THE CRIMINALIZATION OF DIRECTORS AND OFFICERS: PERSONAL RISK AND LIABILITIES IN INSOLVENCIES
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MATERIALS PROVIDED BY:
ROBERT B. MILLNER
SONNENSHEIN NATH & ROSENTHAL LLP
7800 SEARS TOWER
CHICAGO, ILLINOIS
(312) 876-7994
RMILLNER@SONNENSHEIN.COM
FIDUCIARY DUTIES OF DIRECTORS OF U.S. CORPORATIONS DURING INSOLVENCY AND LIABILITY FOR DEEPENING INSOLVENCY

Robert B. Millner*

In the United States issues of corporate governance, including fiduciary duties of corporate directors, are generally governed by state law. The most significant state corporation law is that of Delaware. As noted by Judge Leif Clark of the Bankruptcy Court for the Western District of Texas:

The Delaware courts’ decisions have proved to be immensely influential in the national debate over the shape of causes of action that have their genesis in breach of fiduciary duties on the part of officers and directors.


There has been significant activity over the last year in both the Delaware Supreme Court and the Delaware Court of Chancery in the area of fiduciary duties of directors of insolvent entities and liability for “deepening insolvency.”

In May 2007, the Delaware Supreme Court decided North American Catholic Educational Programming Foundation v. Gheewalla, 930 A.2d 92 (Del. 2007). In Gheewalla the court ruled as to corporations not insolvent but in the “zone of insolvency”:

In this case, the need for providing directors with definitive guidance compels us to hold that 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. When 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 best interest of the corporation for the benefit of its shareholder owners....

* Partner, Sonnenschein Nath & Rosenthal, Chicago, Illinois
As to insolvent corporations, the court ruled in Gheewalla:

When a corporation is *insolvent*, however, its creditors take the place of the shareholders as the residual beneficiaries of any increase in value.

Consequently, the creditors of an *insolvent* corporation have standing to maintain derivative claims against directors on behalf of the corporation for breaches of fiduciary duties. The corporation's insolvency "makes the creditors the principal constituency injured by any fiduciary breaches that diminish the firm's value." Therefore, equitable considerations give creditors standing to pursue derivative claims against the directors of an insolvent corporation. Individual creditors of an insolvent corporation have the same incentive to pursue valid derivative claims on its behalf that shareholders have when the corporation is solvent.

930 A.2d at 101-102 (quoting Production Resources Group, L.L.C. v. NCT Group, Inc., 863 A.2d at 772, 794 n.67 (Del. Ch. 2004).

In August, 2007, the Delaware Supreme Court affirmed the Chancery Court's decision Trenwick America Litigation Trust v. Ernst & Young, L.L.P., 906 A.2d 168 (Del. Ch. 2006).

The Delaware Supreme Court specifically approved the "basis" and "reasons" given by the Court of Chancery in its opinion, which had rejected the existence of a tort of "deepening insolvency":

The concept of deepening insolvency has been discussed at length in federal jurisprudence, perhaps because the term has the kind of stentorous academic ring that tends to dull the mind to the concept's ultimate emptiness.

Delaware law imposes no absolute obligation on the board of a company that is unable to pay its bills to cease operations and to liquidate. Even when the company is insolvent, the board may pursue, in good faith, strategies to maximize the value of the firm.

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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.

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No doubt the fact of insolvency might weight heavily in a court’s 
analysis of, for example, whether the board acted with fidelity and 
care in deciding to undertake more debt to continue the company’s 
operations, but that is the proper role of insolvency, to act as an 
important contextual fact in the fiduciary duty metric.

906 A.2d at 204-205 (footnote omitted).

Most recently, in Nelson v. Emerson, 2008 WL 1961150 (Del.Ch. May 6, 2008), the 
Delaware Court of Chancery emphasized the notion that the directors’ duty upon insolvency is to 
maximize the value of the firm and not simply to pay creditors:

It is settled Delaware law that “[e]ven when the company is 
insolvent, the board may pursue, in good faith, strategies to 
maximize the value of the firm.” Filing a Chapter 11 bankruptcy 
petition is a federally-sanctioned strategy for maximizing the value 
of an insolvent company. Here, after a full trial, the Bankruptcy 
Court determined that Repository used that strategy in good faith. 
Directors of a Delaware corporation do not commit a breach of 
fiduciary duty against the corporation if they, in good faith, seek to 
benefit the equity holders by bringing a bankruptcy, in order to 
recharacterize certain debt as equity. So long as that action is not 
frivolous, such an exercise of business judgment to advance the 
interests of the equity holders is not a breach of fiduciary duty 
simply because the directors do not achieve ultimate success.

2008 WL 1961150 at *8 (footnotes omitted).

Fortunately there has been much excellent writing on these subjects over the last year.

Attached as Tab A is a significant paper by former Chief Justice E. Norman Veasey of the 
Delaware Supreme Court, entitled “Counseling the Board of Directors of a Delaware 
Corporation in Distress.” Chief Justice Veasey presented an earlier version of this paper in 
March, 2008 at the Annual Meeting of the American College of Bankruptcy and has recently
updated it for inclusion in the International Insolvency Institute materials. Included as Tab B is a paper prepared by Sally Neely in September 2007 for the Lawrence P. King and Charles Seligson Workshop on Bankruptcy at New York University, and as Tab C a paper by the undersigned prepared in April 7, 2007 (before the Gheewalla decision) for the Annual Meeting of Section of Litigation of the American Bar Association.
Counseling the Board of Directors of a Delaware Corporation in Distress

E. Norman Veasey

Directors of a Delaware corporation have a statutory duty to direct the management of the business and affairs of the corporation. That is a proactive mandate that contemplates full engagement by directors. In carrying out that duty, directors are generally protected by the business judgment rule if they are not found to have violated their fiduciary duties of care and loyalty. The duty of loyalty embraces the principle that directors must act in good faith.

The applicable standards of review determine whether a director may be held liable or a transaction set aside when the standards of conduct are not met. We begin with the business judgment rule.

* Retired Chief Justice of Delaware (1992-2004), Senior Partner of Weil, Gotshal & Manges LLP, Wilmington and New York. Chief Justice Veasey has served as President of the Conference of Chief Justices and is a Fellow of the American College of Trial Lawyers.


3 In re Walt Disney Co. Deriv. Litig., 906 A.2d 27 (Del. 2006).


5 Veasey & Di Guglielmo, supra note 2, at 1416-39.
1. The Business Judgment Rule

The conduct of directors of Delaware corporations in their decisionmaking role continues to be reviewed under the business judgment rule, which is alive and well in Delaware corporate jurisprudence. Because of the mandate that directors manage or direct the management of the business and affairs of the corporation, the focus of the business judgment rule remains on the process that directors use in reaching their decisions. The business judgment rule will normally protect the decisions of a board of directors reached by a careful, good faith process. The rule itself has been restated numerous times. In *Brehm v. Eisner*, the Supreme Court provided the following formulation:

The business judgment rule has been well formulated by *Aronson* and other cases. *See, e.g., Aronson [v. Lewis, 473 A.2d 805, 812 (Del. 1984)]* (“It is a presumption that in making a business decision the directors ... acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the corporation.”). Thus, directors’ decisions will be respected by courts unless the directors are interested or lack independence relative to the decision, do not act in good faith, act in a manner that cannot be attributed to a rational business purpose or reach their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available.

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6 See *Brehm v. Eisner*, 746 A.2d 244, 264 (Del. 2000) (explaining the deference courts give a director’s decision). In *Brazen v. Bell Atlantic Corp.*, the court explained:

The business judgment rule is a presumption that directors are acting independently, in good faith and with due care in making a business decision. It applies when that decision is questioned and the analysis is primarily a process inquiry. Courts give deference to directors’ decisions reached by a proper process, and do not apply an objective reasonableness test in such a case to examine the wisdom of the decision itself.

695 A.2d 43, 49 (Del. 1997) (footnotes omitted).

7 *Brehm*, 746 A.2d at 264 n.66.
Delaware’s emphasis on responsible corporate governance practices as a standard of conduct is intended to promote good decisionmaking by directors, thereby obviating the specter of judicial second-guessing. Good governance practices permit the time-honored business judgment rule regime to operate with integrity by checking self-interest and sloth while permitting valuable and prudent risk taking.

The goal is to promote good governance and avoid the need (or the temptation) for courts and regulators to second-guess directors. By encouraging sound structures and processes, good disclosure, and fair elections, the courts can continue to accord directors wide discretion, because sound practices of internal corporate governance limit the potential for abuse.9

2. Standard of Review Issues

As noted above, the standards of conduct are the goals and aspirations to which directors should aspire. Standards of review are the standards that courts apply in judging the conduct of directors.10

The standards of review include various gradations of judicial scrutiny. If the business judgment rule applies, courts will not second-guess directors or even question whether a business decision is “reasonable.” But the takeover era of the 1980s, culminating in the watershed year of 1985, led to more and increasingly complicated

8 For an excellent primer on good corporate governance practices by directors in aspiring to high standards of conduct, see THE CORPORATE DIRECTORS GUIDEBOOK (5th ed. 2007), available from the ABA Section of Business Law and reproduced at 62 Bus. Law. 1482 (2007).

9 Veasey & DiGuglielmo, supra n.2 at 1406.

10 Id. at 1416-1435.
standards of review. For example, the Delaware Supreme Court has articulated differing
review mechanisms to be applied in various contexts, ranging from testing the
reasonableness and proportionality of the directors’ resistance to a takeover under the
Unocal\textsuperscript{11} standard, to the “entire fairness” test applying to controlling stockholder
transactions under Weinberger,\textsuperscript{12} to the “best price on sale of control” standard under
Revlon\textsuperscript{13} and QVC.\textsuperscript{14}

3. “Vicinity” or “zone” of insolvency

For many years there has been a very challenging and debatable issue of whether
(and to what extent) directors, in making their business decisions when the corporation is
in the vicinity or zone of insolvency, may be required to consider the interests of
creditors—a different constituency from that to which their duties normally extend,
namely stockholders. In his 1991 opinion in Credit Lyonnais Bank Nederland, N.V. v.
Pathe Communications Corp., then-Chancellor Allen stated that “[a]t least where a
corporation is operating in the vicinity of insolvency, a board of directors is not merely
the agent of the residue risk bearers, but owes its duty to the corporate enterprise.”\textsuperscript{15} The
Chancellor then provided, in his famous footnote fifty-five, an example of how the

\begin{footnotes}
\item[12] See Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983) (holding that in a
transaction involving conflicted insiders, those who are conflicted have the burden to
satisfy the court that the transaction is entirely fair to stockholders or the corporation,
both as to fair price and fair process).
\end{footnotes}
possibility of insolvency can alter the incentives facing directors in their decisionmaking processes. 16

The key here is that directors, in these and all circumstances, must act in the honest belief that they are carrying out the best interests of the corporate entity. In Production Resources Group, LLC v. NCT Group, Inc., 17 a creditor of NCT Group sought to have a receiver appointed for NCT under title 8, section 291 of the Delaware General Corporation Law (DGCL), and also alleged certain breaches of fiduciary duty. The Court of Chancery largely denied a motion to dismiss the action, allowing the section 291 claims and some of the fiduciary duty claims to proceed. In his decision, Vice Chancellor Strine stated that the plaintiff had sufficiently pleaded:

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 preferential treatment of the company's primary creditor and de facto controlling stockholder (and perhaps of its top officers, who are also directors) without any legitimate basis for the favoritism. 18

I cite Production Resources not because it announces anything new. Rather, it reaffirms what, in my view, has always been the law—that directors who make good faith, careful

16 In that footnote, former Chancellor Allen stated:

The 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 the efficient and the 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.

Id. at *108 n.55.

17 863 A.2d 772, 775 (Del. Ch. 2004).

18 Id. at 800 (emphasis added).
judgments in the honest belief that they are acting in the best interests of the corporation should not fear liability.

Nevertheless, there is an issue here that should be heeded. Directors facing a collapsing enterprise in the vicinity of insolvency may be under some constraints to take action and prudent risks to preserve the enterprise and attempt to get the best transaction available that will benefit the entity, and thus stockholders and creditors.

For example, directors may flirt with the idea of locking up a “saving” merger transaction in a way similar to that which the directors of NCS Healthcare attempted to do in the famous and controversial Omnicare case.\(^\text{19}\) There, in a highly unusual split decision of the Delaware Supreme Court in which I and Justice (now Chief Justice) Steele dissented, the Court enjoined a lockup of a merger. In our view and the view of Vice Chancellor Lamb, the lockup was permissible. In the vernacular, the merger was the “only game in town” for directors who had searched diligently and in good faith for the best transaction for the corporation, but were “between a rock and a hard place.” In Omnicare, we said, in dissent:

\[
\begin{align*}
\text{The process by which this merger agreement came about involved a joint decision by the controlling stockholders and the board of directors to secure what appeared to be the only value-enhancing transaction available for a company on the brink of bankruptcy.} \\
\text{...}
\end{align*}
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\begin{align*}
\text{... The essential fact that must always be remembered is that this agreement and the voting commitments of Outcalt and Shaw concluded a lengthy search and intense negotiation process in the context of insolvency and creditor pressure where no other viable bid had emerged. Accordingly, we endorse the Vice Chancellor’s well-reasoned}
\end{align*}
\]

\(^{19}\) Omnicare v. NCS Healthcare, Inc., 818 A.2d 914 (Del. 2003).
analysis that the NCS board’s action before the hostile bid emerged was within the bounds of its fiduciary duties under these facts.\textsuperscript{20}

I believe it is likely (but not certain) that the Delaware Supreme Court in the future would uphold director action in circumstances that may be comparable to (if not substantially the same as) those present in \textit{Omnicare} and give conscientious directors in such a predicament the benefit of the doubt.

Yet, prudent counseling today suggests the following. First, the courts are likely to limit and not expand the reach of \textit{Omnicare}. Second, practitioners should not count on the Court to overrule the decision—not only because of stare decisis but also because, if the transacted that is to be tested provides legitimate distinctions from \textit{Omnicare}, the reach of the Court’s decision on review, will be limited. So, it should not become necessary or practical for the Court to overrule \textit{Omnicare}.

Finally, the Delaware Supreme Court is a practical institution and has expertise in business law. A deal protection measure that makes good business sense, particularly if the transaction appears to the board to be necessary to save the corporation, should pass muster if the board has followed a best practices process in good faith. I caution, however, that a disingenuous attempt to use some transparently artificial measure that is too-clever-by-half in order to try to get around \textit{Omnicare} in a superficial way while maintaining an ironclad lockup with no realistic wiggle room may be too aggressive and may result in the practitioner taking an unnecessary risk that \textit{Omnicare} will be

\textsuperscript{20} \textit{Id.} at 940 (Veasey, CJ, and Steele, J. dissenting).
overruled. Moreover, unless and until the Delaware Supreme Court is presented with a case that raises questions about the application of *Omnicare*, other courts must treat it as the law of Delaware.

4. The Delaware Supreme Court in 2007 Clarified the Standing of Creditors to Bring Fiduciary Duty Claims

Today, as a result of the 2007 decision of the Delaware Supreme Court in *National American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, the law of Delaware concerning the standing of creditors to sue has been clarified. In *Gheewalla*, creditors brought a direct claim for breach of fiduciary duty in the Delaware Court of Chancery against directors of a Delaware corporation operating in the zone of insolvency. The Court of Chancery dismissed the action for failure to state a claim. The Supreme Court affirmed.

Observing that this was a case of first impression, Justice Holland, writing for the Supreme Court *en banc*, held that: (a) creditors may not assert direct claims for breach of fiduciary duty against directors of a solvent corporation, whether or not it is operating in the “zone of insolvency,” and (b) creditors may not assert direct claims for breach of fiduciary duty against directors of an insolvent corporation. *Gheewalla* also states (in

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22 930 A.2d 92 (Del. 2007).

23 *Id.* at 101.

24 *Id.* at 103; see also *Nelson v. Emerson*, C.A. No. 2937-VCS, 2008 WL 1961150, at *6 n.29 (Del. Ch. May 6, 2008) (acknowledging that creditor had agreed that his direct claims for breach of fiduciary duty should be dismissed in light of the Delaware Supreme Court’s decision in *Gheewalla* “holding that creditors cannot bring direct actions for breach of fiduciary duties”).
dicta, because the plaintiff did not raise, in the Court of Chancery or on appeal, any derivative claim) that creditors of an insolvent corporation have standing to assert derivative claims on behalf of the corporation for breach of fiduciary duty.\textsuperscript{25} The Court does not address, even in dicta, whether creditors of a solvent corporation in the "zone of insolvency" may assert derivative claims.\textsuperscript{26} Moreover, the Court in \textit{Gheewalla} also declined to set forth a precise definition of "zone of insolvency."

The relevant language of the Court follows:

It is well established that the directors owe their fiduciary obligations to the corporation and its shareholders. While shareholders rely on directors acting as fiduciaries to protect their interests, creditors are afforded protection through contractual agreements, fraud and fraudulent conveyance law, implied covenants of good faith and fair dealing, bankruptcy law, general commercial law and other sources of creditor rights. Delaware courts have traditionally been reluctant to expand existing fiduciary duties. Accordingly, "the general rule is that directors do not owe creditors duties beyond the relevant contractual terms."

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... When 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 best interests of the corporation for the benefit of its shareholder owners. Therefore, we hold the Court of Chancery properly concluded that ... the ... Complaint fails to state a claim, as a matter of Delaware law, 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.

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It is well settled that directors owe fiduciary duties to the corporation. When a corporation is \textit{solvent}, those duties may be enforced by its

\textsuperscript{25} \textit{Gheewalla}, 930 A.2d at 101.

\textsuperscript{26} \textit{See Production Resources}, 863 A.2d at 790 n. 56.
shareholders, who have standing to bring derivative actions on behalf of the corporation because they are the ultimate beneficiaries of the corporation’s growth and increased value. When a corporation is insolvent, however, its creditors take the place of the shareholders as the residual beneficiaries of any increase in value.

