existing causes of action. It is pernicious because it skews incentive and liabilities for those involved in running and representing corporations. Indeed, I have written that "The practical consequence [of finding a fiduciary duty to creditors] is that no ethical or rational lawyer should ever willingly represent an insolvent corporation outside bankruptcy." Bruce A. Markell, *The Folly of Representing Insolvent Corporations: Examining Lawyer Liability and Ethical Issues Involved in Extending Fiduciary Duties to Creditors*, 6 J. BANKR. L. & PRACTICE 403, 403 (1997)

That being said, I will try to confine my remarks to whether such a duty, if it exists, should be regularized and federalized.

### *The Existence of the Duty (Or More Precisely, Three Duties)*

Trouble comes in threes. When dealing with the potential fiduciary duties owed to creditors upon a corporation's insolvency, there are potentially three groups to whom such duty might attach: the corporation itself; its officers and directors; and any controlling shareholders.

With very little dissent, courts have acknowledged the existence of a fiduciary duty of a corporation to its creditors, created upon insolvency or when the corporation is in the "zone" of insolvency. As was summarized in papers presented at the 2002 annual meeting of the National Bankruptcy Conference:

Absent bankruptcy or insolvency, directors and managers of a corporation have a fiduciary duty to manage the corporation for the benefit of the stockholders and managerial decisions in the conduct of the corporation's business are subject to deferential judicial scrutiny. Once a corporation enters the vicinity of "insolvency" or commences a reorganization case under chapter 11 of the Bankruptcy Code, its board of directors and managers assume new duties and roles, encounter new constraints, and often find their actions subject to more intense scrutiny by a wide range of interest groups. A new array of issues confront managers and directors of a corporation in the vicinity of insolvency or operating as a debtor under chapter 11 of the Bankruptcy Code in serving the

“community of interests” that may be affected by the decisions made by the board and the management.

In the absence of entry into the vicinity of insolvency or the occurrence of insolvency, the fiduciary relationship between the board of directors and the corporation and its stockholders derives from the directors’ control over the corporation and its affairs. Characterized as the true owners of the corporation, stockholders are the ultimate beneficiaries of the director’s fiduciary duties.<sup>1</sup> Consequently, the directors of a solvent corporation discharge their fiduciary duties of care and loyalty in the interests of the corporation’s stockholders.

The duty of care requires the exercise of that degree of care that an ordinarily careful and prudent person would exercise under the same or similar circumstances.<sup>2</sup> The duty of care requires directors to make reasonable efforts to ascertain, consider and use all information relevant to the particular transactions that they are called upon to consider.<sup>3</sup> The duty of loyalty prohibits directors from using their positions of trust and control over the rights of other parties to further their own private parochial interests, either by usurping corporate opportunities, holding undisclosed conflicts of interest or otherwise exploiting their positions as corporate fiduciaries.<sup>4</sup>

Generally, in discharging their duties, directors may rely upon the business judgment rule. This rule recognizes that fiduciaries must exercise discretion in making their decisions. Accordingly, unless a complainant establishes fraud, bad faith gross over-reaching, or abusive discretion, a court will not interfere with the exercise of business judgment by corporate directors.<sup>5</sup> The business judgment rule creates a “presumption that the Board acted independently, with due care, in

---

<sup>1</sup>Harvey R. Miller, *Corporation Governance in Chapter 11: The Fiduciary Relationship between Directors and Stockholders of Solvent and Insolvent Corporations*, 23 Seton Hall L.Rev. 1467, 1473 (1993) (“This relationship of trust between directors and the corporation and its stockholders ‘springs from the fact that directors have the control and guidance of corporate business affairs and property and hence of the property interests of the stockholders.’”) (quoting from *Ashman v. Miller*, 101 F.2d 85, 91 (6th Cir. 1939)).

<sup>2</sup>*Meyer v. Moody*, 693 F.2d 1196, 1209 (5th Cir. 1982).

