# Potential Liability For Deepening Insolvency And Breach Of Fiduciary Duty To Creditors

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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 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

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directors. *Prod. Resources*, 2004 WL 2637593, *12 (Del. Ch. Nov. 17, 2004) (discussed more 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-1 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

[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 BR 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).

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

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.[2] 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.[3]

The duty of care requires that directors exercise the care that an ordinarily prudent person would exercise under similar circumstances.[4] 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

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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.

Model Bus. Corp. Act §8.30(a) (1991).

[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.")

[4] 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, '[h]aving 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).

of loyalty or intentional misconduct). Del. Code. Ann. tit. 8 § 102(b)(7). More than 40 other states have passed similar statutes.[5]

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).[6] 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*.[7] If the protection of the business judgment rule is lost, the burden shifts to the director to prove the fairness of the challenged transaction.[8]

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.[9] Federal decisions have upheld this principle in change of control situations, where debtholders assert

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5 *See* Rao, *supra* note 7, at 59

6 The protection of the business judgment rule is modified in the takeover context, in Delaware and certain other jurisdictions, to require that directors make a threshold showing of the reasonableness of their actions before receiving the protection. Richard M. Cieri, Lyle G. Ganske & Heather Lennox, "Breaking Up Is Hard to Do: Avoiding the Solvency-Related Pitfalls in Spinoff Transactions," 54 Bus. L. 533, 544 n.37 (1999).

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 vitiate 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).

(unsuccessfully) that the transaction (an LBO or other acquisition) will impair their ability to be paid.[10] There are limited exceptions to the general rule.[11]

## 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).[12] *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

[10] *Metropolitan Sec. v. Occidental Petroleum Corp.*, 705 F. Supp. 134, 141 (S.D.N.Y. 1989); *Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504, 1525 (S.D.N.Y. 1989); *C-T of Virginia, Inc. v. Barrett*, 124 B.R. 689, 692-93 (W.D. Va. 1990).

[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.

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) 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.[14] *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)

[13] Christopher W. Frost, "The Theory, Reality and Pragmatism of Corporate Governance in Bankruptcy Reorganizations," 72 Am. Bankr. L.J. 103, 107 (1998).

[14] 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).

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.

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 claims. That is the appropriate scope of a duty that exists only to protect the contractual and priority rights of creditors.

225 B.R. at 655.

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.

225 B.R. at 652 (footnote omitted). *Accord Pereira v. Cogan*, 2001 WL 243537 at *9-*10 (S.D.N.Y. Mar. 8, 2001) (directors liable for failure to exercise due care to prevent principal from taking large loans from corporation and excessive compensation while corporation insolvent). *Cf. In re Healthco Int'l, Inc.*, 208 B.R. at 308-09 (such provisions are effective as to directors but grant "no protection to third parties who aid and abet directors" in their breach of duty); *but see Prod. Resources*, 2004 WL 2637593, *15, n.69 (specifically disapproving *Pereira*).

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

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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).

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.

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

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[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 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.

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.

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. <u>Does the Fiduciary Duty Shift to Consideration of Creditor Interests, to the Exclusion of Shareholder Interests?</u>

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).[18] However, it has been held, at 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).[19]

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

[18] *E.g., Ed Peters Jewelry Co., Inc. v. C&J Jewelry Co., Inc.*, 124 F.3d 252, 276 (1st Cir. 1997); *Geyer v. 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.").

[19] *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. Polonitza*, 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.").

directors continue to owe fiduciary duties to stockholders.[20] 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 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. Byllesby & 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

20 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.").

> 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).[21] 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.

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

[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.

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 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." *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. <u>Other Fundamental Issues</u>

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. *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,

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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.

make no mention of the business judgment rule (*e.g. Bovay*, 38 A.2d 808), or view the rule as of "no consequence." *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 (*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.

*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.[23] *Cf. 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, *Bovay* (Delaware Supreme Court) and *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 *Healthco*, the director defendants challenged the trustee's standing, and the challenge was rejected:

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23 *See Snyder Electric Co. v. Fleming*, 305 N.W.2d at 871; *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."); *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."); *In re Mortageamerica Corp.*, 714 F.2d at 1271 ("Any money collected in the action is distributed pro-rata to all creditors and shareholders.").

The Trustee can bring any suit 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 Healthco, the Trustee is not asserting the claim of creditors. He alleges 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 *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.

> [U]nder Texas law a cause of action under the trust fund (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.*[24]

*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.*[25]

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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

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.

judgment. In the jury trial that followed in the district court, the verdict was in favor of the defendants.

## II. DEEPENING INSOLVENCY

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. <u>Origins of Deepening Insolvency</u>

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. <u>Exemplar Cases</u>

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 previously treated deepening insolvency as a claim based upon the "fraudulent expansion of corporate debt and prolongation of corporate life", and that accordingly, fraud is an essential element. *Id.* at 681 (quoting *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co. (In re R.F. Lafferty & Co.)*, 267 F.3d 340, 347 (3rd Cir. 2001); *see also Stanziale v. Pepper Hamilton LLP (In re Student Finance Corp.)*, 335 B.R. 539, 548-49 (D. Del. 2005) (requiring allegation of fraud for viable deepening insolvency claim).