Consequently, the creditors of an insolvent corporation have standing to maintain derivative claims against directors on behalf of the corporation for breaches of fiduciary duties. The corporation’s insolvency “makes the creditors the principal constituency injured by any fiduciary breaches that diminish the firm’s value.” Therefore, equitable considerations give creditors standing to pursue derivative claims against the directors of an insolvent corporation. Individual creditors of an insolvent corporation have the same incentive to pursue valid derivative claims on its behalf that shareholders have when the corporation is solvent.

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... 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, as discussed earlier in this opinion, that may be available for individual creditors.

* * *

The creditors of a Delaware corporation that is either insolvent or in the zone of insolvency have no right, as a matter of law, to assert direct claims for breach of fiduciary duty against its directors.27

So, it is clear that creditors have no direct fiduciary duty claims against directors of an insolvent corporation or a solvent one, whether or not it is in the “zone of

27 Id. at 99-103 (footnotes omitted; some alterations in original).
insolvency.” If the corporation is actually insolvent, they may have derivative claims to make on behalf of the corporate entity, if the facts support such a claim. Whether creditors may bring derivative claims against directors of a corporation that is solvent but in the zone of insolvency is unclear, but doubtful as a practical matter, in my view.

5. Authorities Before Gheewalla

As the opinion in Gheewalla catalogues, there were a number of cases after Credit Lyonnais that either contributed to the confusion or to the clarity of the law relating to directors’ fiduciary duties in these areas. Justice Frankfurter’s 1943 quote about fiduciary duties is a good starting point:

But to say that a man is a fiduciary only begins analysis; it gives direction to further inquiry. To whom is he a fiduciary? What obligations does he owe as fiduciary? In what respects has he failed to discharge these obligations? And what are the consequences of his deviation from duty?

In Production Resources v. NCT Group Vice Chancellor Strine presented a discursive analysis of the subject of directors’ fiduciary duties. Although he assumed arguendo that there could be a direct creditor claim for violation of fiduciary duty, he did

28 Cf. Nelson, 2008 WL 1961150, at *8-9 (holding that derivative claim that directors breached their fiduciary duty of loyalty by filing for bankruptcy in a bad faith effort to frustrate a creditor’s secured claims against the company failed to state a claim because “the directors of a Delaware corporation do not commit a breach of fiduciary duty if they have the corporation file a non-frivolous claim, seeking to recharacterize certain debt as equity in order to protect the interests of the company’s equity holders”); id. at *2 (“an insolvent company is not required to turn off the lights and liquidate when that company’s directors believe that continuing operations will maximize the value of the company”).


30 Supra n.17.
not decide that question. He decided only that directors of an insolvent corporation have fiduciary duties to the corporation that creditors may have standing to pursue on behalf of the corporation unless those claims are merely due care claims that are barred by the Delaware director exoneration statute.

In *Trenwick America Litigation Trust v. Ernst Young, L.L.P.*, Vice Chancellor Strine clarified further the import of the *Credit Lyonnais* language. He stated in *Trenwick*, as he had in *Production Resources*, that the language in *Credit Lyonnais* was not intended as a sword hanging over the heads of directors. Rather, it was more in the nature of a shield. That is, to the extent that directors of a corporation in the zone of insolvency may consider the rights of creditors in the context of their duties in serving the corporate entity, they may not be breaching their duty to stockholders.

So, *Credit Lyonnais* is not a case that endorses a theory of liability based on “deepening insolvency” of an insolvent Delaware corporation. Rather, in *Trenwick*, the Court explicitly rejected the notion that there is a viable fiduciary duty claim of “deepening insolvency,” in the following language:

> 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

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31 Id. at 800. Other cases employing the “arguendo” assumption include the Court of Chancery decision in *Gheewalla* and *Big Lot Stores, Inc. v. Bain Capital Fund VI LLC*, 922 A.2d 1169 (Del. Ch. 2006).

32 Del. Code Ann. tit. 8, § 102(b)(7). He also declined to decide the application of derivative pleading standards under Court of Chancery Rule 23.1.

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.

The rejection of an independent cause of action for deepening insolvency does not absolve directors of insolvent corporations of responsibility. Rather, it remits plaintiffs to the contents of their traditional toolkit, which contains, among other things, causes of action for breach of fiduciary duty and for fraud. The contours of these causes of action have been carefully shaped by generations of experience, in order to balance the societal interests in protecting investors and creditors against exploitation by directors and in providing directors with sufficient insulation so that they can seek to create wealth through the good faith pursuit of business strategies that involve a risk of failure. 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.

Moreover, the fact of insolvency does not render the concept of “deepening insolvency” a more logical one than the concept of “shallowing profitability....”

For an incisive and scholarly analysis of Gheewalla and Trenwick, see the upcoming article by Michelle M. Harner and Jo Ann J. Brighton, The Implications of North American Catholic and Trenwick: Final Death Knell for Deepening Insolvency? Shift in Directors' Duties in the Zone of Insolvency?

So, in Delaware, at least, directors are not guarantors that insolvency will not “deepen.” Their fiduciary duties to the corporation are the general duties of care and loyalty, to be measured, of course, by the financial and other circumstances in which the corporation finds itself. If a prudent, good faith and deliberative corporate decision

34 Id. at 205.

results in a "deepening insolvency," there should be no valid claim against them solely because, in hindsight, the decision was unsuccessful.

6. Post-Gheewalla Bankruptcy Court Cases

Judge Leif Clark of the Bankruptcy Court of the Western District of Texas in the Medlin case in July 2007 provided a succinct overview of the development of the law from Credit Lyonnais to Gheewalla. Although the adversary proceeding there was recommended\textsuperscript{36} to be dismissed on grounds of res judicata, the Court noted that the Gheewalla decision held that no direct fiduciary duty claims may be maintained by creditors, but indicated that derivative claims and "any other nonfiduciary claims" may be asserted by creditors. Judge Clark went on to add:

The Delaware courts' decisions have proved to be immensely influential in the national debate over the shape of causes of action that have their genesis in breach of fiduciary duties on the part of officers and directors.\textsuperscript{37}

In September 2007, District Judge Harlin Hale of the Northern District of Texas in the Vartec Telecom case\textsuperscript{38} also discussed the impact of Gheewalla:

Prior to the Delaware Supreme Court's decision, an open question had existed as to what fiduciary claims creditors could bring against directors of an insolvent corporation or a corporation operating in the "zone of insolvency." However, in Gheewalla the court clarified that directors owe fiduciary duties to the corporation .... When a corporation is solvent, those duties may be enforced by its shareholders, who have standing to bring derivative actions on behalf of the corporation because they are the ultimate beneficiaries of the corporation's growth and increased value. When a corporation is insolvent, however, its creditors take the place of

\textsuperscript{36} Judge Clark's decision is a recommendation to the District Court. There is no record that the District Court acted on this recommendation.


\textsuperscript{38} Mims v. Fail, 2007 Bankr. LEXIS 3240 (N.D. Tex. Sept. 18, 2007).
the shareholders as the residual beneficiaries of any increases in value, and consequently the creditors of an insolvent corporation have standing to maintain *derivative* claims against debtors on behalf of the corporation for breaches of fiduciary duties....

The guidance offered by *Gheewalla* helps to resolve our issue in this case. The essence of a derivative action is that it is brought in the stead of a direct action brought by the corporation itself. Consistent with the holding in *Gheewalla*, the Chapter 7 Trustee in this case is bringing such a derivative action on behalf of the corporation’s creditors. Thus, it appears that Delaware law also recognizes the cause of action brought by the Trustee in this case.

* * *

Both Texas and Delaware law recognize a cause of action for breach of fiduciary duty against the directors or officers of a corporation may be brought by the creditors of a corporation when the corporation is either insolvent or in the “zone” or “vicinity of insolvency” which is what the Trustee has pled in this case.

Although Judge Hale flatly stated that, under Delaware law, a derivative suit could be asserted by a trustee bankruptcy against directors of a corporation in the “zone of insolvency,” Delaware Courts have not explicitly so held. Nor have they defined “zone of insolvency,” as expressly noted in *Gheewalla*. So, not only does that term defy definition and has no judicial gloss in Delaware, but also it is unclear how it would apply as a practical matter to the standing of a creditor or trustee to assert a derivative claim on behalf of a Delaware corporation in that status. My own view is that the assertion of such a claim would be highly problematic.

39 See *Gheewalla*, 930 A.2d at 99 n.26 (citing Veasey & DiGuglielmo, *supra* note 2, at 1432). The Court noted further regarding the “zone of insolvency” that the “subject has been discussed, however, in several judicial opinions and many scholarly articles,” and cited a number of such authorities and writings. *Id.* at 99 n.27, 99 n.28.

40 But see *Stanziale v. Dalmia (In re Allserve Systems Corp.)*, 379 B.R. 69, 79 (Bank D. N.J. 2007) in which the Bankruptcy Court sitting in the District of New Jersey, departed
It makes sense to me that Vice Chancellor Strine is correct in his analysis in *Production Resources* and *Trenwick* that the *Credit Lyonnais* dictum is not a sword in the hands of *creditors* to make fiduciary duty claims against directors of a corporation in the "zone of insolvency" for "deepening insolvency" or to provide them with standing to sue derivatively while the corporation is solvent. Rather, it is a shield against *stockholder* claims that permit directors to consider the interests of creditors when evaluating their business decisions on behalf of the corporation.

A recent decision by Vice Chancellor Strine in *Nelson v. Emerson* further reinforces the view that *Credit Lyonnais* did not create a new duty to creditors, independent of the duty to the corporation. In *Nelson*, the Court of Chancery dismissed a creditor's claims for breach of fiduciary duty because the creditor was collaterally estopped from bringing them by a decision by the Bankruptcy Court for the Northern District of Illinois. But Vice Chancellor Strine opined that the claims also failed to state a claim upon which relief could be granted. The creditor asserted that the company's

from the normal rule that the law of the state of incorporation governs fiduciary duty claims against directors. There, Bankruptcy Judge Michael Kaplan applied New Jersey law to claims by a Chapter 7 trustee against fiduciaries of a Delaware corporation on the ground that New Jersey had "substantial and more significant interests." Indeed he held that the New Jersey contacts meant that it had the "paramount interest," trumping the interests of Delaware, the state of incorporation. Although the Court also said that the claims are not limited to those involving internal affairs of the corporation, I believe that the law of the state of incorporation should control the fiduciary duty claims.

41 *Geyer v. Ingersoll Publications Co.*, 621 A.2d 784, 787 (Del. Ch. 1992) ("[T]he general rule is that directors do not owe creditors duties beyond the relevant contractual terms.").

42 See also *The Ins and Outs for Ds and Os: In the Zone: Fiduciary Duties and the Slide Toward Insolvency*, 5 DePaul Bus. & Com. L.J. 667, 676-82 (2007) (to the same effect).

directors had breached their fiduciary duties by filing for bankruptcy in a bad faith effort to frustrate the creditor’s efforts to collect on his secured claims against the company.\textsuperscript{44}

Rejecting that claim, the court observed:

the directors of a Delaware corporation do not commit a breach of fiduciary duty if they file a non-frivolous claim, seeking to recharacterize certain debt to equity in order to protect the interests of the company’s equity holders. In such a circumstance, the non-frivolous, good faith nature of the lawsuit makes filing that lawsuit a decision that is protected by the business judgment rule.\textsuperscript{45}

The decision in \textit{Nelson} thus highlights the longstanding principle that directors’ duties run to the company and that directors’ disinterested, independent, and good faith business decisions will be protected by the business judgment rule.

Moreover, in my view, the “zone of insolvency” might lie within such a narrow and ambiguous band that it has little practical application when considering the standing of a creditor or trustee to assert a derivative claim. If it means uncertainty about whether the corporation is, in fact, insolvent, then the directors need the best financial and legal advice obtainable in order to determine on which side of the solvency line the corporation is sitting. But I don’t think the concept of the zone of insolvency should give creditors standing to sue derivatively if the corporation is, in fact, solvent but close to the line of insolvency. Nevertheless, directorial focus on the best interests of corporate viability and a skeptical view of the wisdom of aggressive risk-taking would seem to be the best advice for fiduciaries of a corporation that is close to the line.

\textbf{7. Summary and Conclusion}

\textsuperscript{44} \textit{Id.} at *9.

\textsuperscript{45} \textit{Id.}
Directors owe fiduciary duties of due care and loyalty to the enterprise. And stockholders, having supporting facts, may sue either derivatively or, if applicable, directly. Creditors have no standing to bring a direct fiduciary duty claim but do have standing to sue derivatively if the corporation is insolvent. I doubt that creditors have standing to sue derivatively if the corporation is solvent but close to insolvency. The main counseling lesson is that directors should always follow best practices in the interests of the corporate enterprise, particularly those articulated in the 2007 version of *The Corporate Directors Guidebook*.47

Those best practices should tend to guide directors in avoiding derivative or direct stockholder claims for violation of the duties of care and loyalty in a solvent corporation.48 Similarly, they should help directors to avoid liability to an insolvent corporation in a derivative action brought by a creditor.


47 *The Corporate Directors Guidebook*, supra note 8.

48 It is to be noted that Section 102(b)(7) of the DGCL permits a corporation in its charter to exonerate directors from personal liability “to the corporation or its stockholders” for due care violations but not loyalty or good faith violations. Most states have comparable provisions and most public corporations have enshrined the exoneration provision in their charters. Following *Production Resources* and *Trenwick*, Section 102(b)(7) is applicable to due care claims in the case of derivative suits brought by creditors on behalf of a corporation that is insolvent or in the “zone of insolvency.”
TAB B
RECENT DEVELOPMENTS RE: FIDUCIARY DUTY
IN THE ZONE OF AND DURING INSOLVENCY
AND RE: DEEPENING INSOLVENCY

Sally S. Neely
Sidley Austin LLP
Los Angeles, California
(September 7, 2007)

Lawrence P. King & Charles Seligson
Workshop on Bankruptcy and
Business Reorganization
September 26-28, 2007
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RECENT DEVELOPMENTS RE: FIDUCIARY DUTY IN THE ZONE OF AND DURING INSOLVENCY AND RE: DEEPENING INSOLVENCY

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 Pathe/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.

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 ha[d] 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 traded in pennies – shares far in excess of what [was] authorized by its charter.” Id. 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 shares 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 its 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." \textit{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\textsuperscript{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 ha[d] 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 ha[d] allegedly been additional convertible notes of NCT itself." \textit{Id.} at 781. According to the court, the allegations of the complaint "generate[d] an aroma of fiduciary infidelity." \textit{Id.}

(footnote continued...)

\textsuperscript{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." \textit{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. PRO 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. PRO 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 788.11 The

11 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 prudent 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.

Production Resources, 863 A.2d at 788 (citing Credit Lyonnais, 1991 WL 277613, at *34 & n.55). As articulated by Bankruptcy Judge Gropper in In re Granite Broadcasting Corp., 369 B.R. 120, 135 (Bankr. S.D.N.Y. 2007) (citations omitted): "When a company is in the vicinity of insolvency a board of directors ...
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.*

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. 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.*

(footnote continued ...)

has a responsibility to manage its affairs in the interests of the corporation and all of its constituencies. ... There is no duty to abdicate and turn over control to a third party or, worse, to one of the constituencies." 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)).


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 ...
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

15 The bankruptcy court in Liquidating Trustee v. Baker (In re Amcast Industrial Corp.), 365 B.R. 9, 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

Production Resources, 863 A.2d at 790 n.57 (citation omitted).
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).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.17 The court also noted that section 102(b)(7) should remain applicable in chapter 11. See id. at 792 n.63.

(footnote continued...) fiduciaries who received or hold assets transferred by a corporation while insolvent. "The Trustee need not prove that the transfer occurred by the commission of some wrong or unconscionable conduct, only that the transfer occurred outside the prescribed order of distribution and harmed creditors." Id. at 181. 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.

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..."
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

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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, tortuous 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

(please note 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. Wittycombe, 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 Futech’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.

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 fiducial 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.
Id. at 799-800 (footnotes omitted). The court found that these allegations supported a non-exculpated, derivative claim for injury to the NCT.

(4) 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. 25

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

24 In another context – PRG's claim for the appointment of a receiver – the court described the situation as follows:

PRG has pled facts that rationally support the inference that NCT's board, facing a situation in which its primary duty is to maximize the value of assets available to satisfy its creditors, is, instead, operating in concert with the company's de facto controlling stockholder to avoid payment of debts to a large creditor, to advantage that controlling stockholder (and her family's companies) and NCT's top managers to the detriment of outside creditors of the firm.

. . . [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.

25 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. 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.

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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.28 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.
(2) 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”;

(3) 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”;

(4) “[T]he 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 Clearwire 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 Clearwire under which Clearwire 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 Clearwire’s board, and were able to control Clearwire, 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 Clearwire, by “not preserving the assets of Clearwire for [the] benefit . . . of its creditors when it became apparent that Clearwire 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 Clearwire 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, Clearwire 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, Clearwire 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). 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.

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

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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. The impetus for this decision was the need for "more precise conceptual line drawing." *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. *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.” *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 creditors in the "zone of insolvency"...

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31 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 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. DEEPENING INSOLVENCY

A. CltX: 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 Seitz v. Detweiler, Hershey & Assocs., P.C. (In re CltX 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 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., CltX, 448 F.3d at 677. CltX also involved the application of Pennsylvania law.

In CltX, “[a]n insolvent internet company involved in an illegal Ponzi scheme used its financial statements, compiled by its accounting firm, to attract investors.” 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 CltX, and wrongfully expanded the debt of CltX and waste of its illegally raised capital, by permitting CltX to incur additional debt by virtue of the compilation statements prepared and relied upon by third parties.’” Id. at 677. Thus, the court had “to decide whether deepening insolvency is a viable theory of damages for negligence” (id. at 677) – and it concluded that it is not. According to

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).

33 The court also indicated that deepening insolvency would not be a valid theory of damages for any cause of action, such as fraud. CltX, 448 F.3d at 677 n.8. Accord, Christians v. Grant Thornton, L.L.P., supra, 733 N.W.2d at 810-12. In 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.
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.35 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.36

(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, ShalJows 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.”