<sup>3</sup>*Paramount Communications v. QVC Network*, 637 A.2d 34, 44 (Del. 1994); *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

<sup>4</sup>*Guth v. Loft*, 5 A.2d 503 (Del. 1939); *Broz v. Cellular Info. Sys.*, 673 A.2d 148, 155-56 (Del. 1996); *Science Accessories Corp. v. Summa Graphics Corp.*, 425 A.2d 957, 963 (Del. 1980); *Borden v. Sinskey*, 530 F.2d 478, 489-90 (3d Cir. 1976).

<sup>5</sup>*Treadyway Co. v. Care Corp.*, 638 F.2d 357, 382 (2d Cir. 1980).

good faith, and in the honest belief that its actions were in the stockholders' best interests."<sup>6</sup>

As a standard to evaluate the discharge of the director's fiduciary duties, the business judgment rule is supported by important policy considerations. The business judgment rule recognizes "business decisions frequently entail risk, and thus ensures directors the broad discretion they need in formulating dynamic and effective company policy without fear of judicial second guessing \*\*\*." As a result, the business judgment rule precludes courts from "becoming enmeshed in complex corporate decision-making – a task that they admittedly are ill equipped to handle \*\*\*." In addition, the rule recognizes that directors rather than stockholders are entrusted with the responsibility to manage the affairs of the corporation and to establish its governing policies.<sup>7</sup> . . . .

A board of directors of a solvent corporation is charged with the fiduciary duties of care and loyalty to the corporation and its stockholders.<sup>8</sup> During the period of solvency, generally, other constituents of the corporation are owed no fiduciary duties but are left to rely upon their contractual or common law rights.

The occurrence of insolvency or movement into the vicinity of insolvency, however, causes an expansion of the fiduciary duties which state law imposes upon a corporation's directors. In that context, the universe of those to whom a fiduciary duty is owed expands to include not just the stockholders but creditors as well.<sup>9</sup> . . . .

Several rationales have developed for the creation of expanded fiduciary duties to creditors in the context of insolvency. The most widely accepted is the view that upon the occurrence of insolvency, a creditors' claim against the corporation becomes an equitable interest in the enterprise inasmuch as the creditors may no longer expect to be paid in accordance with their contractual or

---

<sup>6</sup>Williams v. Grier, 671 A.2d 1368, 1376 (Del. 1996).

<sup>7</sup>2 Weil, Gotshal & Manges, LLP, Reorganizing Failing Businesses: A Comprehensive Review and Analysis of Financing Restructuring and Business Reorganization, at 16 – 40 (1998).

<sup>8</sup>United States v. Byrum, 408 U.S. 125, 141-42 (1972); Cohen v. Beneficial Industrial Loan Corp., 337 U.S. 541 (1941); C-T of Virginia, Inc. v. Barrett, 124 B.R. 689 (W.D. Va. 1990); Hartford Fire Ins. Co. v. Federated Dept. Stores, Inc., 723 F.Supp. 976 (S.D.N.Y. 1989); Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 716 F.Supp. 1504 (S.D.N.Y. 1989); Simons v. Cogan, 549 A.2d 300 (Del. 1988); Revlon, Inc. v. McAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986).

<sup>9</sup>Unsecured Creditors Comm. of STN Enters., Inc. v. Noyes (In re STN Enters, Inc.), 779 F.2d 901, 904 (2d Cir. 1985); FDIC v. Sea Pines Co., 692 F.2d 973 (4th Cir. 1982), cert. denied, 461 U.S. 928 (1983); Clarkson Co. v. Shaheen, 660 F.2d 506, 512 (2d Cir. 1981), cert. denied, 455 U.S. 990 (1982).

legal rights.<sup>10</sup> Accordingly, a fiduciary duty rises on the part of the board of directors to manage the enterprise so as to maximize the value of the equitable interest.