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. <u>Theory of Damages</u> – Damages for fraud or other wrongful conduct are calculated by measuring the corporation's deepening insolvency.

2. <u>Exemplar Cases</u>

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."

d) *Kittay v. Atlantic Bank of N.Y. (In re Global Serv. Group)*, 316 B.R. 451, 457 (Bankr. S.D.N.Y. 2004) – ruling that an "insolvent corporation suffers a distinct and compensable injury when it continues to operate and incur more debt."

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 theory of damages in this jurisdiction regardless of whether the injury occurred as a result of negligence or fraud.". *Id*. at 338.

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

4. <u>Exemplar Cases - Deepening Insolvency Recognized</u>

a) *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc.*, 267 F.3d 340, 349 (3d Cir. 2001) – concluding that "if faced with the issue, the Pennsylvania Supreme Court would determine that 'deepening insolvency' may give rise to a cognizable injury."

b) *In re Exide Technologies, Inc.*, 299 B.R. 732, 752 (Bankr. D. Del. 2003) – ruling that "Delaware Supreme Court would recognize a claim for deepening 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.

e) *In re LTV Steel*, 333 B.R. 397, 421-22 (Bankr. N.D. Ohio 2005) - holding 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. <u>Exemplar Cases - Deepening Insolvency Not Recognized</u>

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*

*Creditors of RSL Com Primecall v. Beckoff (In re RSL Com Primecall),* 2003 WL 22989669, *4 (Bankr. S.D.N.Y. 2003) (stating that nondisclosure of corporate insolvency by directors was not wrongful absent allegation of corresponding injury).

c) *Alberts v. Tuft (In re Greater Southeast Cmty. Hosp. Co.)*, 333 B.R. 506, 517 (Bankr. D.D.C. 2005) (noting that the courts in the District of Columbia have not yet recognized a deepening insolvency claim). The Southern District of New York also recently dismissed a deepening insolvency claim, basing its decision upon the tort's duplicative nature. *Bondi v. Bank of America Corp. (In re Parmalat),* 383 F.Supp.2d 587, 601 (S.D.N.Y.2005) (noting that "[i]f officers and directors can be shown to have breached their fiduciary duties by deepening a corporation's insolvency, and the resulting injury to the corporation is cognizable, . . . that injury is compensable on a claim for breach of fiduciary duty.").

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. <u>Deepening Insolvency - What Remains?</u>

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. Kohlbert & 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. <u>*In Pari Delicto* and Imputation</u>

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-abetters when the sole shareholder of the debtor corporation is alleged to have perpetrated the fraud." *Id.* at 229.

d) <u>Exceptions</u> – 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. *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." *Id.* at 247. As a result, the owner's fraud was not imputed to the Trustee, standing in the shoes of the postpetition debtor. *Id.* Importantly, the court distinguished the present case from *Lafferty*, where the plaintiff creditors' committee brought its action under Section 541 of the Bankruptcy Code. "'[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." *Id.* at 245 (*citing Lafferty*, 267 F.3d at 356-57). Further, the *Lafferty* court specifically noted that its holding did not extend to actions brought pursuant to Bankruptcy Code sections other than Section 541. *Id.* Thus, the *PFS* court concluded *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' strong equitable arguments that *in pari delicto* should not apply where a bad actor has been removed and the defense only bars the claims of innocent successors. *Id.* at 246. "[T]he defense of *in pari delicto* loses its sting when the person who is *in pari delicto* is eliminated." *Id.* (*citing Scholes v. Lehmann*, 56 F.3d 750, 754 (7th Cir. 1995)).

(2) *See also Podell & Podell v. Feldman (In re Leasing Consultants Inc.)*, 592 F.2d 103 (2d Cir. 1979) (in case under Bankruptcy Act, *in pari delicto* did not bar trustee from recovering under avoidance action instituted in trustee's capacity as representative of creditors of the estate); *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 *in pari delicto* defense).

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

2. <u>Business Judgment Rule</u>

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.").

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## 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.

He has written many articles, including "Insulating Asset Purchasers from Debt Through Bankruptcy Sales," 15 J. Bankr. L. & Prac. ____ (2006); "Successor Liability and Bankruptcy Sales Revisited – A New Paradigm," 61 Bus. Law. 179 (2005); "Special Purpose Entities in a Post-Enron World," The American Banker (2003); "The Discharge of Environmental Claims in Bankruptcy," 48 Pract. Law 33 (2002); "Successor Liability and Bankruptcy Sales," 51 Bus. Law. 653 (1996); and "Subject Matter Jurisdiction, Abstention and Removal Under the New Federal Bankruptcy Law," 56 Am. Bankr. Law J., 121 (1982).

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.