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...”

(foothe note 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 (7th 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 __, 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 *Laffery*, 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 “heightens[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.
averting costs of some $3 million that the company incurred as a result of its continued operation under the restrictions imposed by [its secured lender] and other adversities.” Id. at 1.

Nevertheless, the Seventh Circuit held, the trustee’s claim failed because E&Y had not violated auditing standards in failing to predict Taurus’s demise based on the information made available to it by the company. Further, the claim was barred by Indiana’s one-year statute of limitations because management was aware of the problem more than a year before Taurus’s bankruptcy filing.

The Seventh Circuit discussed deepening insolvency because “[t]he trustee’s damages claim [was] based on the theory of ‘deepening insolvency’” (id. at *2). The court said:

[A]s explained in Trenwick . . . , the theory makes no sense when invoked to create a substantive duty of prompt liquidation that would punish corporate management for trying in the exercise of its business judgment to stave off a declaration of bankruptcy, even if there were no indication of fraud, breach of fiduciary duty, or other conventional wrongdoing. Nor would it do to fix liability on a third party for lending or otherwise investing in a firm and as a result keeping it going, when “management . . . misused the opportunity created by that investment . . . [T]hey [management] could have instead used that opportunity to turn the company around and transform it into a profitable business. They did not, and therein lies the harm to [the company].” In re CitX, 448 F.3d 672, 678 (3d Cir. 2006).

Fehribach, 2007 WL 2033734, at *2. However, the court considered the case before it to be “different” in that, under applicable Indiana law, creditors are not permitted to sue auditors directly. Id. Therefore, it addressed whether a chapter 7 trustee’s suit against the auditor for negligence and breach of contract would nonetheless lie, even though recovery would benefit only creditors, and determined that it would: the auditor’s “duty to its client, Taurus, . . . does not evaporate just because the client is bankrupt and any benefits from suing will accrue to its creditors. Id. at *3. Nevertheless, as noted above, the court affirmed the summary judgment because the auditor had not breached its duty and because the statute of limitations had run.

By contrast, in a curious opinion, the court in Buckley v. O’Hanlon, 2007 WL 956947 (D. Del. Mar. 28, 2007), cited the Court of Chancery’s opinion in Trenwick for the proposition that “[i]n Delaware, there is no general duty to liquidate an insolvent company” (id. at *9), but then ignored the Trenwick decision entirely in its analysis of the viability of a claim for deepening insolvency under Delaware law. See id. at *7-8. Instead, without independent analysis, it relied, on the Delaware bankruptcy court’s opinion in Oakwood Homes, 340 B.R. at 531 – which was criticized in Trenwick (see note 42, supra) – that Delaware would recognize 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. 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*). 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.

_Id._

"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_?50) 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."
TAB C
Potential Liability For Deepening Insolvency And Breach Of Fiduciary Duty To Creditors

Robert B. Millner
Sonnenschein Nath & Rosenthal LLP
Chicago, Illinois

Sally Neely
Sidley Austin LLP
Los Angeles, California

Michael H. Reed
Pepper Hamilton LLP
Philadelphia, Pennsylvania
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POTENTIAL LIABILITY FOR DEEPENING INSOLVENCY AND BREACH OF FIDUCIARY DUTY TO CREDITORS

When a corporation is in serious financial distress, complex issues arise with respect to the directors' (and officers') duties to the corporation, its shareholders, and its creditors. This paper will address two overlapping areas of law - breach of fiduciary duty to creditors and deepening insolvency. These concepts, while often litigated in bankruptcy courts, essentially deal with the prepetition conduct of the debtor and liabilities incurred by the company before filing for bankruptcy relief (and even if there is no filing). The wrongful conduct that is alleged is, in substance, the failure to maximize or preserve the entity's value available to pay creditors and/or the creation of illusory corporate health by those with superior knowledge regarding the company's withering abilities. Both theories continue to evolve creating uncertainty about the nature and breadth of the concepts.*

This paper will first deal with breach of fiduciary duties and the potential liabilities. In particular, the paper will address a recent decision by the Delaware Chancery Court, In re Production Resources Group, LLC v. NCT Group, Inc., No. C.A. 114-N., 2004 WL 2647593 (Del. Ch. Nov. 17, 2004), which may have a significant impact on the development of law in this area. Second, this paper will address the theory of deepening insolvency, which has been used to impose liability upon defendants for prolonging corporate life to the detriment of the corporation and the creditor body. In particular, this section will focus on two cases from last year - the Third Circuit's decision in Seitz v. Detweiler, Hershey and Associates (In re CITX Corp., Inc.), 448 F.3d 672 (3d Cir. 2006) and the Delaware Chancery Court's decision in Trenwick America Litigation Trust v. Ernst & Young, L.L.P., No. Civ. A., 2006 WL 2333201 (Del. Ch. June 2, 2006) - both of which may signal a reversal of prior acceptance of deepening insolvency liability.

I. FIDUCIARY DUTIES OF OFFICERS AND DIRECTORS

The concept that the fiduciary duties of directors shift from shareholders to creditors in the event of insolvency is not new; indeed, its origin has been traced by courts and commentators to the "trust fund doctrine" promulgated 175 years ago by Justice Story in Wood v. Dummer, 30 F. Cas. 435 (C.C.D. Me. 1824) (No. 17,944). See In re Mortgageamerica Corp., 714 F.2d 1266, 1268-69 (5th Cir. 1983). Under this theory, upon insolvency of the corporation, the directors become "trustees" for creditors and hold corporate assets as a "trust fund" for their benefit. Id. at 1269; Clarkson Co., Ltd. v. Shaheen, 660 F.2d 506, 512 (2d Cir. 1991), cert. denied 455 U.S. 990 (1992). More recent leading decisions are Geyer v. Ingersoll Publications Co., 621 A.2d 1266, 1268-69 (5th Cir. 1983). Under this theory, upon insolvency of the corporation, the directors become "trustees" for creditors and hold corporate assets as a "trust fund" for their benefit. Id. at 1269; Clarkson Co., Ltd. v. Shaheen, 660 F.2d 506, 512 (2d Cir. 1991), cert. denied 455 U.S. 990 (1992). More recent leading decisions are Geyer v. Ingersoll Publications Co., 621 A.2d 1266, 1268-69 (5th Cir. 1983). Under this theory, upon insolvency of the corporation, the directors become "trustees" for creditors and hold corporate assets as a "trust fund" for their benefit. Id. at 1269; Clarkson Co., Ltd. v. Shaheen, 660 F.2d 506, 512 (2d Cir. 1991), cert. denied 455 U.S. 990 (1992). More recent leading decisions are Geyer v. Ingersoll Publications Co., 621 A.2d 784 (Del. Ch. 1992) and Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., No. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991). Credit Lyonnais, in particular, contains the now famous statement imposing broadened duties when "a corporation is operating in the vicinity of insolvency." Id. at *34. Recently, however, the Delaware Chancery Court issued an opinion specifically disagreeing with the idea that Credit Lyonnais expands the duties of directors. Prod. Resources, 2004 WL 2637593, *12 (Del. Ch. Nov. 17, 2004) (discussed more

* The authors wish to acknowledge the significant contribution of Matthew B. Stein, an associate of Sonnenschein Nath & Rosenthal LLP, to the research and writing of this paper.
fully infra, §B(1)(a)). In particular, Production Resources takes issue with cases which interpret Credit Lyonnais to stand for either the proposition that (i) directors' fiduciary duties shift at or prior to insolvency or (ii) creditors are given direct (as opposed to derivative standing) rights against directors when a company is insolvent.

In general, judicial decisions in which a breach of fiduciary duty to creditors is found involve diversion or disposition of assets from an insolvent or near insolvent entity for the benefit of insiders or shareholders — the type of conduct regulated by fraudulent transfer, preference, and illegal dividend statutes. The fiduciary concept often functions to extend the reach of personal liability for such conduct, and most specifically to impose personal liability on directors for fraudulent transfers by a corporate entity. Official Committee of Asbestos Claimants of G-I Holding, Inc. v. Heyman, 277 B.R. 20, 37 (S.D.N.Y. 2002) (distribution to shareholders constituted not only fraudulent transfer but also breach of fiduciary duty to creditors by debtor's chairman, CEO and controlling shareholder); Hechinger Investment Co. of Del. V. Fleet Finance Group, 274 B.R. 71, 89-91 (D. Del. 2002) (even where payments to debtor’s shareholders in connection with LBO were insulated from avoidance as settlement payments under Code § 546(e), directors could still be personally liable for transfer amounts based on breach of fiduciary duty to creditors). “Whereas the remedy for a fraudulent transfer claim is avoidance of the transfer and recovery from the transferee, the remedy for breach of fiduciary claim is a money judgment against the directors and their aiders and abettors.” Hechinger Investment Co., 274 B.R. at 89 n.8. Not only directors, but also officers and, in most jurisdictions, all those who aid, abet, or conspire — may be personally liable for breach of fiduciary duty to creditors.¹

A. Basic Principles

To analyze fiduciary duties that arise in the insolvency context, one must start with the base case, a solvent, non-distressed corporation.

¹ See In re Healthco Int'l, Inc., 208 B.R. 288, 309-10 (Bankr. D. Mass 1997) (recognizing action under Delaware law for aiding and abetting breach of fiduciary duty in approval of LBO); Crowthers McCall Pattern Inc. v. Lewis, 129 B.R. 992, 999 (S.D.N.Y. 1991) (denying lenders' motion to dismiss count asserting aider/abettor fiduciary liability in connection with directors' approval of LBO); Amerifirst Bank v. Bomar, 757 F. Supp. 1365, 1380 (S.D. Fla. 1991) (the majority of case law ... recognizes a cause of action for aiding and abetting common law torts, such as breach of fiduciary duty.″). Compare cases applying Illinois law: Shapo v. Engle, 1999 U.S. Dist. LEXIS 17966 at *60 (N.D. Ill. Nov. 10, 1999) ("Although it seems that at one point Illinois did not recognize a tort of aiding and abetting a breach of fiduciary duty, it appears that such a claim is now viable."); but see Koutsoubos v. Casanave, 816 F. Supp. 472, 475 (N.D. Ill. 1993) ("Illinois has never recognized the tort of aiding and abetting a breach of a fiduciary duty."); cf. Technic Engineering, Ltd. v. Basic Envirotech, Inc., 53 F. Supp. 2d 1007, 1011, 1012 (N.D. Ill. 1999) (Illinois law recognizes liability "for inducement or participation in breach of fiduciary duty."); In re Aluminum Mills, Corp., 132 B.R. 869, 892 (Bankr. N.D. Ill. 1991) (noting "[u]nder Illinois law, a third party's inducement of, or knowing participation in, a breach of duty by an agent is a wrong against the principal that may subject the third party to liability" and denying motion to dismiss claim of inducement (as opposed to aiding and abetting) of breach of fiduciary duty).
1. **Duties Owed in a Solvent Corporation**

State corporation statutes generally vest responsibility for management of the corporation's business and affairs in a board of directors. See, e.g., Del. Code Ann. tit 8, § 141(a). The directors, in turn, owe fiduciary duties to stockholders of a solvent corporation. It is the stockholders who own the corporation and who have entrusted the directors with control and management of their property.

The duties owed by directors are principally duties of loyalty and care. The duty of loyalty requires that directors act in good faith and in the reasonable belief that the action taken is in the best interests of the corporation. This duty prohibits self-dealing-type conduct, such as, misappropriation of corporate opportunities, taking excessive compensation, and utilizing corporate assets or information for personal gain.

The duty of care requires that directors exercise the care that an ordinarily prudent person would exercise under similar circumstances. Delaware, however, allows corporations, by provision in the certificate of incorporation, to eliminate personal liability of directors to the corporation or its stockholders for failure to act with due care (but not liability for breach of duty of loyalty or intentional misconduct). Del. Code. Ann. tit. 8 § 102(b)(7). More than 40 other states have passed similar statutes.

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2 Section 8.30(a) of the Model Business Corporation Act provides:

A director shall discharge his duties as a director . . .

(1) in good faith; (2) with the care an ordinary prudent person in a like position would exercise under similar circumstances; and (3) in a manner he reasonably believes to be in the best interests of the corporation.


3 See Ramesh K.S. Rao, David Simon Sokolow & Derek White, "Fiduciary Duty a la Lyonnais: An Economic Perspective on Corporate Governance in a Financially-Distressed Firm," 22 J. Corp. L. 53, 60-61 (1996) (collecting cases to illustrate specific violations of duty of loyalty). See also Pepper v. Litton, 308 U.S. 295, 306-07, 311 (1939) ("The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain.... He who is in such a fiduciary position cannot serve himself first and his cestuis second.")

Model Bus. Corp. Act § 8.30(a). See also Richard M. Cieri, Patrick F. Sullivan & Heather Lennox, "The Fiduciary Duties of Directors of Financially Troubled Companies," 3 J. Bankr. L & Prac. 405, 406 (1994) ("The duty of care requires that directors act in an informed and considered manner, meaning that prior to making a business decision, the directors must have informed themselves of 'all material information reasonably available to them' and, 'having become so informed, they must then act with requisite care in the discharge of their duties.")") (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

5 See Rao, supra note 7, at 59
2. Business Judgment Rule

Directors are also protected by the business judgment rule, which is a judicially created "presumption that in making a business decision the director of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company." In re Healthco Int'l, Inc., 208 B.R. 288, 306 (Bankr. D. Mass. 1997) (quoting Aronson, 473 A.2d at 812). The protection of the business judgment rule will be lost upon a showing of inter alia improper director interest in a transaction (if the transaction is not approved by a majority of disinterested directors) or that the director has not adequately informed himself. Id. If the protection of the business judgment rule is lost, the burden shifts to the director to prove the fairness of the challenged transaction.

3. No Fiduciary Duty to Creditors

Another basic rule is that directors of a solvent company do not owe fiduciary duties to creditors. A leading case, Simons v. Cogan, 549 A.2d 300, 302-04 (Del. 1988), holds that no fiduciary duties are owed to holders of a corporation's convertible debentures. Federal decisions have upheld this principle in change of control situations, where debtholders assert (unsuccessfully) that the transaction (an LBO or other acquisition) will impair their ability to be paid. There are limited exceptions to the general rule.

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7. See Cieri, supra note 6 at 547-49 (discussing actions leading to loss of business judgment rule protection). It does appear, however, that the burden to overcome the business judgment rule has increased to an extent where only the most egregious conduct would vitiating the rule. See In re Walt Disney Company Derivative Litigation, 35 Employee Benefits Cas. (BNA) 1705, 2005 WL 2056651 at *30 (Del. Ch. 2005) (stating that while there existed "many aspects of defendants' conduct that fell significantly short of the best practices of ideal corporate governance", best practices are not relevant in determining whether fiduciary duties were breached).

8. See Cieri supra note 6, at 549 n.47 (citing Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983)) for proposition that under "entire fairness" standard of review, directors must establish that the transaction in question was the product of both fair dealing and a fair price).

9. Accord Lorenz v. CSX Corp., 1 F.3d 1406,1417 (3d Cir. 1993) ("Even if the debentures are convertible, the debentureholder is merely a creditor who is owed no fiduciary duty until conversion takes place"). See generally Weil, Gotshal & Manges, Reorganizing Failing Businesses, ch. 16 at 5-9 (1998) (also noting several cases finding that directors do not owe duties to creditors).

B. Fiduciary Duties Upon Insolvency

A number of cases state that when a corporation becomes insolvent, "the fiduciary duty of directors shifts from the stockholders to the creditors." FDIC v. Sea Pines Co., 692 F.2d 973, 976-77 (4th Cir. 1982), cert. denied, 461 U.S. 928 (1983). "[I]t is universally agreed that when a corporation approaches insolvency or actually becomes insolvent, directors' fiduciary duties expand to include general creditors." In re Kingston Square Assoc., 214 B.R. 713, 735 (Bankr. S.D.N.Y. 1997) (holding that an "independent" director of several "bankruptcy proofed" entities whose consent was needed for a bankruptcy filing breached his fiduciary duty to creditors and limited partners by failing to ratify involuntary filings). In one court's view, upon insolvency "the rights of creditors become paramount." In re Healthco Int'l, 208 B.R. at 300 (applying Delaware law). See also Weil, Gotshal & Manges, n. 13, at 11 (collecting numerous cases).

The reason for this shift in duties, as articulated in this line of cases, is easily understood. Creditors deal with corporations by entering into contracts or recovering on tort liability. As long as the corporation is solvent, satisfaction of creditors' claims requires only compliance with their contracts, and maintenance of adequate insurance and cash flow to pay tort claims. "The business decisions of managers will ... have no affect [sic] on the income of creditors." In re Ben Franklin Retail Stores, Inc., 225 B.R. 646, 653 (Bankr. N.D. Ill. 1998), aff'd in relevant part, No. 97 C 7904 (N.D. Ill. Oct. 20, 1999). Shareholders, in contrast, are residual claimants on the corporation's assets and cash flow. "So long as the corporation is solvent, business decisions made by managers directly affect the income of shareholders."13 As set forth in Ben Franklin:

The economic rationale for the "insolvency exception" is that the value of creditors' contract claims against an insolvent corporation may be affected by the business decisions of managers. At the same time, the claims of the shareholders are (at least temporarily)

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11 Directors of banking institutions owe fiduciary duties to depositors, and directors of nonbanking corporations that hold funds in trust owe fiduciary to the owners of the funds held in trust. See Weil, Gotshal & Manges, supra note 9, at 16-9. An exception also arises out of "constituency statutes," enacted in the mid 1980s largely in response to takeover activities. See Cieri, supra note 10, at 540 n.31 (collecting statutes). These statutes generally authorize but do not require director consideration of non-shareholder constituencies.

12 Credit Lyonnais, a significant case, states the rule differently. "At least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise." 1991 WL 277613, at *34. It is clear, however, from the court's discussion, that it had protection encompassing the interests of creditors in mind.

worthless. As a result it is the creditors who "now occupy the
position of residual owners."