A variation on the foregoing rationale was articulated by the Delaware Chancery Court in a footnote to its decision in *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, No. 122150, 1992 WL 277613 (Del. Ch. Dec. 30 1991). In that footnote, the court stated that once a corporation approached the “vicinity of insolvency, a board of directors is not merely the agent of the residual risk bearers, but owes its duty to the corporate enterprise.”<sup>11</sup> Corporate enterprise is defined as being comprised of a “community of interests” which includes stockholders, creditors, employees or any other “single group interested in the corporation.”<sup>12</sup>

An alternative rationale for the creation of the fiduciary duty to creditors is the view that upon insolvency the property of the corporation no longer “belongs” to the corporation, but is placed in trust for the benefit of creditors and stockholders. This “trust fund doctrine” has been explained as follows:

Solvent, [a corporation] holds its property as any individual holds his, free from the touch of a creditor who has acquired no lien; free also from the touch of a stockholder who, though equitably interested in, has no legal right to the property. Becoming insolvent, the equitable interests of the stockholders in the property, together with their conditional liability to the creditors, places the property in the condition of trust, first for the creditors and then for the stockholders.<sup>13</sup> . . . .

Unfortunately, a clear definition of insolvency or what constitutes the vicinity of insolvency is lacking. There are two very different approaches to defining insolvency, which can lead to different results. The first approach – know as accounting insolvency or balance sheet insolvency – considers whether a debtor’s assets, at a fair valuation, are worth less than its liabilities. This approach is consistent with the Bankruptcy Code definition.<sup>14</sup> The second approach known as equitable insolvency – considers whether a debtor is able to meet its obligations as they mature, regardless of the value of the assets versus the liabilities.

---

<sup>10</sup>FDIC v. Sea Pines Co., 692 F.2d 973, 977 (4th Cir. 1982), cert. denied, 461 U.S. 928 (1983).

<sup>11</sup>Ibid. at 36 note n. 55.

<sup>12</sup>Ibid.

<sup>13</sup>American Nat’l. Bank v. MortgageAmerica Corp., (In re MortgageAmerica Corp.), 714 F.2d 1266, 1269 (5th Cir. 1983).

<sup>14</sup>11 U.S.C. § 101(32)

These two definitions are often blended together. Thus the Delaware Chancery Court has stated:

[A]n entity is insolvent when it is unable to pay its debts as they fall due in the usual course of business. That is, an entity is insolvent when it has liabilities in excess of a reasonable market value of assets held.<sup>15</sup>

Once a corporation is in the vicinity of insolvency, the Delaware Chancery Court has concluded that its board of directors has a fiduciary duty to creditors because the corporation's solvency has dwindled to the point that stockholders have an incentive to "bet the ranch" on high risk transactions as their economic stake in the corporation is so minimal. Thus, the expansion of the board's fiduciary duty is intended to protect creditors from high risk transactions.

To this summary can be added the opinion of the Southern District of New York, which last year stated that:

One of the fiduciary duties of directors of an insolvent corporation, and indeed, a corporation near insolvency, is to take account of the interests of the corporation's creditors in business decisions. See *Odyssey Partners, L.P. v. Fleming Companies, Inc.*, 735 A.2d 386, 417-18 (Del. Ch.1999); *In re Buckhead America Corp.*, 178 B.R. 956, 968 (D. Del.1994); *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, Civ. A. No. 12150, 1991 WL 277613, \*36, mem. op. at 84 & n. 55 (Del. Ch., Dec. 30, 1991) (Unreported Decision).

*In re Subpoena Issued to Dennis Friedman*, 286 B.R. 505, 508 (S.D.N.Y. 2002). See also *In re Joy Recovery Technology Corp.*, 286 B.R. 54 (Bankr. N.D. Ill. 2002) (Officer, director and 50% shareholder owed fiduciary duty to creditors); Andrew D. Shaffer, *Corporate Fiduciary - Insolvent: The Fiduciary Relationship Your Corporate Law Professor (Should Have) Warned You About*, 8 AM. BANKR. INST. L. REV. 479 (2000).

More recently, creditors and others have sought to advance the notion that controlling shareholders may have a fiduciary duty to creditors. Last year, for example, the Delaware District Court noted that:

Delaware case law suggest[s] that controlling shareholders may be liable to creditors for breach of fiduciary duty, [but the court] acknowledge[d] that due to

---

<sup>15</sup>*Geyer v. Ingersoll Publications Co.*, 621 A.2d 784, 789 (Del. Ch. 1992)' See also New York Debt. & Cred. Law §271 (McKinney 1990) (defining insolvency as "when the present fair salable value of [a debtor's] assets is less than the amount that will be required to pay [the debtor's] probably liability on [its] existing debts as they become absolute and mature").

the lack of Delaware case law directly on point, the precise question is a novel question of law whose proper resolution may not be beyond dispute. Although Delaware courts have held that directors of a corporation may owe fiduciary duties to creditors when the corporation is insolvent, no Delaware court has expressly extended that duty to controlling or majority shareholders.

*In re Hechinger Inv. Co. of Delaware*, 280 B.R. 90, 94 (D. Del. 2002).

*The Scope of the Duty – Is There a There There?*

If the duty exists, the next question concerns the effect of finding such a fiduciary duty. Does it create a cause of action that affects actions not previously touched by the existing array of avoidance and other similar actions? At least with respect to the fiduciary duty to corporations, it is arguable that finding such a duty adds nothing. As Lynn LoPucki summarized over ten years ago:

In virtually every case, the results reached under the trust fund doctrine [the basis of fiduciary duties to creditors] could have been reached under rules governing fraudulent transfers, preferences or illegal dividends. The "fiduciary duty" to creditors appears to be no more than a duty not to act illegally.

Lynn LoPucki, *Corporate Governance in the Troubled Company Context*, Commercial Law and Practice Course Handbook Series 891 (618 PLI/Comm 887, 1992).

But that is only as to the corporation. If the duty extends to officers, directors or controlling shareholders, then what is expanded is the universe of defendants, rather than the types of actions that lead to liability.<sup>16</sup> This expansion comes not only from direct liability of such entities, but also from possible aiding and abetting, or conspiracy, liability for assisting the corporation's breach of such duties.

Even in this context, however, there may be disparate opinions due to the procedural context in which such fiduciary duties arise. Put another matter, this issue may not matter unless it affects administration of the bankruptcy estate in some way. That one creditor may sue a director of a debtor in bankruptcy may be important to that creditor, but may not matter to the bankruptcy estate if the resolution of that dispute will not affect creditor distributions. In

---

<sup>16</sup>This expansion would also seem to expand the potential sources of recovery to proceeds of directors and officers' insurance, or the personal assets of controlling shareholders. This raises a whole host of other concerns, especially with respect to the availability of insurance in such as case. See generally Maureen Mulligan, Michael P. Duffy, Kristin M. Kraeger, & Margaret Sunkel, *Recent Developments in the Law Affecting Professionals, Officers, and Directors*, 37 TORT & INS. L.J. 651(2002).

addressing the relevancy of fiduciary duty claims, attorneys and courts have pursued two separate inquiries:

- First, is the cause of action part of the bankruptcy estate under Section 541(a)?
- Second, even if the cause of action does not belong to the estate under Section 541(a), does the trustee have standing under the avoiding powers to pursue the claim under Section 544(b)?

*Is the Breach of Fiduciary Claim Property of the Estate?*

The analysis of whether the claim belongs to the debtor or creditor consists of two separate inquiries: (1) whether the claim, under state law, belongs to the debtor rather than the creditors, and (2) whether there is a separate and cognizable injury to the debtor. Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co. (*In re R.F. Lafferty & Co.*), 267 F.3d 340, 348 (3rd Cir. 2001). If the claim belongs to the debtor, the trustee has exclusive standing to assert it, but if it belongs to the creditors or shareholders, the trustee has no standing to bring the claim. *In re Granite Partners*, 194 B.R. 318, 324 (Bankr. S.D.N.Y. 1996); *In re S.I. Acquisition, Inc.*, 817 F.2d 1142, 1152-53 (5th Cir. 1987) (holding that because a corporation could bring an alter ego claim against its principals under state law, the claim was a right of the debtor that passes to the trustee in bankruptcy). In addition, some state law, particularly Delaware's, permits the debtor to sue third parties who aid and abet the insider's wrongful conduct. *Granite*, 194 B.R. at 328; *Malpiede v. Townson*, 780 A.2d 1075, 1096 (Del. 2001).<sup>17</sup>