225 B.R. at 653 (footnote omitted) (quoting Frost, supra n.18 at 108).

In short, in an insolvency situation, the directors are playing with the creditors' money. "Since the liability of shareholders is limited to their investments, anything the managers do to increase or decrease shareholder equity is primarily to the benefit or detriment of the creditors, rather than the shareholders, until the corporation regains solvency." In re Ben Franklin Retail Stores, Inc., 225 B.R. at 653 n. 13.

1. Scope of the Duty

There is no single formulation, or set of clearly articulated competing formulations, defining a fiduciary duty (or duties) owed creditors upon insolvency. Courts tend, simply, to invoke undefined trust duties. See Bovay v. H.M. Byllesby & Co., 38 A.2d 808 (Del. 1944). To obtain an understanding of how courts have actually understood the fiduciary duty to creditors, one must look closely at specific cases. It should be noted that this area of law is currently in a state of flux. Credit Lyonnais, which has until now been largely credited as expanding the fiduciary duty of directors, has recently been given a limiting interpretation by a recent decision of the same court. See Prod. Resources, 2004 WL 2637593, *12 (discussed more fully infra, §B(1)(a)).

a) The Narrow View (Prohibition Against Self-Dealing and Insider Preferences; Creditor Derivative Standing)

In Production Resources Group, LLC v. NCT Group, Inc., No. C.A. 114-N., 2004 WL 2647593 (Del. Ch. Nov. 17, 2004), a creditor of NCT unsuccessfully pursued collection of its judgment against NCT. In the meanwhile, NCT continued to operate, primarily through capital infusions by the company’s “de facto controlling shareholder” who is alleged to have given liens superior to PRG and other creditors of NCT. Id. at *1. NCT’s public filings indicated it was balance-sheet insolvent and unable to pay debts as they became due. Id. PRG subsequently brought an action to appoint a receiver for NCT and, more relevantly, for breach of fiduciary duty against certain of its directors and officers, notwithstanding the exculpatory charter provisions under Delaware law.

The typical state-court case involves a closely-held corporation in which the directors are also significant shareholders. The alleged breaches of duty generally involve self-dealing. Cases in which fiduciary liability to creditors has been found are collected and catalogued by commentators. See, 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. & Prac. 403, 413-14 (1997); Laura Lin, “Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors’ Duty to Creditors,” 46 Vand. L. Rev. 1485, 1513-22 (1993).
While sustaining the claim to appoint a receiver, the court found PRG's breach of fiduciary duty claims problematic. *Id.* at *3. Although PRG asserted that NCT's insolvency resulted in a direct duty owed to creditors, the court disagreed and held that such claims, when asserted by creditors, are derivative:

Claims of this type are classically derivative, in the sense that they involve an injury to the corporation as an entity and any harm to the stockholders and creditors is purely derivative of the direct financial harm to the corporation itself. The fact that the corporation has become insolvent does not turn such claims into direct creditor claims, it simply provides creditors with standing to assert those claims. At all times, claims of this kind belong to the corporation itself because even if the improper acts occur when the firm is insolvent, they operate to injure the firm in the first instance by reducing its value, injuring creditors only indirectly by diminishing the value of the firm and therefore the assets from which the creditors may satisfy their claims. By the plain terms of § 102(b)(7) an exculpatory charter provision may, as NCT's charter does, insulate directors from due care claims brought by the corporation itself, including derivative claims.

*Id.* at 3.

At its core, *Prod. Resources* articulates a fundamental notion that the objective of directors does not change upon insolvency. At all times, a director owes a duty of care to the corporation, and the so-called "duty to creditors" arises vis a vis the creditors' derivative standing to pursue causes of action that belong to the corporation. At the point of insolvency, it is the creditors who become the residual riskbearers and therefore can prosecute derivative actions as if they were shareholders. Importantly, *Prod. Resources* suggests that *Credit Lyonnais* has been misinterpreted to impose new fiduciary duties upon directors. According to *Production Resources*, what *Credit Lyonnais* really suggests is that directors have the discretion, *but not the obligation*, to pursue less risky business alternatives during times of financial distress where, in the directors' business judgment, such alternative is in the best interests of the corporation and its constituents. Despite its narrow view of duties to creditors, *Production Resources* in fact leaves several doors open for creditors to pursue. While breach of duty of care actions are protected by the Delaware exculpation provision, breach of duty of loyalty claims (self-dealing type conduct) are not. *See Official Committee of Unsecured Creditors v. American Tower Corp. (In re Verestar, Inc.),* 343 B.R. 444, 477 (Bankr. S.D.N.Y. 2006) (holding that, under Delaware law, the Verestar exculpatory provision relieves the directors "of all liability except for breach of the duty of loyalty and knowing, willful violation of law or fraud" (citing *Prod. Resources*, 863 A.2d at 777)). Moreover, *Production Resources* leaves open the idea that actions motivated by directors' self-interest which disadvantage specific creditors could result in the directors' breach of fiduciary duty owed directly to such creditors.
St. James Capital Corp. v. Pallet Recycling Assoc. of North America, Inc., 589 N.W.2d 511 (Minn. App. 1999), the court ruled that directors and officers owe no duty of care to the creditors of an insolvent corporation, and that their fiduciary duty does not extend beyond a prohibition against self-dealing and insider preferences. Accord, Helm Financial Corp. v. MNVA RR., Inc., 221 F.2d 1076, 1082 (8th Cir. 2000) (Under Minnesota law, spinoff of subsidiary to shareholders is not actionable as breach of fiduciary duty to creditors because defendants were not creditors of debtors and hence did not receive insider preferences.).

b) Intermediate Views (Duty To Minimize Loss Upon Insolvency)

(1) New York Credit

New York Credit Men's Adjustment Bureau v. Weiss, 110 N.E.2d 397 (N.Y. 1953), articulates a duty to obtain the best results for creditors in a non-bankruptcy liquidation. New York Credit was an action by a bankruptcy trustee against the directors (and owners) of a corporation, a wholesaler of electrical supplies, that had liquidated its assets through public auction sale. There was no allegation of self-dealing or insider preference, and the auction proceeds were turned over to the bankruptcy trustee upon an involuntary filing shortly after the auction.

The complaint against the directors was that they had failed to personally supervise the liquidation sale. They had instead put the liquidation in the hands of a licensed auctioneer. The cornerstone of plaintiff’s case was that the sale proceeds were too little ($23,262.33), given that the book value of the assets was $73,492.21, and their cost was $60,000. The trustee specifically contended that a larger return could have been obtained in a "proper sale or orderly liquidation." 110 N.E.2d at 399. Yet, there was no allegation of irregularity in the auction or that the sale constituted a fraudulent transfer (or any other fraud).

The court closely scrutinized the directors’ conduct and focused, in particular, on the fact that creditors were not given notice of the sale. The court rejected any notice requirement. "[D]espite the fact that the creditors were primarily concerned with defendant's [sic] activities in this respect, defendants were under no obligation to give notice to each creditor of their intention to convert the assets into cash." 110 N.E.2d at 398. Nevertheless, the court put the burden on defendants to prove that they had obtained "full value under the circumstances." The court did not define what it meant by "full value under the circumstances." The court remanded for a new trial to afford defendants "an opportunity to account for their handling of the res in the matter of the sale and to show that full value was realized for the assets upon the sale." 110 N.E.2d at 400.

(2) Ben Franklin

In re Ben Franklin Retail Stores, Inc., 225 B.R. 646 (Bankr. N.D. Ill. 1998), aff’d in part and rev’d in part, 2000 WL 28266 (N.D. Ill.), is difficult to categorize. The bankruptcy court
decision, which dismisses a fiduciary claim based on fraudulent misrepresentation to creditors, endorses a narrow view of the fiduciary duty to creditors. Yet, core dicta in the case (perhaps reflecting the impact of *Credit Lyonnais* to be discussed next) shows that the court would impose liability for conduct other than transfers resembling insider preferences and fraudulent transfers.

*Ben Franklin* involved a failed chapter 11 of a holding company and subsidiaries that comprised a wholesale and retail variety store business. Upon conversion, the chapter 7 trustee brought suit for breach of fiduciary duty against the debtors' officers and directors. The charge was that the defendants had wrongfully prolonged the debtors' lives through fraudulent valuation of receivables:

They are accused of wrongfully prolonging the Debtors' corporate lives beyond the point of insolvency by misrepresenting the true value of the Debtors' accounts receivable. Specifically, they "refreshed" or redated the due dates of millions of dollars of receivables to make it appear that they were current when, in fact, they were seriously past due. As a result, receivables that should have been written down were recorded at full value. Based on that overvaluation, the Defendants induced creditors to lend money and supply inventory and other value to the Debtors, even after the Debtors were insolvent. Creditors were harmed because the Debtors sank deeper into insolvency as their liabilities grew.

225 B.R. at 649.

As the court recognized, the trustee had made a tactical decision to dress fraud claims, based on individual reliance of specific creditors, as a breach of fiduciary duty (undoubtedly to enhance the prospect of insurance recovery). *See* 225 B.R. at 656. Indeed, in order to assure the trustee's standing and ability to prove damages based on creditor losses, the creditors expressly assigned their claims to the trustee. *See* 225 B.R. at 649.

The bankruptcy court in *Ben Franklin* focused on the theory of law advanced by the trustee and carefully analyzed whether the conduct alleged constituted a breach of the duty of care, as the trustee contended. The court dismissed the complaint, stating that the trustee "has attempted to allege a breach of fiduciary duty. He has failed to do so." 225 B.R. at 656.

The principal basis for the bankruptcy court's ruling in *Ben Franklin* is the view that fiduciary duties to creditors should be limited to something like a prohibition on directors denuding the entity of assets for the benefit of insiders and shareholders:

On this theory, creditors have a right to expect that directors will not divert, dissipate or unduly risk assets necessary to satisfy their
The concept of "unduly risk[ing]" assets in the above quotation is significant. Although dictum (because not necessary to this decision), the articulation of the concept is a part of an attempt by the bankruptcy court to distill a coherent theory based on the case law and academic writing to date. The court continued:

This is not to say that the duty could not be violated by causing the corporation to incur unnecessary debt to or for the benefit of shareholders. Subjecting assets to unwarranted claims is a way of diverting them from legitimate corporate uses. In an appropriate case, therefore, directors who cause their corporation to incur debt may be in breach of duties enforceable by creditors. This is not such a case.

225 B.R. at 656 (footnote omitted).

Moreover, the bankruptcy court viewed the duty of care as very much operative in the area of fiduciary duty to creditors. As authorized by Delaware law, the debtor's certificate of incorporation eliminated liability for failure to act with due care. See 225 B.R. at 652. The directors urged, and the court rejected, the certificate as a defense:

It is also true, however, that shareholders' elect directors; creditors do not. Creditors should not be bound by limitations on the scope of the duties of fiduciaries they had no part in selecting because, unlike shareholders, they cannot protect themselves by being careful in their selection of managers.

More broadly, shareholders' investments in corporations are subject to the rights and limitations of the certificate of corporation. Creditors' "investments" are not; they are subject to specific contracts. The Defendants' duties to creditors arose, if at all, to protect the value of those contract claims from diminution by reason of improper conduct. Those duties cannot be reduced by a provision in a certificate that forms no part of the creditors' contracts or the inducement for their "investments." Indeed, the provision itself is limited to "the Corporation or its stockholders." It makes no mention of creditors.

All in all, the bankruptcy court's decision in Ben Franklin is one of the most thoughtful expositions to date of fiduciary duty to creditors. The lasting significance of the case may be its warning that ill-planned turnaround efforts, based on unrealistic or excessive new debt obligations, will expose directors to fiduciary liability.

c) Other Cases of Note

(1) Pereira V

Yet another noteworthy case in the exposition of fiduciary duties is Pereira v. Cogan, 294 B.R. 449 (S.D.N.Y. 2003) ("Pereira V"), which arises in the context of a line of decisions involving the Chapter 7 bankruptcy case of Trace International Holdings, Inc. and its affiliates. In Pereira V, the Chapter 7 trustee (the "Trustee") sued various insiders, including a controlling shareholder and various directors/officers. In its detailed opinion, the court addressed, inter alia, two main issues dealing with fiduciary duties owed to a privately held corporation (which in turn, was the holding company of two public corporations): (i) first, whether a controlling shareholder and founder of a privately held corporation could be held liable for self-dealing (in the form of excessive compensation) where such shareholder was the attractor of loans and investments in the company; and (ii) second, the scope of the fiduciary duties owed to a corporation by directors and officers who were aware of the shareholder’s self-dealing. Id. at 462-63.

With respect to the first issue, the court found the controlling shareholder was guilty of self-dealing: “Once Cogan created the cookie jar - and obtained outside support for it - he could not without impunity take from it.” Id. at 463. At the outset, the court dealt with the question of which party carried the burden of demonstrating that the transaction was fair. The court held that when a shareholder engages in self-dealing, he has the burden of demonstrating fairness, which can only be shifted by showing approval of the transaction by a “well-functioning” set of independent directors. Id. at 518. Finding that an independent board did not exist, the court ruled the burden of proving fairness rested with the shareholder. Id. Next, the court set forth a two-pronged inquiry into the fair price and the fair process of the transaction.” Id. Again, the court found neither existed, as the shareholder received excessive compensation when compared to other similarly situated executives (unfair price) and the board was largely bypassed with respect to the decision regarding the shareholder’s compensation (unfair process). Id. at 519.
With respect to the second issue, the court held the directors and officers had a duty to creditors to protect the company from looting by its controlling shareholder once the company entered the vicinity of insolvency. Id. at 464. After delving deep into the issue of how the "vicinity of insolvency" should be measured, the court concluded the debtor was indeed in the zone several years prior to its bankruptcy (with the exception of a single fiscal quarter). Id. at 521. The court extensively examined the facts of the case and found the Trustee had carried its initial burden showing that the directors had breached their duty of loyalty and care vis-à-vis their close relationship to the controlling shareholder and failure to exercise diligence in matters concerning the shareholder; thus, the directors bore the burden of showing the fairness of the transactions in order to be afforded the protections of the business judgment rule. Id. at 527-30. The court again utilized the two-pronged inquiry of fair price and fair process, and found that neither element was satisfied in various of the challenged transactions.15 Id. at 534-539. Thus, certain directors were not entitled to protection of the business judgment rule. Further, the court rejected the directors’ contention that their abstention from voting upon material corporate decisions absolved them of liability, asserting that it would create a loophole for "directors with sinister intentions." Id. at 525. “[D]irectors will not be excused from liability if they either (1) knew about the challenged expenditure yet unreasonably failed to take action; or (2) if they did not know, should have taken steps by which they would have been informed of the challenged expenditure.” Id. at 526.16.

(2)  Toy King Distributors, Inc.

In re Toy King Distributors, Inc., 256 B.R. 1 (Bankr. M.D. Fla. 2000), is another decision of significance. Indeed, the court in Toy King, in a thorough and well researched opinion, covers the full panoply of fiduciary issues confronting insolvent entities. Toy King involved serial chapter 11 cases. In the second case, the creditors’ committee sued debtor’s principals (directors and officers)17 for breach of fiduciary duty relating to fraudulent transfer and other alleged wrongs. The corporate debtor in Toy King was insolvent at all times relevant.

15 Alternatively, the defendants could prove fairness of the transaction by showing that their actions were consistent with those that an ordinary prudent person would take. Id. at 534.
16 The directors also attempted to invoke the exculpation clause under Delaware law and in the debtor’s corporate charter. Reiterating its previous holding in Pereira v. Cogan, 2001 WL 243537, *11 (S.D.N.Y. March 8, 2001), the court stated the exculpatory clause “would not provide any protection for officers for any breach of fiduciary duty, and for any directors who breached the duty of loyalty.” Id. at 534; but see Prod. Resources, 2004 WL 2647593, *15 (holding that creditor was subject to Delaware exculpation clause for breach of fiduciary duty claims, although such provision did not insulate directors from liability for breach of duty of liability).
17 There is an issue (not often addressed) concerning the extent that fiduciary duties extend to officers. The court made clear in Toy King that at least under Florida law the fiduciary duties extend to both directors and officers.

“Although the statute is not specifically directed to corporate officers, the case law makes clear that both officers and directors of a corporation owe fiduciary duties to the corporation. See, e.g., Sea Pines, 692 F.2d at 977; Tinwood v. Sun
Among other transgressions, the insider officers and directors in *Toy King* authorized borrowings from the corporate parent at excessive interest rates and charges, which the court held to constitute a violation of the duty of care. 256 B.R. at 169. In addition, two of the directors were held to have violated the duty of loyalty during the first *Toy King* bankruptcy by acquiring a significant creditor’s claims, without advance disclosure to the court or the committee. 256 B.R. at 170-173 (relying on *In re Papercraft Corp.*, 187 B.R. 486, 500 (Bankr. W.D. Pa. 1995)).

d) Expansive View (Duty To Maximize Long-Term Wealth Creating Capacity)

As discussed *supra*, *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, 1991 WL 277613 (Del.Ch. Dec. 30, 1991), has recently been reinterpreted by *Prod. Resources*, thereby raising doubt whether it truly represents an expansive view of fiduciary duties of directors. Nevertheless, many courts have viewed *Credit Lyonnais* to stand for just that and the case has indeed taken on a life of its own. Accordingly, *Credit Lyonnais* must be discussed in this context.

*Credit Lyonnais* arguably presents a different, and more expansive, view of directors’ duties in insolvency situations. *Credit Lyonnais* involved a dispute as to control of MGM-Pathe Communications Co. ("MGM"). Plaintiff, Credit Lyonnais, was a major lender to MGM; the principal defendant, Giancarlo Parretti, was the indirect controlling shareholder of MGM. The action sought a judicial determination of the persons who constituted the lawfully elected board of MGM.