In *R. F. Lafferty*, the court found that an Unsecured Creditors' Committee had standing under Pennsylvania law to bring a claim against a third party for aiding and abetting a breach of fiduciary duty.<sup>18</sup> The claims arose out of the bankruptcy of two lease financing corporations that the Committee alleged had been run as a "Ponzi scheme" by the Debtor's management with the help of third party professionals. *R. F. Lafferty*, 267 F.3d at 343. The Committee brought claims on behalf of the two debtor corporations, alleging, among other claims, that the third parties had aided and abetted the breach of fiduciary duty by the Debtor's management, thereby deepening the corporation's insolvency and forcing it into bankruptcy. *Id.* at 344, 346. The District Court found that the corporation had alleged a cognizable injury, but nevertheless dismissed the claim,

---

<sup>17</sup>In order for a complaint against a third party for aiding and abetting a breach of a corporate fiduciary's duty to stockholders to survive dismissal, the complaint must allege facts to satisfy the four elements of the claim: (1) the existence of a fiduciary relationship, (2) a breach of the fiduciary's duty, (3) knowing participation in the breach by the defendants, and (4) damages proximately caused by the breach. *Malpiede*, 780 A.2d at 1096.

<sup>18</sup>*Lafferty* may no longer be good law in the Third Circuit depending on the outcome of the now infamous *Cybergenics* decision. See Official Comm. of Unsecured Creditors v. Chinery (*In re Cybergenics, Inc.*), 304 F.3d 316 (3<sup>rd</sup> Cir. 2002), *reh'g en banc granted and opinion vacated*, 310 F.3d 785 (3d Cir. 2002).

finding that the Committee lacked standing because the Debtor was in pari delicto with the parties the Committee was suing on the Debtor's behalf. *Id.*

The Court of Appeals affirmed the judgment, but held that the Committee had standing to bring the claim, even though the claim was still subject to the in pari delicto defense. *Id.* The court found that Pennsylvania state law recognized a cause of action for the Debtor against the third party. *Id.* at 348. The court went on to find that the Committee had demonstrated the existence of a separate and cognizable injury to the debtor when it alleged that the Debtor's property was injured by the fraudulent expansion of corporate debt and prolongation of corporate life. *Id.* at 347. The court found that although the most obvious injuries may have been to the creditors, the court could not, at the motion to dismiss stage, rule out the possibility of a separately cognizable injury to the Debtor. *Id.* Consequently, the court found that the claim was property of the Debtor and the Committee had standing to bring the claim. *Id.*

In *Official Comm. v. Investcorp S.A. (In re Color Tile, Inc.)*, 80 F. Supp. 2d 129, 137. (S.D.N.Y. 1999), however, the court held that the plaintiff, the Official Committee of Unsecured Creditors of Color Tile (the "Committee"), lacked standing under Delaware state law to bring a claim on behalf of the Debtor against a third party for aiding and abetting a breach of fiduciary duty. The claims arose out of a transaction in which Investcorp, an entity that held control over the management and operations of Color Tile, forced Color Tile to acquire the assets of another business at a grossly inflated price in order to prepare for a future public equity offering that would allow Investcorp to cash out its interest in Color Tile. *Id.* at 132. The Committee brought the aiding and abetting claim against Coopers & Lybrand ("Coopers"), Color Tile's financial advisor, because Coopers failed to notify Color Tile before the transaction that the transaction would be detrimental to Color Tile's interests and that the controlling shareholders were breaching their fiduciary duties by forcing the transaction on Color Tile. *Id.* at 133.

The court found that both Delaware and New York law permitted a corporation to bring a claim for aiding and abetting a breach of fiduciary duty. *Id.* at 136. The court found that generally, under New York law, aiding and abetting breach of fiduciary duty claims accrue to the corporation. *Id.* However, the court applied the "*Wagoner*" rule which requires that when claims are against a third party for defrauding a corporation with the cooperation of management, the claims accrue to the creditors, not to the guilty corporation. *Id.* Because no Delaware cases had been decided that were contrary to New York law, the court reasoned that under Delaware law the claim would also accrue to the creditors when management had cooperated with those accused of defrauding the corporation. *Id.*

#### *Is the Breach of Fiduciary Duty a Claim Cognizable Under the Avoiding Powers?*

If a breach of fiduciary duty claim is not part of the estate under Section 541(a)(1), it may still come into the estate if the transaction giving rise to the breach can be brought within the avoiding powers. In particular, an estate may look to Section 544 of the Bankruptcy Code, which reads in pertinent part:

(b) . . . the trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim that is allowable under section 502 of this title or that is not allowable only under section 502 . . . .

11 U.S.C. § 544(b). As broad as this may be, a debtor's bankruptcy trustee is not authorized to pursue every action that creditors of the debtor are able to pursue. *In re Hamilton Taft & Co.*, 176 B.R. 895, 902 (Bankr. N.D. Cal. 1995). Under the 1898 Bankruptcy Act, the trustee was not permitted to assert the direct claims of creditors for the benefit of the estate or a particular class of creditors. *Caplin v. Marine Midland Grace Trust Co.*, 406 U.S. 416 (1972) (holding that under Chapter X of the former Bankruptcy Act, the trustee lacked standing to sue indenture trustee on behalf of debenture holders). *Caplin* was silently adopted by Congress in 1978 when it refused to add a paragraph (4) to Section 544(a) that would have allowed the trustee to bring such actions. *But see Arwood v. Dunn (In re Caribbean K Line, Ltd.)* 288 B.R. 908, 914-15 (S.D. Fla. 2002) (finding that chapter 7 trustee had standing to pursue claims of breach of fiduciary duty against chief operating office on behalf of all unsecured creditors generally).

As a consequence, the trustee's only authority to assert creditors' state-law claims for breach of fiduciary duty would seem to be section 544(b).<sup>19</sup> *Wyle v. Howard, Weil, Labouisse, Friedrichs Inc. (In re Hamilton Taft & Co.)*, 176 B.R. 895, 902 (Bankr. N.D. Cal. 1995). In order to determine whether an aiding and abetting breach of fiduciary claim is within the trustee's section 544(b) authority, a court will look at whether the trustee is attempting to assert the rights and powers of the creditor found in section 544. *Baehr v. Touche Ross & Co.*, 62 B.R. 793, 798 (Bankr. E.D. Pa. 1986) (holding that the trustee lacked standing to assert a claim for accountant malpractice against a third party on behalf of the creditors and shareholders because to allow the trustee to do so would require the court to blatantly misapply the unambiguous language of section 544).

In *Hamilton*, the court held that the trustee lacked standing to bring an aiding and abetting fraudulent transfer claim against a third party on behalf of creditors. *Hamilton*, 176 B.R. at 902. The trustee brought claims arising out of an LBO in which MaxPharma, Inc. used the Debtor's funds to purchase CIGNA's stock in the Debtor. *Hamilton*, 176 B.R. at 897. The trustee alleged that the leveraged buy out rendered the Debtor insolvent and that the LBO therefore constituted a fraudulent conveyance. The trustee then brought a claim against Howard, Weil, Labouisse, Friedrichs, Inc., an investment bank, for aiding and abetting a fraudulent transfer. The court

---

<sup>19</sup>See *E.F. Hutton & Co., Inc. v. Hadley*, 901 F.2d 979, 986 (11th Cir. 1990) (listing the circuit decisions regarding the ability of the trustee to bring actions against third parties on behalf of the debtor). However, those courts that have spoken to the issue have found that the trustee has no standing to bring such claims on behalf of the creditor. *In re Hamilton Taft & Co.*, 176 B.R. at 902; *Mediators, Inv. v. Manney (In re Mediators, Inc.)*, 105 F.3d 822, 826 (2d Cir. 1997) (holding that under New York law, a claim for aiding and abetting a fiduciary's duty belonged to the creditors qua creditors and therefore the trustee could not bring such an action under Section 541(a)(1); no claim made under Section 544(b) since all individual claims of unsecured creditors were time barred).

found that the trustee’s only authority to bring state law claims on behalf of creditors was section 544 (b). *Id.* Because section 544 (b) only permits the trustee to avoid fraudulent transfers on behalf of creditors, the court found that it did not enable the trustee to recover damages for aiding and abetting a fraudulent transfer. *Id.*

*Hamilton*, and other cases like it, make sense given the statute. The estate is given only those avoidance claims that were available to creditors generally – such as fraudulent transfer claims – and not claims that may belong to individual creditors due to their specific position.