The case arose out of a leveraged buyout of MGM by a Parretti entity. Five months after the LBO, MGM’s creditors forced it into bankruptcy. Credit Lyonnais financed MGM’s emergence from Chapter 11 with substantial new bank debt. As part of that transaction, Credit Lyonnais obtained significant governance restrictions which ceded control to the lender (through an executive committee of the board controlled by the lender). The applicable governance contract provided that the controlling (98.5%) shareholder (a Parretti entity) would regain control (and the executive committee be dissolved) when the debt was paid down to a certain amount.

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*Banks, Inc.*, 570 So.2d 955, 959 (Fla. 5th DCA 1990); *Snyder Electric*, 305 N.W.2d at 869. *Cf. Steinberg v. Kendig (In re Ben Franklin Retail Stores, Inc.)*, 2000 WL 28266 (N.D. Ill.) ['Although Delaware courts have found that officers owe fiduciary duties to the corporation, this Court has found that the only instances where such a duty is found are where the circumstances involved self-dealing.'].

256 B.R. at 165 n.18.
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When MGM emerged from bankruptcy, the controlling shareholder demanded that the executive committee sell certain assets to pay down the loan sufficiently to restore control to Parretti. The executive committee rejected the demand out of concern as to adequacy of the price. "Ladd [bank nominee] and his team could reasonably suspect that he [Parretti] might be inclined to accept fire sale prices." 1991 WL 277613, at *34. At all relevant times, MGM was "in the vicinity of insolvency." Id.

Each side claimed that the other had breached its contractual governance obligations and purported to remove the other's board representatives. Parretti further alleged that the bank nominees breached their fiduciary duty to the controlling shareholder. 1991 WL 277613, at *33. The chancellor ruled for plaintiffs and held that "the executive committee decisions were valid and did not represent a breach of duty." 1991 WL 277613, at *33. "[T]he Ladd management group acted prudently with respect to these transactions from the point of view of MGM." Id. The court explained:

In these circumstances where the company was in bankruptcy until May 28 and even thereafter the directors labored in the shadow of that prospect, Mr. Ladd and his associates were appropriately mindful of the potential differing interests between the corporation and its 98% shareholder. At least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise. [FN55]

* * *

Ladd and his team could reasonably suspect that he [Parretti] might be inclined to accept fire-sale prices. But the MGM board or its executive committee 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.

1991 WL 27761, at *34 (emphasis supplied).

In footnote 55 to the above-quoted text, the chancellor emphasized the need to protect creditors. "The possibility of insolvency can do curious things to incentives, exposing creditors to risks of opportunistic behavior, and creating complexities for directors." 1991 WL 277613, at n.55. In the footnote, the chancellor posed a hypothetical in which a corporation's sole asset is a claim against a solvent entity for $51 million, with a value (taking into consideration the likelihood of success) of $15.55 million; and the corporation's debt is only $12 million. In the hypothetical, the stockholders (whose equity is worth only $3.55 million) have a 1 in 4 chance of realizing $39 million for themselves ($51 million less $12 million to debtholders) if the claim is
not settled, but would receive little if the claim were settled in the range of its market value, $15.55 million. The shareholders, accordingly, might well prefer to reject a fair market value settlement and gamble for a win at trial. If they lose, it is mostly all creditors' money that will be lost, and if the stockholders win, they will get all the reward.

In the chancellor's view, the directors may incur personal liability if they take such high risk action for the benefit stockholders. Instead, as fiduciaries to the enterprise, they should choose the best settlement over $15.55 million:

If we consider the community of interests that the corporation represents it seems apparent that one should in this hypothetical accept the best settlement offer available providing it is greater than $15.55 million, and one below that amount should be rejected. But that result will not be reached by a director who thinks he owes duties directly to shareholders only. It will be reached by directors who are capable of conceiving of the corporation as a legal and economic entity.

1991 WL 277613, at n.55.

The upshot of the court's analysis is (a) to subordinate the interests of shareholders to the interests of creditors in an insolvency situation when they conflict and (b) to impose an open-ended duty of care to "maximize the corporation's long-term wealth creating capacity." One might try to limit Credit Lyonnais to situations involving potential disposition of assets for the benefit of stockholders on terms unfair to creditors, since that is what Parretti wanted to do. See In re Ben Franklin Retail Stores, Inc., 225 B.R. at 655. But the reasoning of the court in Credit Lyonnais is clearly not tied to such situations and footnote 55 has nothing to do with asset disposition and everything to do with directors' undertaking undue risk to achieve a return for stockholders whose equity is worth little or nothing. See also In re Global Service Group, LLC, 316 B.R. 451, 460 (Bankr. S.D.N.Y. 2004) (stating that directors and officers of an insolvent company owe fiduciary duties to shareholders, as well as, "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.")

2. Does the Fiduciary Duty Shift to Consideration of Creditor Interests, to the Exclusion of Shareholder Interests?

The majority of cases state or contemplate that upon insolvency, fiduciary duties are owed to both creditors and stockholders, although certain duties to creditors may predominate under certain circumstances (as Credit Lyonnais contemplates). However, it has been held, at

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18 E.g., Ed Peters Jewelry Co., Inc. v. C&J Jewelry Co., Inc., 124 F.3d 252, 276 (1st Cir. 1997); Geyer v.
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the federal court of appeals level, that "when a corporation becomes insolvent ... the officers and directors no longer represent the stockholders . . . ." FDIC v. Sea Pines, 692 F.2d at 977 (citation omitted).

The majority view would appear to be the more sound and consistent with the Delaware Chancery Court's decision in Production Resources, which emphasizes that the duty is to the corporation as an entity. The fact of insolvency (either in a bankruptcy or an equity sense) does not preclude rehabilitation of the enterprise and restoration of positive net worth and cash flow. It has been argued persuasively that even post-petition, in a corporate chapter 11 case, until it is clear that there will be no going concern (or liquidation) value available for stockholders, the directors continue to owe fiduciary duties to stockholders. The rule should be no different pre-petition.

The practical effect of this dual (creditor/shareholder) enterprise or obligation or enterprise is to weaken or defeat any argument that the directors have a duty upon insolvency to arrange an orderly sale or liquidation for the benefit of creditors. In re Ben Franklin Retail Stores, Inc., 225 B.R. 646 (Bankr. N.D. Ill. 1998), supra is instructive on this point. A significant part of the court's analysis was its view that, given the existence of duties to both creditors and shareholders, there simply was no duty (on the allegations presented) to liquidate the company:

[T]heir [directors'] duty is to serve the interests of the corporate

Ingersoll Publications Co., 621 A.2d at 789 ("The existence of the fiduciary duties at the moment of insolvency may cause directors to choose a course of action that best serves the entire corporate enterprise rather than any single group interested in the corporation at a point in time when shareholders' wishes should not be the director's only concern.") Pepper v. Litton, 308 U.S. 295, 307 (1939) ("For that standard of fiduciary obligation is designed for the protection of the entire community of interests in the corporation.").

Sea Pines ruled on duties of directors of a South Carolina corporation, although no South Carolina cases are cited. 692 F.2d at 977; see also In re Hoffman Assoc., Inc., 194 B.R. 943, 964 (Bankr. S.C. 1995) ("[W]hen the Debtor became insolvent, the fiduciary duty owed by [the defendant] as a director of the Debtor, shifted from the stockholders to all of the creditors of the Debtor."); First Options v. Polonita, 1990 WL 114740 at *4 (N.D. Ill. July 31, 1990) (applying California law and upholding verdict based on instruction that "[a]n officer and director of an insolvent corporation has a duty to the corporation's creditors to be loyal, to act solely for the financial benefit of the creditors in all matters, and to enhance the financial interest of the insolvent corporation.").

Harvey R. Miller, "Corporate Governance in Chapter 11: The Fiduciary Relationship Between Directors and Stockholders of Solvent and Insolvent Corporations," 23 Seton Hall L. Rev. 1467, 1468, 1514-15 (1993) ("It is the gray area between liquidation value and going concern value which may be realized because of a chapter 11 reorganization that provides a potential interest for existing stockholders . . . . The interests of stockholders should not prolong a chapter 11 case when it is patent that there is not, and there never will be, sufficient value to provide any consideration for the stockholders. However, so long as a debtor has a good faith belief that the corporation can be rehabilitated and that going concern value will be preserved and enhanced, the debtor and its directors have a duty to attempt to achieve a consensual plan of reorganization incorporating plan treatment for stockholder interests and junior creditor claims as contemplated by the Bankruptcy Code.").
enterprise, encompassing all its constituent groups, without preference to any. That duty, therefore, requires directors to take creditor interests into account, but not necessarily to give those interests priority. In particular, it is not a duty to liquidate and pay creditors when the corporation is near insolvency, provided that in the directors' informed, good faith judgment there is an alternative.

225 B.R. at 655.

3. When is the Fiduciary Duty to (or Right to Derivative Standing of) Creditors Triggered?

The fiduciary duty to (or right to derivative standing of) creditors is triggered at or about the point of insolvency. "The fact which creates the trust is the insolvency . . . ." Bovay v. H.M. Byllsby & Co., 38 A.2d at 813. Insolvency, however, is a term with more than one meaning. As set forth in Healthco:

Insolvency has a settled meaning under fraudulent transfer law, whether the relevant statute be section 548 of the Bankruptcy Code, the Uniform Fraudulent Transfer Act or the Uniform Fraudulent Conveyance Act. Its statutory definition is, in essence, an excess of liabilities over the value of assets. This is sometimes referred to as insolvency in the bankruptcy sense.

The Trustee's claims against the directors are based on principles of fiduciary obligations rather than fraudulent transfer law. Here another form of insolvency is equally relevant-insolvency in the equity sense. This is an inability to pay debts as they mature. Even though not insolvent in the bankruptcy sense, a business is insolvent in the equity sense if the assets lack liquidity.

208 B.R. at 301-02 (footnotes omitted). Insolvency under either definition should trigger the duty. If a corporation is insolvent in either the bankruptcy or equity sense, creditors are at risk of nonpayment and the value of their debt claims is dependent on the business decisions of the corporation's managers.

21 In Geyer v. Ingersoll, the court mixed the two concepts:

An entity is insolvent when it is unable to pay its debts as they fall due in the usual course of business. Webster's Ninth New Collegiate Dictionary 626 (1988). That is, an entity is insolvent when it has liabilities in excess of a reasonable market value of assets held.

621 A.2d at 789.
The practical problem here is that it is hard to determine when, exactly, a corporation becomes insolvent. The court in *Geyer* rejected the position that the trigger should be a bright line test, specifically, the institution of bankruptcy or other statutory insolvency proceedings:

While it is true, as Mr. Ingersoll argues, that defining the exception as arising when statutory proceedings have begun would give directors a clear and objective indication as to when their duties to creditors arise, there are other policy concerns which suggest that I interpret the insolvency exception to arise when insolvency exists in fact. That is, it is efficient and fair to cause the insolvency exception to arise at the moment of insolvency in fact rather than waiting for the institution of statutory proceedings. [Citations omitted.] The existence of the fiduciary duties at the moment of insolvency may cause directors to choose a course of action that best serves the entire corporate enterprise rather than any single group interested in the corporation at a point in time when shareholders' wishes should not be the directors only concern. Furthermore, the existence of the duties at the moment of insolvency rather than the institution of statutory proceedings prevents creditors from having to prophesy when directors are entering into transactions that would render the entity insolvent and improperly prejudice creditors' interests.

621 A.2d at 789. *Compare Fagan v. La Gloria Oil and Gas Co.*, 494 S.W.2d 624, 628-29 (Tex. Civ. App. 14th Dist. 1973) (under Texas law, fiduciary duty to creditors is triggered only when a corporation is insolvent and has ceased doing business altogether or without reasonable prospect of success).

Compounding the difficulty is the dictum from *Credit Lyonnais* which would trigger a fiduciary duty to creditors in the “vicinity of insolvency.” 1991 WL 277613 at 34; accord *In re Buckhead America Corp.*, 178 B.R. 956, 968 (D. Del. 1994); cf *Prod. Resources*, 2004 WL 2647593, *12, n.56 (raising question as to validity of “zone” concept). *But see North American Catholic Educ. Programming Foundation, Inc. v. Gheewalla*, No. Civ. A. 1456-N, 2006 WL 2588971 at *13 (Del Ch. Sept. 1, 2006) (holding that “no direct claim for breach of fiduciary duties may be asserted by creditors of a solvent corporation operating in the zone of insolvency.”). There is no test or definition for "vicinity of insolvency."²² In a similar vein, the court in *Healthco* suggests that fiduciary duties are triggered when a transaction leaves the

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²² Given that the court's footnote hypothetical involves a balance sheet solvent entity and risk to creditors of nonpayment through dissipation of an asset, *see Credit Lyonnais*, 1991 WL 277613 at *34 n.55, it would seem that "vicinity of insolvency" refers to risk of nonpayment.
company with "unreasonably small capital" (a fraudulent transfer concept), which "connotes a condition of financial debility short of insolvency (in either the bankruptcy or equity sense) but which makes insolvency reasonably foreseeable." \textit{Healthco}, 208 B.R. at 302.

The upshot of all this is a great deal of uncertainty. Directors, and those assisting them, must exercise great care to demonstrate (and document) that creditor interests are being taken into account whenever they believe the company is in financial difficulty.

4. Other Fundamental Issues

The case law is unclear, and remarkably undeveloped, as to three additional (and fundamental) issues: applicability of the business judgment rule; standing to sue for breach of fiduciary duty to creditors; and measure of damages.

a) Business Judgment Rule

The business judgment rule is a significant protection for directors. It functions to prevent courts from second guessing directors' actions, and its effect is to require a showing of gross negligence to establish breach of the duty of care. \textit{See In re Healthco}, 208 B.R. at 306.

The business judgment rule, however, is a corporation law, not a trust, concept. Some courts that purport to apply trust principles, as if the trust fund doctrine is an aspect of trust law, make no mention of the business judgment rule (\textit{e.g. Bovay}, 38 A.2d 808), or view the rule as of "no consequence." \textit{E.g., In re General Homes Corp.}, 199 B.R. 148, 151-52 (S.D. Tex. 1996). Since many or most trust fund cases involve breaches of the duty of loyalty (often self-dealing in closely-held corporations), this omission often is of no consequence; business judgment protection is lost upon a showing of improper director interest in a transaction. However, the business judgment role has been ignored in at least one frequently-cited case (\textit{see New York Credit}, 110 N.E.2d 397) decided by a leading state appellate court (the New York Court of Appeals) that did not involve any self-dealing, insider preference, or diversion of assets to shareholders.

A January 2002 decision in the Chancery Court of Delaware specifically held that even where the law recognizes that the duties of directors encompass the interests of creditors, there is room for application of the business judgment rule. Thus, I tentatively conclude that, to overcome the presumption of regularity attending the application of the business judgment rule, plaintiffs must carry an initial burden of showing circumstances supporting an inference that the directors did not act in good faith after a reasonable investigation.
ABA Section of Litigation Annual Conference, April 11-14, 2007:
Potential Liability For Deepening Insolvency And Breach Of Fiduciary Duty to Creditors

Angelo, Gordon & Co., L.P. v. Allied Riser Communications Corp., 805 A.2d 221 (Del. Ch. 2002). In Allied Riser, the board of directors retained an investment banking firm to provide a fairness opinion with respect to a proposed merger. After the fairness opinion was provided, the board oversaw substantial and significant revisions to the proposed merger and did not seek a further fairness opinion. Indeed, there was even a hint that the investment banking firm may not have been prepared to provide a subsequent fairness opinion based on the revisions to the proposed merger. 805 A.2d at 226, n.12. Notwithstanding this evidence, the Chancery Court held that the board of directors was entitled to the protections of the business judgment rule even where the company was in financial difficulty.

No case has articulated a principled basis for depriving directors of business judgment protection in insolvency situations. Regardless of how narrowly or broadly courts view the scope of fiduciary duty to creditors, it is an aspect of corporate governance — requiring directors to give due consideration to creditor interests in their decision making. Indeed, the seminal case, Wood v. Dummer, has nothing to do with trust law. Justice Story used the "trust fund" concept as a basis to enforce the rule that an insolvent corporation's assets be distributed in accordance with absolute priority (creditors to be paid before stockholders).

Even under restrictive views of fiduciary duty to creditors, the protection of the business judgment rule is especially significant for outside directors. Without its protection, they risk being second-guessed and being required to shoulder the burden to prove the fairness of leveraged transactions and spin-offs that result in distributions to shareholders — regardless of their good faith and diligence in approving the transactions. If the duty of care is understood more expansively to prohibit undue risking of assets or a duty to maximize the corporation's long-term wealth creating capacity, as the dicta in Ben Franklin and Credit Lyonnais would indicate, the protection of the business judgment rule is all the more important and appropriate.

b) Standing to Sue

Injury to the plaintiff generally is a requirement for standing to sue. See Steinberg v. Buczynski, 40 F.3d 890, 892 (7th Cir. 1994); Hirsch v. Arthur Andersen & Co., 72 F.3d 1085, 1091 (2d Cir. 1995). In the typical fiduciary duty to creditors case, the actionable conduct consists of an unlawful diversion of an insolvent corporation's assets to insiders or stockholders. The immediate injury is to the corporation, whose assets have been depleted. The creditors' injury is derivative, in the sense that less corporate assets remain to pay them.

However, those jurisdictions that extend fiduciary duties to creditors upon insolvency also generally permit individual creditors to sue for breach of the duty. See, e.g., Geyer v. Ingersoll, 621 A.2d 784; Snyder Electric Co. v. Fleming, 305 N.W.2d 863; Rosebud Corp. v. Boggio, 561 P.2d 367; Fagan v. Gloria Oil and Gas Co., 494 S.W.2d 624; FDIC v. Sea Pines, 692 F.2d 973. Perhaps because the reported cases tend to involve self-dealing in closely-held corporations, courts do not appear to have required (or recognized a need to excuse)
requirements of a derivative action, and therefore one could read the state court cases as creating rights personal to individual creditors. There is a recognition in some cases, however, that an individual creditor's recovery should not exceed his ratable share of assets recovered.\textsuperscript{23} Cf. \textit{Production Resources Group, supra}, 2004 WL 2647593 at *3 ("Claims of this type are classically derivative..."").