But the relatively new claim of breach of a fiduciary duty to creditors might arguably fit within this sphere of claims. Although the contours of the duty is not well set, it appears to be a duty to unsecured creditors generally, with any individual creditor’s claim being capped at the amount of that creditor’s claim; that is, there is no punitive damages element or any other additional damage. This aligns the claim with fraudulent transfer claims, and distinguishes it from actions such as those represented by *Caplin*, in which the actions of one individual – the indenture trustee – only harmed a subset of the general creditor body. That issue, however, has yet to be litigated in any helpful fashion.

Yet doubt remains. Section 544(b) is an *avoidance* power. By its terms, it only allows the estate representative to “*avoid* any transfer of an interest of the debtor in property or any obligation incurred by the debtor.” Yet a breach of a fiduciary duty does not necessarily, or even usually, involve a transfer of an interest or the incurring of an obligation. Rather, it is an cause of action that attempts to cure a wrong by imposing a damages remedy. Unless a creative estate representative can find some transfers to avoid, or obligations to nullify, Section 544(b) may not be helpful.<sup>20</sup>

As a consequence, without a unifying or central structure, the recognition of state law fiduciary duties in favor of creditors may lead to confusion, and collection in non-bankruptcy courts, if at all.

#### *Arguments for Federal Duty – Confusion and the Fresh Start*

The central argument for a federal duty would be administrative convenience, and a reduction of confusion. Having one rule, instead of fifty, would make pre-petition decisionmaking more efficient. This claim has some substance; it appears that not all states have the same basis for the duty, and not all states describe the required actions similarly. *See, e.g., Webster Indust., Inc. v. Northwoods Doors, Inc.*, 234 F. Supp.2d 981, (D. Iowa 2002) (in an action under state law in a non-bankruptcy context, the court noted that “Iowa does not recognize

---

<sup>20</sup>There also is a problem in matching harm with breach. If an insider transfers property in violation of a fiduciary duty, Section 544(b) may very well assist in the recovery of that transfer. But the amount of the transfer bears no necessary relationship to the amount of creditors’ loss. Moreover, any such transfers will more than likely also be vulnerable under fraudulent transfer or other laws.

the broadest version of that exception. Instead, under Iowa law, a creditor may pursue an action against an officer or director of an insolvent corporation to recover from the officer or director payments from the insolvent corporation to the officer or director for "antecedent debts," but not for payments to the officer or director for "contemporaneous debts" that is, debts incurred by the corporation to the officer or director at the time of the insolvency assuming that the officer or director receiving the payments acted with the utmost good faith and fairness.”).

Cases like *Webster* underscore that the articulation of the requirements of fiduciary duties are subject to change and evolution among the states.

There is an additional argument for regularizing the duty. It has to do with the ability of individual directors and officers to avail themselves of the fresh start. If a fiduciary duty is found to exist, then breach of that duty arguably may give rise to a non-dischargeable claim against the officers and directors under Section 523(a)(4).<sup>21</sup>

In *Dakota Steel, Inc. v. Dakota (In re Dakota)*, 284 B.R. 711, 723-24 (Bankr. N.D. Cal. 2002), the court addressed such a claim. There, the claim was that a director of a California corporation owed a fiduciary duty to creditors, which had been breached and that the director was thus saddled with a non-dischargeable debt in the amount of the creditor’s loss. The court dismissed the claim – primarily because it appears that the act which “breached” the fiduciary duty was undertaken when the debtor was solvent, but also because the court found no “defalcation.” As stated by the court:

In the context of § 523(a)(4), "the term 'defalcation' includes innocent, as well as intentional or negligent defaults so as to reach the conduct of all fiduciaries who were short in their accounts", *In re Lewis*, 97 F.3d 1182, 1186 (9th Cir. 1996) if a creditor establishes that a debtor occupied a fiduciary capacity, the burden shifts and it is the debtor's burden to show that defalcation did not occur, by accounting for the *res*, see *In re Niles*, 106 F.3d 1456 (9th Cir. 1997). Debtor has not failed to account for the corporate property that he took. With respect to funds on deposit in the corporate bank account, Debtor showed that he applied them to corporate purposes and Creditor did not show otherwise.