When the corporation files for bankruptcy relief, the issue arises as to whether the trustee (debtor-in-possession) or individual creditors have standing to pursue claims of pre-petition breach of fiduciary duty to creditors. In general, the cases recognize the standing of the bankruptcy trustee to pursue the action. In fact, two of the leading cases, \textit{Bovay} (Delaware Supreme Court) and \textit{New York Credit} (New York Court of Appeals) are actions in state court by federal bankruptcy trustees (whose standing appears not to have been challenged). In \textit{Healthco}, the director defendants challenged the trustee's standing, and the challenge was rejected:

The Trustee can bring any suit \textit{Healthco} would have brought, including suits against directors and controlling shareholders for breach of fiduciary duty. In complaining that directors authorized a transaction which unduly weakened \textit{Healthco}, the Trustee is not asserting the claim of creditors. He alleges \textit{Healthco} was the victim of poor management causing damage to the corporation

which necessarily resulted in damage to its creditors by diminishing the value of its assets and increasing its liabilities.

208 B.R. at 300 (footnotes omitted).

In \textit{In re Mortgageamerica Corp.}, 714 F.2d 1266, a judgment creditor sought to prosecute an action for breach of fiduciary duty against an individual who controlled (and owned all stock of) an insolvent corporation. The defendant had stripped the corporation of assets pre-petition, and the corporation was put into involuntary bankruptcy. The issue was whether creditor's action was property of the estate subject to the bar of the automatic stay. The creditor's position was that under the Texas trust fund doctrine, the fiduciary action accrued to individual creditors, not the estate. The court rejected the plaintiff's position.

[\textit{U}	extsuperscript{nder} Texas law a cause of action under the trust fund

\textsuperscript{23} \textit{See Snyder Electric Co. v. Fleming}, 305 N.W.2d at 871; \textit{Fagan v. La Gloria Oil and Gas Co.}, 494 S.W.2d at 631 ("[A]ppellants have not preserved any point to the effect that the trial court's judgment is excessive in that it awards La Gloria a recovery more than it would have received if Cooper's assets had been ratably and properly distributed among its valid creditors."); \textit{Delgado Oil Co., Inc. v. Torres}, 785 F.2d 857, 861 (10th Cir. 1986) ("Central to the common law doctrine is the recognition that creditors may pursue this remedy on behalf of the corporation to ensure that all creditors are treated equally."); \textit{In re Mortgageamerica Corp.}, 714 F.2d at 1271 ("Any money collected in the action is distributed pro-rata to all creditors and shareholders.").
(denuding) theory is in the right of the corporation, though, to be sure, that right is assertable (and usually is asserted) by the corporation's creditors. . . . Despite the fact that the action under normal circumstances is frequently not brought by the corporation itself, the courts have uniformly held that, upon bankruptcy, it passes to the trustee, who is then charged with prosecuting it for the benefit of all creditors and shareholders.

714 F.2d at 1276 (footnote omitted); accord Delgado Oil, 785 F.2d at 860.

In re Mediators, Inc., 105 F.3d 822 (2d Cir. 1997), injects an element of confusion into the analysis. Mediators was an action by a creditors committee, on behalf of a chapter 11 debtor, against the debtor's lender, attorneys and accountants, asserting that they had aided and abetted a breach of fiduciary duty by debtor's president and sole shareholder, whereby he obtained ownership of the corporation's valuable art collection for inadequate consideration. The Second Circuit acknowledged that "a bankruptcy trustee, suing on behalf of the debtor under New York law, may pursue an action for breach of fiduciary duty against the debtor's fiduciaries." 106 F.3d at 827. However, the court viewed standing to pursue aiding and abetting claims against third parties as a different matter. It held that those claims "belong to the creditors qua creditors," and could not be pursued by a bankruptcy trustee. 105 F.3d at 826. The court relied on precedent dealing with fraud and malpractice claims and raised the specter of pari delicto type defenses if the estate pursued the action. "Because Manney was the sole shareholder and decision-maker of the Mediators [debtor], his orchestration of the art transfer rendered the Mediators a participant." 105 F.3d at 826. See also In re Granite Partners, L.P., 194 B.R. 318, 328-32 (Bankr. S.D.N.Y. 1996) (recognizing pari delicto defense against trustee asserting fiduciary breach, where claim is that insiders and third parties acted in concert to defraud investors); Official Committee of Unsecured Creditors of Color Tile, Inc. v. Investcorp S.A., 80 F. Supp. 2d 129, 137 (S.D.N.Y. 1999); Official Committee of Unsecured Creditors v. Pardee (In re Stanwich Fin. Servs.), 317 B.R. 224 (Bankr. D. Conn. 2004) (discussion of theory of imputation).

c) Damages

The least developed area of creditor fiduciary actions is measure of damages. In most (or almost most all) creditor actions for breach of fiduciary duty, the relief requested is to recover the value of assets that have been diverted to (or for the benefit of) insiders or shareholders and to distribute that sum to creditors (or at least a ratable share to the plaintiff). Fagan v. La Gloria Oil and Gas Co., 494 S.W.2d 624, is typical. "La Gloria's measure of recovery against the officers and directors of Cooper, who became La Gloria's trustees, is the difference between what
it got of such assets (nothing) and what it would have got on equitable distribution." 494 S.W.2d at 633. Liability, moreover, was joint and several under Texas law. *Id.*

*Healthco* sets forth a different (or alternative) measure of damages based on business valuation in a failed LBO situation:

The measure of damages governing the Trustee's claims for breach of fiduciary duties and aiding and abetting that breach is the amount of decrease in the fair market value of *Healthco* that resulted from the defendants' actions. Based upon this measure of damage, the Trustee must prove: (a) the value of *Healthco* at the time of the tortious conduct, (b) its decreased value resulting from the tortious conduct, and (c) that the tortious conduct was a significant contributing cause of the decrease.

208 B.R. at 310 (footnote omitted). The opinion is vague as to how this measure is actually calculated, except to advise that the relevant post-LBO value was not the value immediately after the transaction, but rather the value two years later, when the debtor's assets were liquidated. *Id.*

The benefit of the *Healthco* approach is that it recognizes that the damage caused by a fiduciary breach is not necessarily equal (or limited) to the value of assets wrongfully diverted. It also takes into account situations like the footnote hypothetical in *Credit Lyonnais*, where the value of the entity is ascertainable and that value is lost by the directors' taking undue risk in an attempt to benefit equity. In the same vein, it should be recognized lost profits are also a measure of damages for breach of fiduciary duty. *See S&K Sales Co. v. Nike, Inc.*, 816 F.2d 843, 851 (2d Cir. 1987). There is no reason why creditors should not be permitted to recover lost profits damages (up to the amount of the entity's debt) if the requisite facts are proved and opinions rendered.

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24 *Clarkson Co. Ltd. v. Shaheen*, 660 F.2d 506 (2d Cir. 1981), *cert. denied*, 455 U.S. 990 (1982), suggests that under New York law, damages may be apportioned among directors in accordance with their respective degrees of responsibility. The court upheld a jury's apportionment of 24% of the damages to the chief financial officer who "had actively breached the duty of care." *Id.* at 513.

25 The bankruptcy court in *Healthco* made its ruling in the context of denying cross-motions for summary judgment. In the jury trial that followed in the district court, the verdict was in favor of the defendants.
Deepening insolvency is the nomenclature that has been given to a number of different concepts amounting to the underlying theory that there are times when a defendant’s conduct prolongs the life of a corporation and/or exacerbates the corporation’s debt and exposure to its creditors. In determining whether a claim for deepening insolvency exists and defining the parameters of the claim, federal courts have relied on state law or, more specifically, what the federal court believes the courts of the relevant state would hold if presented with the issue. Due perhaps in part to this speculation, the reported federal decisions have characterized deepening insolvency differently, some treating it as a cause of action and others treating it as a method of measuring damages. Compare Official Comm. of Unsecured Creditors v. F.R. Lafferty Co., 267 F.3d 340, 347 (3d Cir. 2001) (deepening insolvency is an independent cause of action, with Allard v. Arthur Andersen & Co. (USA), 924 F. Supp. 488, 494 (S.D.N.Y. 1996) (deepening insolvency is a measure of damages).

At the core of this debate is the issue of whether deepening insolvency actually represents a new tort or whether it is merely the repackaging of already existing duties into a tort with a new, more sonorous name. See Production Resources Group, LLC v. NCT Group, Inc., 863 A.2d 772, 788 (Del. Ch. 2004). In the past year several courts that have added to this debate. Of these courts, none have had a greater impact on the landscape of deepening insolvency than the Third Circuit Court of Appeals in Seitz v. Detweiler, Hershey and Associates (In re CitX Corp., Inc.), 448 F.3d 672 (3d Cir. 2006), and the Delaware Chancery Court in Trenwick America Litigation Trust v. Ernst & Young, L.L.P., 906 A.2d 168 (Del Ch. 2006). The CitX Court stated that fraud is an essential element to successful assert a claim for deepening insolvency and that where the tort of deepening insolvency is not present, deepening insolvency is not a valid method to calculate damages. The Trenwick Court went even further, holding that Delaware does not recognize the tort of deepening insolvency. Together, these cases have greatly diminished the thunder that deepening insolvency had a mere three years ago.

A. Theory of Deepening Insolvency

1. Origins of Deepening Insolvency

a) American law reflects a preference for continued corporate existence. This preference is seen through the availability of Chapter 11 reorganization for businesses. See e.g., Kittay v. Atlantic Bank of N.Y. (In re Global Serv. Group), 316 B.R. 451, 460 (Bankr. S.D.N.Y. 2004) (noting that “chapter 11 is based on the accepted notion that a business is worth more to everyone alive than dead”).

b) Continued corporate existence is often seen as a benefit because it fosters economic growth, maintains employee jobs, provides incentive for risky,
but possibly rewarding, business undertakings, and generally benefits the "community of interests" that sustain a corporation.

c) The theory of deepening insolvency, however, carves an exception to this general rule and suggests that where the corporation is artificially prolonged through fraud or wrongful conduct, such existence cannot be deemed beneficial to either the corporation or its creditors. See e.g., Global Serv., 316 B.R. at 456 ("'Deepening insolvency' refers to the 'fraudulent prolongation of a corporation's life beyond insolvency,' resulting in damage to the corporation caused by increased debt.") (citations omitted).

2. Exemplar Cases

a) In Bloor v. Dansker (In re Investors Funding Corp. of N.Y. Secs. Litig.), 523 F. Supp. 533 (S.D.N.Y. 1980), reh'g denied, 36 B.R. 1019 (1983), the trustee for IFC (the "Trustee") alleged the corporation had suffered massive damages at the hands of corporate insiders and the company's auditors, who supposedly certified false financial statements. Based on this fraudulent image of corporate health, the insiders received and misappropriated credit and investments from innocent third parties. Id. at 536. The Trustee sued the auditors for their participation in the fraud. In response, the auditors argued the actions of the controlling insiders should be imputed to IFC such that IFC would be deemed to have known of their wrongful conduct. Id. at 541.

The court noted that under New York law, the knowledge of an agent acquired within the scope of his employment is generally imputed to his principal. Id. An exception to this rule of imputation, known as the "adverse interest exception," is when the agent is acting adversely to the interests of the principal. Id. The auditors argued the adverse interest exception did not apply because the insiders' conduct, while for their primary benefit, benefited IFC by allowing it to continue in business.

The court, in its now famous pronouncement, disagreed: "A corporation is not a biological entity for which it can be presumed that any act which extends its existence is beneficial to it." Id. at 541. The court held that if the underlying allegations were true, the insiders' conduct only benefited the insiders and their "confederates," and not IFC; thus, the actions of the insiders could not be imputed to IFC Id.

b) In Schacht v. Brown, 711 F.2d 1343 (7th Cir. 1983), cert. denied, 464 U.S.
1002 (1983), the Illinois State liquidator (the “Liquidator”) sued insiders (the “Defendants”) of a defunct insurance company alleging they had schemed to loot the company and defraud its creditors, resulting in deepening insolvency and financial harm to the corporation and its policyholders and creditors. On appeal to the Seventh Circuit, the Defendants renewed portions of their motion to dismiss which were previously denied by the district court. In particular, certain of the Defendants alleged the Liquidator did not have standing to bring a cause of action based on deepening insolvency because a corporation could not “recover damages alleged to have resulted from the artificial prolongation of an insolvent corporation’s life.” See id. at 1346.

The Seventh Circuit rejected the Defendants’ arguments and held that artificial prolongation of the corporation did indeed harm the company because it was drained of income and divested of its most profitable and least risky business. Id. at 1350. “[T]he ‘asset dissipation’ . . . resulted from the bleeding of [the debtor] which was a part of the underlying scheme to defraud.” Id. The court further noted the Defendants’ incorrectly assumed that fraudulent prolongation of corporate existence is beneficial to a corporation. Rather, “[t]his premise collides with common sense, for the corporate body is ineluctably damaged by the deepening of its insolvency, through increased exposure to creditor liability.” Id.

3. Is Deepening Insolvency a Fraud-Based Theory?

a) The concept of deepening insolvency continues to evolve and the nature of the theory remains unclear. There is, however, strong support that courts view it as fraud-type theory. Possibly due to its origins in Ponzi schemes, courts have crafted its meaning and function to apply when there is fraudulent or wrongful conduct. See e.g., Florida Dep’t of Ins. v. Chase Bank of Tex. Nat’l Assoc., 274 F.3d 924 (5th Cir. 2001), reh’g denied, 2002 WL 243390 (5th Cir. Jan 15, 2002), cert. denied, 535 U.S. 1097 (2002) (noting a trend towards recognizing deepening insolvency as “a cause of action against a party who creates the false appearance of solvency”) (emphasis supplied).

The fraud-based nature of deepening insolvency was adopted by the Third Circuit in Seitz v. Detweiler, Hershey and Associates (In re CitX Corp., Inc.), 448 F. 3d 672 (3d Cir. 2006). The CitX Court stated its disagreement with those courts that recognized a deepening insolvency claim based upon negligence alone, holding that only evidence of fraudulent conduct could support such a claim. Id. at 680-81. The Court noted that it had

b) Other recent decisions, however, have cast doubt on the fraud-based nature of deepening insolvency. A district court in New Jersey explicitly “decline[d] to cabin the wrongful prolongation of corporate existence theory to instances in which corporate assets are dissipated or diverted as a result of fraud.”  *Crowley v. Chait,* 2006 U.S. Dist. LEXIS 8894, *14 (D.N.J. March 7, 2006). The Ninth Circuit Court of Appeals also recently suggested that deepening insolvency does not require intentional conduct.  See *Smith v. Arthur Andersen LLP,* 421 F.3d 989, 995 (9th Cir. 2005) (stating that a claim for deepening insolvency is viable if the defendants "misrepresent[ed] (not necessarily intentionally) the firm's financial condition to its outside directors and investors"); see also *Bondi v. Bank of Am. Corp. (In re Parmalat Sec. Litig.),* 383 F. Supp. 2d 587, 601 (S.D.N.Y. 2005); *Joel L. Tabas v. Greenleaf Ventures, Inc. (In re Flagship Healthcare, Inc.),* 269 B.R. 721 (Bankr. S.D. Fla. 2001).

B. Type of Theory

1. **Theory of Damages** – Damages for fraud or other wrongful conduct are calculated by measuring the corporation’s deepening insolvency.

2. **Exemplar Cases**

   a)  *Schacht v. Brown,* 711 F.2d 1343, 1350 (7th Cir. 1983), *cert. denied,* 464 U.S. 1002 (1983) – noting the harm to the corporation was measured by the “asset dissipation” resulting from the “specific actions crippling [the debtor] which were taken as an integral part of that extension.”

   b)  *Allard v. Arthur Andersen & Co. (USA),* 924 F. Supp. 488, 496 (S.D.N.Y. 1996) – following *Schacht* and *Investors Funding Corp.,* court denied defendant’s motion for summary judgment on grounds that theory was not legally recognized: “Because courts have permitted recovery under the ‘deepening insolvency’ theory, [defendant] is not entitled to summary judgment as to whatever portion of the claim for relief represents damages.
flowing from indebtedness to trade creditors.”

c)  *Feltman v. Prudential Bache Secs.*, 122 B.R. 466, 474 (S.D. Fla. 1990) – adopting *Schacht* theory of damages: “This Court agrees . . . that ‘an artificial and fraudulently prolonged life . . . and . . . consequent dissipation of assets’ constitutes a recognized injury for which a corporation can sue under certain conditions.”


e)  *Seitz v. Detweiler, Hershey and Associates (In re CitX Corp., Inc.)*, 448 F. 3d 672 (3d Cir. 2006) - holding that "[t]he deepening of a firm's insolvency is not an independent form of corporate damage." *Id.* at 678 (quoting Sabin Willett, *The Shallows of Deepening Insolvency*, 60 Bus. Law. 549, 552-57 (2005)). Turning to the particular facts of the case - an action against the debtor’s former accounting firm for malpractice - the Court stated that since "there is nothing in the record to support a finding that anyone extended credit to CitX in reliance on the financial statements compiled by [the accounting firm], [the trustee] cannot establish that [the accounting firm] caused any harm to CitX." *Id.* at 680.