*Dakota*, 284 B.R. at 725.

While in *Dakota*, the individual prevailed, the court’s words with respect to the scope of the required defalcation may prove troublesome, especially to directors who take actions which are held to be violative of their fiduciary duty (such as paying insider claims, or claims guaranteed by insiders).

---

<sup>21</sup>Section 523(a)(4) states in relevant part that, in an individual’s case, debts “for fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny” are non-dischargeable.

## *Arguments Against Federal Duty – How to Impose*

A simple argument exists in opposition to the arguments in favor of federalizing the duty. That argument is that there is no authority to promulgate or impose such a rule, owing to the fact that such a rule would preempt the traditional role of states and state courts in setting up the duties of entities such as corporations. This argument is strong; it not only impacts federalism (who really controls the law related to corporations), but also it raises the question of the ability to impose duties on entities before they file bankruptcy.

In other contexts, however, Congress has had no problem in regulating actions taken in contemplation of bankruptcy, even if no bankruptcy occurs. Several bankruptcy crimes, for example, criminalize certain actions taken in anticipation of bankruptcy. *See, e.g.*, 18 U.S.C. § 152(8) (making it a crime “after the filing of a case under title 11 *or in contemplation thereof*, [to] knowingly and fraudulently conceal[], destroy[], mutilate[], falsif[y], or make[] a false entry in any recorded information (including books, documents, records, and papers) relating to the property or financial affairs of a debtor); § 157 (stating that “A person who, having devised or intending to devise a scheme or artifice to defraud and for the purpose of executing or concealing such a scheme or artifice or attempting to do so - . . . [¶ ](3) makes a false or fraudulent representation, claim, or promise concerning or in relation to a proceeding under title 11, at any time *before or* after the filing of the petition, or in relation to a proceeding falsely asserted to be pending under such title); § 1519 (which states that “Whoever knowingly alters, destroys, mutilates, conceals, covers up, falsifies, or makes a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence the investigation or proper administration . . . any case filed under title 11, or in relation to *or contemplation of any such matter or case*).

On a similar note, the Sarbanes-Oxley Act of 2002, Pub. L. 107-204, 116 Stat. 745 (2002), includes provisions which authorized the Securities and Exchange Commission to propose to regulate the attorney-client relationship, and the SEC has already promulgated regulations to that effect. *See* 17 C.F.R. § 205.1 - 205.7 (2003). As stated in the press release announcing such rules, the SEC stated that these rules:

allow an attorney, without the consent of an issuer client, to reveal confidential information related to his or her representation to the extent the attorney reasonably believes necessary (1) to prevent the issuer from committing a material violation likely to cause substantial financial injury to the financial interests or property of the issuer or investors; (2) to prevent the issuer from committing an illegal act; or (3) to rectify the consequences of a material violation or illegal act in which the attorney's services have been used . . .

Securities and Exchange Comm'n Release 2003-13 (Jan. 23, 2003).

The “material violation” referred to includes breach of fiduciary duty:

Material violation means a material violation of an applicable United States federal or state securities law, a material breach of fiduciary duty arising under United States federal or state law, or a similar material violation of any United States federal or state law.

17 C.F.R. § 2.02(i) (2003).

The SEC also acknowledged that their “rules govern in the event the rules conflict with state law . . . .” Securities and Exchange Comm’n Release 2003-13 (Jan. 23, 2003).

Thus, if the power to pre-empt state regulation of the attorney-client relationship, and to for certain effect federalize what a fiduciary duty is (at least by incorporation), already exists for acts under the Commerce Clause, it should be relatively easy to make the same case for a combination of the Commerce Clause and the Bankruptcy Clause.

But making the argument is not the same as being persuaded by it. This may very well be an area in which the problems in federalizing the law of fiduciary duties to creditors are so large as to outweigh the inefficiencies cause by the common law development of the duty, in its many forms.