The Court further noted that an equity investment, in and of itself, is not harmful to a corporation that is insolvent or in the zone of insolvency - surely the corporation can squander the investment, but an equity infusion could also help turn the corporation around.

f)  The Bankruptcy Court for the District of the District of Columbia considered the CitX decision and expressly rejected its conclusion as to whether deepening insolvency was a viable theory of damages. Specifically, the Court argued that “[t]here is no way to make sense of *Lafferty* without concluding that the deepening of a company's insolvency can be harmful; otherwise, the *Lafferty* court could not have concluded that fraudulent conduct leading to the deepening of a company's insolvency constitutes tortious activity. Nor is this court aware of any common law principle holding that an injury sustained as a result of one tort (fraud) is somehow not an injury when it is caused by a different tort (negligence), as the *CitX* court seems to suggest.” *Alberts v. Tuft (In re Greater Southeast Cmty. Hosp. Co.)*, 353 B.R. 324, 337. (Bankr. D.D.C. 2006). The Court continued, "[r]ather than attempt to "discover" a
separate common law tort which must then be neutered, this court prefers
to treat deepening insolvency as the theory of harm that it was always
meant to be, and will rely on other, more established (not to mention less
convoluted) common law causes of action to ascertain whether the
defendants in this case have engaged in a legal wrong for which Alberts is
entitled to recover. Unless and until this court is told differently by a
higher court in its own circuit, deepening insolvency will remain a viable
tort theory of damages in this jurisdiction regardless of whether the injury
occurred as a result of negligence or fraud.". Id. at 338.

3. **Independent Cause of Action** – recognizing deepening insolvency as a separate
   and independent tort, not merely a damage theory.

4. **Exemplar Cases - Deepening Insolvency Recognized**
   
issue, the Pennsylvania Supreme Court would determine that ‘deepening
insolvency’ may give rise to a cognizable injury.”

ruling that “Delaware Supreme Court would recognize a claim for
depthening insolvency where there has been damage to corporate
property.”

c) *Smith v. Arthur Andersen LLP*, 421 F.3d 989, 1004 (9th Cir. 2005) – court
held that Trustee could pursue deepening insolvency claims, stating that
“prolonging an insolvent corporation’s life through bad debt may
dissipate corporate assets and thereby harm the value of corporate
property.” Id. (quoting *Lafferty*, 267 F.3d at 350). - resulted in settlement
of over $180 million. The Trustee had alleged that the corporation was
always insolvent and had a faulty business plan, and that the corporations’
assets were “squandered on an unviable business plan”.

d) *Limor v. Buerger (In re DEL-MET Corp)*., 322 B.R. 781 (Bankr. M.D.
Tenn. 2005) - denying motion to dismiss, holding that deepening
insolvency is a viable cause of action. The deepening insolvency claim
was based upon allegations that defendants exerted sufficient influence
and control to render them insiders who owe fiduciary duties.

that committee had asserted viable deepening insolvency claim, adhering
to the precedent of *Lafferty* and *Exide*. It was alleged that the officers and directors of the corporation concealed the true financial condition when they knew or should have known that LTV could not meet its obligations. Additionally, the court permitted a committee of administrative claimants to pursue (among other things) an action for postpetition deepening insolvency.

5. **Exemplar Cases - Deepening Insolvency Not Recognized**

   a) Recently, however, courts have been increasingly unwilling to recognize deepening insolvency as an independent tort, instead arguing that the tort is subsumed in other, already existing torts, or, in the alternative, arguing that the pertinent jurisdiction has yet to recognize the tort.

   b) In *Kittay v. Atlantic Bank of N.Y. (In re Global Serv. Group)*, 316 B.R. 451 (Bankr. S.D.N.Y. 2004), the Chapter 7 trustee (the “Trustee”) of a limited liability company commenced an adversary proceeding against the debtor’s insiders and senior secured lender alleging they had caused the debtor to operate while insolvent and to incur debt that it would not be able to repay. *Id.* at 455. Certain of the insiders (the “Insiders”) and the lender (the “Bank”) moved to dismiss the deepening insolvency claims.

   In particular, the Trustee alleged the debtor was insolvent from the time of its inception, but the Bank nevertheless loaned funds to the debtor based upon the creditworthiness of certain insiders. *Id.* The Trustee further alleged that other creditors extended credit on account of the Bank’s willingness to loan money to the debtor. *Id.* at 456. Thus, argued the Trustee, the Bank’s loans allowed the debtor to continue its corporate existence and sink deeper into debt. *Id.* With respect to the Insiders, the Trustee alleged they permitted the debtor to conduct business and incur debt despite the fact that the debtor was insolvent and undercapitalized: “The expansion of [the] debt was the proximate cause of the damage to [the debtor] and its creditors.” *Id.*

   Citing numerous cases, the court discussed the divergent trends treating deepening insolvency as either a theory of damages or an independent cause of action. In the end, the court concluded the distinction “may not be necessary”:

   Prolonging an insolvent corporation’s life, without more, will not result in liability under either approach. Instead, one seeking to recover for “deepening insolvency” must
show that the defendant prolonged the company’s life in breach of a separate duty, or committed an actionable tort that contributed to the continued operation of a corporation and its increased debt.

Id. at 459.

The Global Service court emphasized that the mere continuation of an insolvent company is not in and of itself problematic. Rather, the prolongation must be accompanied by fraudulent or wrongful conduct that results in harm to the corporation or its creditors. Consequently, the allegations of the Trustee that the Bank, in loaning funds to the debtor despite knowledge of its insolvency, should be liable for deepening insolvency, were not actionable because they did not allege any wrongdoing. Id. ("This may be bad banking, but it isn’t a tort.").

Similarly, managers of an insolvent limited liability company do not have the absolute duty to liquidate. Id. at 460. Instead, consistent with the business judgment rule, they may continue to operate so long as the enterprise is operated in a manner intended to maximize value for the "community of interest that sustained the corporation." Id. (citing Credit Lyonnais Bank Nederland N.V. v. Pathe Comms. Corp., 1991 WL 277613, at *34 (Del. Ch. Dec. 30, 1991)).

As a result, a manager’s negligent but good faith decision to operate an insolvent business will not subject him to liability for “deepening insolvency.” To overcome the business judgment rule, a complaint must contain specific allegations that the fiduciary acted in bad faith with fraudulent intent.

Id. 316 B.R. at 461 (Lippe v. Bairnco Corp., 230 B.R. 906, 916-17 (S.D.N.Y. 1999)) (emphasis supplied).

Global Service is an important case in the development of the deepening insolvency theory. It clarifies that the mere claim that an entity was kept alive while insolvent is not a sufficient basis for recovery. Rather, an allegation of deepening insolvency must be pinned to something concrete, more particularly, an allegation of fraud or some other wrong. See id. at 461 ("[T]he First Cause of Action wrongly assumes that prolonging the life of an insolvent corporation that continues to incur debt, without more, states a claim for relief."); see also Official Committee of Unsecured


d) In Official Committee of Unsecured Creditors of Vartec Telecom, Inc. v. Rural Telephone Fin. Coop. (In re Vartec Telecom, Inc.), 335 B.R. 631, 2005 Bankr. LEXIS 2512 (Bankr. N.D. Tex. 2005), the creditors’ committee sued the debtor’s prepetition lender. The court held that Texas law would not recognize the tort of deepening insolvency “because the injury caused by the deepening of a corporation’s insolvency is substantially duplicated by torts already established in Texas,” such as e.g., breach of fiduciary duty or accounting malpractice. Id. at 36; see also Alberts v. Tuft (In re Greater Southeast Community Hosp. Corp.), 333 B.R. 506, 517 (Bankr. D.C. 2005) (“There is no point in recognizing and adjudicating 'new' causes of action when established ones cover the same ground.”); Bondi v. Bank of Amer. Corp. (In re Parmalat Secs. Litig., 383 F. Supp. 2d 587, 602 (S.D.N.Y. 2005) (declining to recognize tort of deepening insolvency where North Carolina law already imposes a duty not to aid and abet a breach of fiduciary duty).

The Vartec court also expressed doubt as to whether deepening insolvency was really even a cognizable “tort” because the plaintiff could not establish that a “duty” -- an essential element of a cause of action sounding in tort in Texas -- was owed by the defendant: “The wilful and malicious lending of money is not a tort in Texas and likely will not be recognized as one anytime soon through a theory of deepening insolvency.” In this respect, Vartec closely aligns with the case of Kittay v. Atlantic Bank of N.Y. (In re Global Serv. Group), 316 B.R. 451 (Bankr. S.D.N.Y. 2004), discussed supra.
e) The strongest case thus far to hold against the recognition of the tort of deepening insolvency is *Trenwick America Litigation Trust v. Ernst & Young, L.L.P.,* 906 A.2d 168 (Del Ch. 2006), in which the state court, for the first time, addressed the issue and whether such a tort actually existed under Delaware law. The Court of Chancery, in response to the Defendant’s motion to dismiss, resoundingly rejected the premise that Delaware law recognizes a cause of action for deepening insolvency, stating that “Delaware law imposes no absolute obligation on the board of a company that is unable to pay its bills to cease operations and to liquidate.” *Id.* at 204. The court reasoned that the recognition of such a policy would effectively eviscerate the business judgment rule and the general belief that an insolvent corporation possesses the ability to turn around its profitability by continuing its operations.

The court further noted that the rejection of deepening insolvency does not change the legal landscape, as plaintiffs still had access to traditional causes of action, including breach of fiduciary duties and fraud. A mere increase in the level of insolvency is no more a tort that is “shallowing profitability” and as such, courts have no reason to stray away from the traditional torts. *Id.* at 205.

There is also the argument that, in *Trenwick,* bad facts in this case begot bad law. The Court of Chancery recognized that the Litigation Trust failed to state a viable claim for breach of fiduciary duty, noting that the plaintiff’s complaint “is full of inflammatory adjectival assaults on the motives of the holding company board [and] they are all of an entirely conclusory and unsupported nature.” *Trenwick,* 906 A.2d at 172-73. Therefore, even if the court recognized deepening insolvency, it would not be actionable in this case.

6. **Deepening Insolvency - What Remains?**

a) As a theory of damages - The CitX decision dispelling the notion that deepening insolvency was a viable method to calculate damages resulting from unrelated torts in the Third Circuit. The District Court for the District of Columbia has been the only court, thus far, to criticize the opinion - however, the case is a mere eight months old. It is unclear whether this decision actually affects the amount of damages that plaintiffs can recover or, merely forces plaintiffs to use a different calculation method.

b) As a tort - Future bankruptcy courts that are confronted with a claim for deepening insolvency must analyze its validity in the context of relevant
state law. Therefore, the viability of deepening insolvency in cases arising under Delaware state law is questionable - and will depend upon whether the Delaware Supreme Court jumps into the fray. With respect to claims arising out of the law of other states, however, the future of deepening insolvency is unclear. While, there exists the possibility that those federal courts that previously recognized the tort will look to the Trenwick decision and re-evaluate what it believes respective state law would decide, the issue remains one of first impression.

C. Standing to Assert Deepening Insolvency

In most cases, claims based on deepening insolvency theories are brought by trustees and committees. "The burden of establishing standing lies with the party claiming the status." Unsecured Creditors v. Pardee (In re Stanwich Fin. Servs.), 317 B.R. 224 (Bankr. D. Conn. 2004). Lafferty, 267 F.3d 340, holds that such claims belong to the estate, although it dismissed them on in pari delicto grounds. Other cases, however, suggest the claim, particularly in light of the fact that it is fraud-based, belongs to specific creditors.

1. Exemplar Cases

a) Feltman v. Prudential Bache Secs., 122 B.R. 466 (S.D. Fla. 1990) - In Feltman, the Chapter 11 trustee and official committee of unsecured creditors brought actions against the debtor corporations' principal officer, bankers, accountants and brokers. The complaint alleged the corporations were set up as sham operations and that the officer, with the help of the corporations' bankers, accountants and brokers, had defrauded investors out of approximately $10 million.

All of the defendants, except for the officer, moved to dismiss the complaint asserting that neither the trustee nor the committee had standing to bring such causes of action. Id. at 470. Noting the complaint was "vague regarding which claims belong[ed] to the defrauded investors and which, if any, belong[ed] to the bankruptcy corporation," the court addressed whether the trustee could bring claims on behalf of (i) specific creditors, (ii) general creditors, and (iii) the corporation.26 Id. at 469. The court ruled the trustee did not have the ability to bring causes of action belonging to specific creditors or general causes of action which belonged to the entire creditor body.

26 The committee's standing was dependent upon the trustee's ability to bring such claims: "[T]he Committee can only bring actions initially available to the debtor or Trustee." Id. at 476.
Most relevantly, the court found the trustee, as representative of the debtor, could not pursue a cause of action alleging that the defendants were artificially prolonged the debtors' corporate lives to the detriment of the corporations. *Id.* at 474-75. The corporations were a sham and therefore were not injured by their extended existence: “Thus, any alleged injury to the debtors is as illusory as was their corporate identity.” *Id.* at 474. Rather, the court held, the injury belonged to the defrauded creditors and it would be inappropriate for the trustee to pursue such claims. *Id.* at 474. First, the specific class of injured creditors would be deprived of an opportunity to pursue their own claims. *Id.* Second, if the trustee were successful in its suit, the proceeds would go to the entire creditor body, rather than the defrauded creditors. The court concluded that “the individual creditors rather than the Trustee should seek recovery from third parties.” *Id.*

*Feltman* appears to hold, at least where it is shown the debtor was merely an alter ego, a trustee cannot pursue an injury to a sham corporation because there is no injury to the debtor. Rather, the injury is to the specific creditors who were harmed by the wrongful conduct and the claim therefore belongs to them.

b) In *Official Committee of Unsecured Creditors v. Pardee (In re Stanwich Fin. Servs.)*, 317 B.R. 224 (Bankr. D. Conn. 2004), the Committee argued it had standing to bring causes of action against third parties on behalf of general unsecured creditors despite the fact that the debtor could not pursue such an action and the action did not benefit the estate. The court disagreed and held the committee could only bring those actions that the debtor could have brought prior to the bankruptcy proceeding.

c) In *Official Committee of Unsecured Creditors of RSL Com Primecall v. Beckoff (In re RSL Com Primecall)*, 2003 WL 22989669, *4 (Bankr. S.D.N.Y. 2003), the court held that the plaintiffs, consisting of two joint debtors and their committee of unsecured creditors, did not have standing to bring causes of action based on constructive fraud against various defendants. “It is black letter law that a trustee in bankruptcy (including a debtor in possession) may only pursue claims that belong to the estate.” *Id.* (citing *Caplin v. Marine Midland Grace Trust Co.*, 406 U.S. 416, 429 (1972); see also *Stanziale v. Pepper Hamilton LLP (In re Student Fin. Corp.)*, 335 B.R. 539, 548-49 (Bankr. D. Del. 2005) (holding that trustee was foreclosed from asserting deepening insolvency claim where trustee only alleged damage to creditors).
The court disagreed with the plaintiffs’ contention that all of the debtors’ creditors were equally defrauded by the defendants’ prolongation of the debtor’s life. “A cause of action for fraudulent concealment requires, in addition to a misrepresentation and a fiduciary or confidential relationship, reliance and subsequent injury.” Id. at *4. The court was unconvinced that all of the debtor’s creditors were damaged identically because different creditors likely relied on different information at different times. Id. “Fraud is a claim that peculiarly belongs to individual plaintiffs who had different access to information about RSL USA at different times, and in some cases may not have relied on any information.” Id.

d) Preserving the cause of action for creditors may make sense given the fact that trustees, committees and other representatives of the debtor are frequently barred from asserting the claim on in pari delicto grounds, at least when they bring the action under Section 541. A limited number of cases have permitted trustees to pursue general choses of action on behalf of creditors of the estate under Section 544. *Sender v. Porter (In re Porter McLeod, Inc.),* 231 B.R. 786, 792-93 (D. Colo. 1999); *Raleigh v. Schottenstein (In re Wieboldt Stores, Inc.),* 131 B.R. 655, 668 (N.D. Ill. 1991) *Collins v. Kohlert & Co. (In re Southwest Supermarkets, LLC),* 325 B.R. 417, 426-27 (Bankr. D. Ariz. 2005); *Henderson v. Buchanan (In re Western World Funding, Inc.),* 52 B.R. 743, 773-75 (Bankr. D. Nev. 1985). However, this line of cases has evoked extensive criticism. See *Alberts v. Tuft (In re Greater Southeast Community Hosp. Corp.),* 333 B.R. 506, 518 (Bankr. D.D.C. 2005) (collecting cases); see also *Stanziale v. Pepper Hamilton LLP (In re Student Fin. Corp.),* 335 B.R. 539, 548-49 (Bankr. D. Del. 2005) (holding that trustee was foreclosed from bringing an action under Section 544 because that section deals only with the trustee’s avoidance powers and does not allow him to pursue general tort claims). As a result, it appears the debtor representative is often foreclosed from bringing a deepening insolvency claim leaving no one left to pursue the claim.

D. Defenses And Counter-Defenses to Deepening Insolvency

1. In Pari Delicto and Imputation

   a) In *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc.,* 267 F.3d 340 (3d Cir. 2001), the court recognized a cause of action for “deepening insolvency” under Pennsylvania law. *Lafferty* involved a *Ponzi* scheme by two related and closely-held corporate debtors. Allegedly, the debtors’ principal and related insiders orchestrated a
scheme with two outside professionals, Lafferty (accountant) and Cogan (underwriter) whereby the debtors issued and marketed debt securities while insolvent. The action was brought by a creditors’ committee on behalf of the debtors’ estates. The claims against the principal and insiders were not at issue, having been upheld by the district court on a motion to dismiss and not being subject to the appeal. The appeal dealt exclusively with the claims against the outside professionals (Lafferty and Cogan), who were in essence aiders and abettors.

Although the Third Circuit decision affirmed dismissal of the claims against the professionals on pari delicto grounds, the decision is explicit in recognizing a “deepening insolvency” tort akin to breach of fiduciary duty. The court made clear, in upholding the committee’s standing on behalf of the estate, that expansion of corporate debt out of all proportion to its ability to pay, and consequent prolongation of a corporate life, constitutes a tortious injury to the corporate entity itself, not merely an injury to creditors (for which a bankruptcy trustee could not sue). Id. at 347-48. The harm includes forcing an entity into bankruptcy, “thus inflicting legal and administrative costs,” as well as interference with customers and operations. Id. at 349-50.

The dismissal of Lafferty on in pari delicto grounds arises because the wrongdoing of the entity’s principals is imputed to the corporate debtors, and therefore to the bankruptcy trustee (or committee) which “stands in the shoes of the Debtors.” Id. at 355. While it is possible that the conduct of directors adverse to the corporate entity would not be imputed, when the insider wrongdoers are the sole representatives of the corporate entity, the imputation must be made in any event. The result of this analysis is that the trustee can sue the principals and directors, while third party participants in the fraud or breach of duty must be sued by creditors – a result similarly reached in In re Mediators, Inc., 105 F.3d 822 (2d Cir. 1997) and prior Second Circuit cases.

b) In the case of In re Exide Technologies, Inc., 299 B.R. 732 (Bankr. D. Del. 2003), the Delaware bankruptcy court held that the Official Committee of Unsecured Creditors (the “Committee”) had stated a claim against lenders under Delaware law for deepening insolvency.

In 1997, the prepetition lenders established a $650 million credit facility for Exide and its borrowing subsidiaries. In 2000, a further loan of $250 million was used to finance the acquisition of a competitor, GNB Dunlop. Id. at 736. After that acquisition, Exide’s financial condition began to
deteriorate rapidly. On October 26, 2001, Exide replaced its CFO with a turnaround specialist at the direction of the pre-petition lenders. Shortly thereafter, the parties amended the loan documents to suspend compliance with certain financial covenants in return for liens on all of Exide foreign subsidiaries' assets and capital stock. *Id.*

The amendments to the loan documents did not pull Exide out of its slump. On December 28, 2001, the parties entered into a third amendment to the loan agreements, this time granting a forbearance, coincidentally scheduled to expire just after the 90-day preference period, in exchange for further guarantees and collateral. On April 15, 2002, Exide and certain of its subsidiaries filed for bankruptcy protection. *Id.*

On January 16, 2003 the Committee sued the lenders. Included in the suit was a cause of action to recover against the lenders under a deepening-insolvency theory. The Committee alleged that the lenders caused the Debtor to acquire GNB Dunlop in order that they could then obtain control necessary to force the Debtors to fraudulently continue its business for nearly two years at ever-increasing levels of insolvency. The allegation was that "[t]he conduct by the Lenders caused the Debtors to suffer massive losses and become more deeply insolvent, costing creditors substantial value." *Id.* at 751. The lenders response was that the cause of action was simply not recognized under Delaware law and otherwise barred by the doctrine of *in pari delicto*. *Id.* The lenders filed a motion to dismiss.

In analyzing the issues raised by the motion to dismiss, the Bankruptcy Court acknowledged that the Delaware Supreme Court had not yet spoken on the cause of action. Therefore the Bankruptcy Court must predict how the Delaware courts would rule on such a cause of action, if presented. The Bankruptcy Court relied on the Third Circuit's decision in *Lafferty* (discussed *supra*). The Bankruptcy Court agreed and used the same three pronged test as the Circuit Court used in *Lafferty*. The Bankruptcy Court concluded that the Delaware courts would recognize the theory of a cause of action for deepening insolvency because (1) the theory was inherently sound, (2) there was growing acceptance of the theory among courts and (3) Delaware common law holds that the law provides a remedy where there is an injury. *Id.* at 752.

The Bankruptcy Court dismissed the lenders' argument that the cause of action was barred by *in pari delicto* because *in pari delicto* is an affirmative defense that the Lenders should raise in their answer.
The result of this case is that it appears that causes of action for deepening insolvency are a growing, rather than shrinking, phenomenon. Nonetheless, it is still unclear whether the action is one brought derivatively on behalf of the debtor entity or directly by affected creditors. The ultimate application of the *in pari delicto* defense may defeat the Committee’s cause of action.

c) The theory of imputation was recently seen in *Official Committee of Unsecured Creditors v. Pardee (In re Stanwich Fin. Servs.)*, 317 B.R. 224 (Bankr. D. Conn. 2004). In that case, the creditors’ committee sought to commence an action on behalf of unsecured creditors against professionals who were alleged to have wrongfully assisted the debtor, through its sole shareholder, with the completion of an LBO. The court held that the committee stood in the shoes of the debtor, and not its creditors, for the purposes of bringing such an action. Accordingly, the committee was subject to the same claims and defenses as the debtor. The court applied the imputation rule set forth in the Second Circuit decision of *Shearson Lehman Hutton, Inc. v. Wagoner*, 944 F.2d 114, 118 (2d Cir. 1991), and held that the committee could not assert the claim because the “committee acting on behalf of a debtor corporation lacks standing to assert actions against alleged third-party aider-and-abettors when the sole shareholder of the debtor corporation is alleged to have perpetrated the fraud.” *Id.* at 229.

d) Exceptions – The *in pari delicto* defense, however, is arguably inapplicable where a bankruptcy trustee brings a cause of action under its avoidance powers.

(1) In *McNamara v. PFS (The Personal and Bus. Ins. Agency)*, 334 F.3d 239 (3d Cir. 2003), a Chapter 7 trustee (the “Trustee”) sought to avoid and recover certain prepetition transfers from a sham corporation’s sole owner pursuant to the Trustee’s avoidance powers under Section 548 of the Bankruptcy Code. The issue before the court was whether it could “consider post-bankruptcy petition events, in this case, the appointment of the Trustee, in evaluating a claim brought under Section 548 of the Bankruptcy Code.” *Id.* at 240.

The defendant attempted to utilize the “sole actor” exception set forth in *Lafferty*, 267 F.3d 340 (discussed supra), to argue that the owner’s fraudulent conduct should be imputed to the debtor since the owner was also the debtor’s sole representative. *Id.* The Trustee, on the other hand, contended the “bad actor” had been
replaced postpetition by the Trustee, who brought his claim on behalf of innocent creditors. The Trustee further argued that to bar such creditors’ claims would be inequitable. \textit{Id.} at 241.

The court held that it could take the Trustee’s appointment into consideration and that such appointment cleansed the debtor of “the taint of [its owner’s] fraud.” \textit{Id.} at 247. As a result, the owner’s fraud was not imputed to the Trustee, standing in the shoes of the postpetition debtor. \textit{Id.} Importantly, the court distinguished the present case from \textit{Lafferty}, where the plaintiff creditors’ committee brought its action under Section 541 of the Bankruptcy Code. “\textit{[T]he explicit language of section 541 directs courts to evaluate defenses as they existed at the commencement of the bankruptcy’ and . . . therefore [the Court] was barred from considering the Committee’s status as an innocent successor by the ‘plain language’ of § 541.” \textit{Id.} at 245 (citing \textit{Lafferty}, 267 F.3d at 356-57). Further, the \textit{Lafferty} court specifically noted that its holding did not extend to actions brought pursuant to Bankruptcy Code sections other than Section 541. \textit{Id.} Thus, the \textit{PFS} court concluded \textit{Lafferty} did not apply because the Trustee’s action was brought pursuant to Section 548.

The court’s inquiry did not end there, however. The court was further persuaded by the Trustee’s strong equitable arguments that \textit{in pari delicto} should not apply where a bad actor has been removed and the defense only bars the claims of innocent successors. \textit{Id.} at 246. “\textit{[T]he defense of \textit{in pari delicto} loses its sting when the person who is \textit{in pari delicto} is eliminated.” \textit{Id.} (citing \textit{Scholes v. Lehmann}, 56 F.3d 750, 754 (7th Cir. 1995)).

\textbf{(2)} See also \textit{Podell & Podell v. Feldman (In re Leasing Consultants Inc.)}, 592 F.2d 103 (2d Cir. 1979) (in case under Bankruptcy Act, \textit{in pari delicto} did not bar trustee from recovering under avoidance action instituted in trustee’s capacity as representative of creditors of the estate); \textit{Bondi v. Bank of America (In re Parmalat Securities Litigation)}, 412 F. Supp. 2d 392, 400 (S.D.N.Y. 2006) (stating that an emphasis on the “mastermind role of corrupt insiders may defeat an \textit{in pari delicto} defense).

e) At least one court has recently determined that \textit{pari delicto} can be raised at the outset as a standing issue rather than an equitable defense. \textit{Baena v. KPMG LLP}, 389 F. Supp. 2d 112, 118 (D. Mass. 2005). In that case, the
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court did not even reach the issue of whether deepening insolvency would be a cognizable tort under the applicable law.

2. Business Judgment Rule

As mentioned in the discussion of Global Service, supra, the decision of a manager to continue operating a company – despite the fact of insolvency – may be protected from liability vis-à-vis the business judgment rule. In Official Committee of Unsecured Creditors of RSL Com Primecall v. Beckoff (In re RSL Com Primecall), 2003 WL 22989669 (Bankr. S.D.N.Y. 2003), the debtor, its debtor subsidiary, and the committee for unsecured creditors (collectively, the “Plaintiffs”) jointly commenced an action against various officers and directors of the debtors and affiliated companies (collectively, the “Defendants”). Id. at *1. The complaint alleged, among other things, that the Defendants breached their fiduciary duty to creditors by wrongfully prolonging the life of the debtor when they should have liquidated. Further, the Plaintiffs argued the Defendants were not entitled to protection of the business judgment rule because they were not independent. Id. at 8. The Defendants moved to dismiss the complaint.

As in Global Service, the court confirmed that directors do not have an absolute duty to liquidate and such a decision may be protected by the business judgment rule, absent self-dealing. See id. at *9. Following the Plaintiffs’ argument, noted the court, would cause directors to prematurely run towards an insolvency filing “as the director could have little confidence that the corporation would not, in the bright light of hindsight, be deemed to have been insolvent under one definition or the other.” Id. at *8.

a) Exceptions to Business Judgment Rule

“The business judgment rule in Delaware law creates a presumption that in making a business decision the disinterested directors of a corporation act on an informed basis, in good faith and in the honest belief that the action taken is in the best interests of the company.” Id. at *9 (citations omitted). The protections of the business judgment rule, however, are unavailable where there is evidence of self-dealing, bad faith, or if material decisions are made without any information or deliberation. See id. at *9-10. In RSL, the court found the Plaintiffs had adequately alleged that the Defendants had wrongfully authorized guarantees of affiliate debt in violation of their fiduciary duties.

The Defendants, however, argued they were protected by an exculpation proviso in the debtor’s articles of incorporation. The court rejected the
argument finding that an exculpation clause only protects directors from claims "founded upon negligence, including gross negligence, but does not eliminate claims based on breach of loyalty and does not bar 'acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law.'" Id. at *12; see also In re Prod. Resources Group, LLC v. NCT Group, Inc., No. C.A. 114-N., 2004 WL 2647593, *15 (Del. Ch. Nov. 17, 2004) ("[A]n exculpatory charter provision does not insulate directors from liability for various acts of disloyalty towards the firm.").
ABOUT THE PRESENTERS

Leif M. Clark

Judge Clark is a 1980 honors graduate of the University of Houston Law Center, where he also served as an associate editor on the Houston Law Review. He was appointed to the bankruptcy bench by the Fifth Circuit in 1987. Before becoming a judge, he was a partner with Cox & Smith in San Antonio, Texas--concentrating on bankruptcy and creditors' rights and representing institutional lenders, committees, and debtors during the explosion of bankruptcy cases in Texas in the early and mid-1980's. Prior to attending law school, Judge Clark received a Master of Divinity degree from Trinity Lutheran Seminary in Columbus, Ohio, and served the American Lutheran Church in specialized ministries. He frequently speaks at bankruptcy seminars and has taught American constitutional law to foreign students in Salzburg, Austria as part of the International Law program of McGeorge School of Law. Judge Clark participated in USAID program for training judges in Poland, Romania, and Ukraine, and also hosted a delegation of Arbitrazh Court Judges from the Russian Federation. He also teaches bankruptcy law as an adjunct professor at the University of Texas School of Law. He is married and is the proud father of his son, Harrison (now 3 and a half) and his daughter, Carson, born in January 2006.

Robert B. Millner

Mr. Millner is a partner in the Chicago offices of Sonnenschein Nath & Rosenthal LLP and practices in bankruptcy and commercial litigation. Among other things, he represents financial institutions and insurance companies in significant bankruptcy litigation and lenders and debtors in complex real estate matters. Mr. Millner currently represents the Official Committee of Unsecured Creditors in the Federal Mogul bankruptcy in Delaware, and insurance carriers in the Catholic Church bankruptcies in Spokane and Portland, and in the Artra and Flintkote asbestos bankruptcies. In the past, Mr. Millner has represented a principal energy-contract counterparty in Enron in New York, major parties in interest in the Superior National bankruptcy (and related state-court insurance company insolvency) in Los Angeles, and the former Chairman of the debtor in Fruit of the Loom in Delaware. He has also represented insurance carriers in the Tucson Diocese chapter 11 case; Babcock & Wilcox in New Orleans, Owens Corning in Delaware, USG in Delaware; Kaiser in Delaware, Mid-Valley in Pittsburgh, Combustion Engineering in Delaware, and Plibrico in Chicago. In the past, Mr. Millner also was lead counsel for the principal secured lender in the Carter Hawley Hale bankruptcy in Los Angeles and represented major parties in interest in Celotex in Tampa, Florida, United States Brass in Dallas, Texas, InteLogic Trace in San Antonio, Texas, and Fuller-Austin in Delaware. Mr. Millner has handled cross-border matters both on the debtor side (representing a U.S. flag carrier whose principal routes were to South Africa) and the creditor side, including representation the National Organization of Life and Health Guaranty Associations in the Confederation Life insurance insolvency in Toronto, Canada and Lansing, Michigan.

Mr. Millner is currently Chair of the Insurance Subcommittee of the Business Bankruptcy Committee of the American Bar Association. Mr. Millner has served as Co-Chair, Bankruptcy and Insolvency Committee, Litigation Section of the American Bar Association (1992-1995, 2001-2004), Vice-Chair of the Task Force on Current Developments in Bankruptcy in the ABA Section of Business Law, and has served as Vice-Chair, ABA Joint Ad Hoc Committee on Bankruptcy Court Structure and Insolvency Process (1993-1997). Mr. Millner is a Fellow of the American College of Bankruptcy, a Life Fellow of the American Bar Foundation, a member of the International Insolvency Institute, and an honorary overseas member of the Commercial Bar Association in London. Mr. Millner is a frequent lecturer at major national seminars and is author of numerous articles and papers on Bankruptcy topics.
Mr. Millner is a member of Phi Beta Kappa, and served as law clerk to the late George C. Edwards of the United States Court of Appeals for the Sixth Circuit (1975-76).

**Sally S. Neely, Esq.**

Sally Neely joined Sidley Austin LLP in 1980, when Sidley & Austin merged with Shutan & Trost, a boutique bankruptcy firm in Los Angeles. Ms. Neely joined Shutan & Trost in 1977 from Harvard Law School, where she was Assistant Professor. Following law school, Ms. Neely was law clerk to the Honorable Ozell M. Trask, United States Court of Appeals, Ninth Circuit.

Ms. Neely practices in the area of corporate workouts and chapter 11 reorganizations, representing debtors, committees, creditors, contract parties, purchasers, defendants in adversary proceedings and other interested parties. She is or has recently been involved in representation of, among others, chapter 11 debtors Federal Mogul Global and The Flintkote Company (both in asbestos-related cases) and NewPower Co. (an Enron affiliate); the creditors’ committee for Franchise Pictures, LLC; non-debtor contract parties and defendants Bombardier Inc. and Learjet Inc. in bankruptcy cases for certain individuals; and purchasers of assets in the Consolidated Freightways and PureBeauty, Inc. chapter 11 cases.

Ms. Neely has written and taught extensively for the National Conference of Bankruptcy Judges, ALI-ABA, the NYU School of Law Workshop on Bankruptcy and Business Reorganization, and the Southeast Bankruptcy Law Institute, among others. She is co-chair of the ALI-ABA Advanced Chapter 11 program.

Ms. Neely is a member of the National Bankruptcy Conference, co-chair of its Committee on Legislation, a member of its Executive Committee and past chair of its Committee on Partnerships. She is also a fellow of the American College of Bankruptcy, which she serves as Vice President and co-chair of the Educational Programs Committee. Ms. Neely received both her B.A. and J.D. from Stanford University, and is a member of Order of the Coif and Phi Beta Kappa. She is listed in the Law Business Research “International Who’s Who of Insolvency and Restructuring Lawyers,” the Euromoney “Guide to the Leading U.S. Insolvency and Restructuring Lawyers,” and the K&A Register, among others. She was also named a “leading individual” bankruptcy lawyer by Chambers & Partners and a “Southern California Super Lawyer” by Law and Politics Magazine in 2004, 2005 and 2006.

**Michael H. Reed**

Michael H. Reed is a partner in the Philadelphia office of Pepper Hamilton LLP. He concentrates his practice in the field of corporate reorganization and bankruptcy law. He is a fellow of the American College of Bankruptcy and a member of the American Law Institute. Mr. Reed served as President of the Pennsylvania Bar Association in 2004-05 and served on the Board of Governors of the American Bar Association in 2005-06.

Mr. Reed served as Chairman of the Eastern District of Pennsylvania Bankruptcy Conference in 1997-98. He also served on two Bankruptcy Judge Merit Selection Committees for the Eastern District of Pennsylvania in 1992-93 and 2000, when he also chaired the Committee.

Active in the Business Bankruptcy Committee of the American Bar Association’s Section of Business Law, Mr. Reed chairs its Subcommittee on Bankruptcy Committees, and he previously chaired the Subcommittees on Avoiding Powers, Mass Tort and Environmental Claims and Labor and Employment Law. He also serves on the Section’s Publications Board and the ABA’s Presidential Advisory Council on Diversity in the Profession.
Mr. Reed speaks and lectures nationally on bankruptcy matters and has been an adjunct professor at the Beasley-Temple Law School and Rutgers-Camden Law School.


A native of Philadelphia, Mr. Reed joined Pepper Hamilton in 1972 and was elected a partner in 1980. He received a B.A. in political science in 1969 from Temple University and his J.D. in 1972 from Yale Law School. He was admitted to the bar of the Supreme Court of Pennsylvania in 1972.

Mr. Reed and his wife, Yalta Gilmore-Reed, reside in Philadelphia. The Reeds have two children, Alexandra and Michael, Jr.