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Enforcement of Directors' Fiduciary Duties in the Vicinity of Insolvency

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Since the decision of the Delaware Court of Chancery in *Credit Lyonnais Bank Nederland N.V. v. Pathe Communications Corp.*,² commentators have repeated what has been characterized as the court's warning that when a corporation enters the vicinity of insolvency, the fiduciary duties of the directors of the corporation shift to the creditors of the corporation. This article argues that, properly analyzed, the duties of directors do not run to creditors, but instead always run to the corporation.³ The shift that does occur is in the parties that can enforce the corporation's claim when a corporation enters the vicinity of insolvency. In addition, this article addresses the definition and the proper scope of the directors' duties and the method by which those duties may be enforced.

General Principles

Several principles of law are clearly established for solvent corporations, each of which is developed in some detail below: The directors owe fiduciary duties to the corporation, those fiduciary duties may be enforced by the shareholders of the

corporation through a shareholders' derivative action, the directors do not owe fiduciary duties to the creditors of the corporation and the creditors have no right to assert claims directly or derivatively against the directors for breach of fiduciary duty. This article does not attempt to provide a full explication of these principles, since many other sources examine them thoroughly.⁴

In Solvent Corporations, Directors Have Fiduciary Duties that Run to the Corporation



James Gadsden

The corporation laws of all states agree that directors owe fiduciary duties to the corporation.⁵ The duty owed by directors to the corporation flows from the principle that the board of directors is responsible for the management of the business of a corporation.⁶ This proposition is particularly well-developed in Delaware because of that state's status as the forum of choice for the incorporation of businesses.⁷

The principal duties owed by directors are the duty of care and the duty of loyalty.⁸ Practically speaking, the duty of care requires directors to exercise reasonable care in discharging their responsibility for the management of the corporation.⁹ Directors

fulfill their duty of care where they inform themselves of the information and consult the advice of experts to the extent it is necessary to make a decision and they participate in the decision-making process.¹⁰ The "business judgment rule" protects directors by granting deference to their decisions.¹¹ So long as the director takes certain necessary steps, such as informing himself about the background of a transaction, the rule protects a director from liability for the consequences of his or her actions.¹²

The duty of loyalty, on the other hand, involves the avoidance of self dealing.¹³ This duty prevents directors from advancing their personal interests at the expense of the corporation by, for example, misappropriating corporate business opportunities for their personal benefit¹⁴ or by taking part in self-interested transactions at the expense of the corporation.¹⁵ This duty does not comprise all of the duties of a trustee of an express trust.¹⁶ For example, while

¹⁰ *Van Gorkem*, 488 A.2d at 872; *Aronson*, 473 A.2d at 812; *Zapata Corp.*, 430 A.2d at 782.

¹¹ The Supreme Court of Delaware has recognized the business judgment rule as a "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." *Aronson*, 473 A.2d at 812.

¹² "[T]o invoke the rule's protection, directors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them. Having become so informed, they must act with requisite care in the discharge of their duties." *Aronson*, 473 A.2d at 812. As expressed in one treatise:

A decision by a board of directors (1) in which the directors possess no direct or indirect personal interest, (2) is made (a) with reasonable awareness of all reasonably available material information and (b) after prudent consideration of the alternatives, and (3) which is in good faith furtherance of a rational corporate purpose, will not be interfered with by the courts, either prospectively by injunction or retrospectively by imposition of liability for damages upon the directors, even if the decision appears to have been unwise or have caused loss to the corporation or its stockholders.

¹³ Balotti and Finkelstein, *The Delaware Law of Corporations and Business Organizations Inc.*, §15.03 (3d ed. 2003) (footnote omitted).

¹⁴ See, e.g., *Demoulas v. Demoulas Super Markets Inc.*, 677 N.E.2d 159, 179 (Mass. 1997) (stating directors "are bound to act with absolute fidelity and must place their duties to the corporation above every other financial or business obligation") (quoting *Spiegel v. Beacon Participations Inc.*, 297 Mass. 398, 410-11, (1937)); see, also, *Clements v. Rogers*, 790 A.2d 1222 (Del. Ch. 2001) (stating "as traditionally conceived, the duty of loyalty is implicated when conflicted directors propose a self-dealing transaction").

¹⁵ *Broz v. Cellular Information Systems Inc.*, 673 A.2d 148, 155-56 (Del. 1996); *Kaplan v. Fenton*, 278 A.2d 834, 836 (Del. 1971); *Guth*, 5 A.2d at 510-11.

¹⁶ *In re eBay Inc. Shareholders Litigation*, 2004 WL 253521 (Del. Ch. Jan. 23, 2004) (denying motion to dismiss shareholders' claims that certain directors usurped corporate opportunity by accepting securities of IPO companies that investment banker "spun" into their accounts).

¹⁷ *Bovay*, 38 A.2d at 813; *Guth*, 5 A.2d at 510 (stating that corporate officers and directors, while technically not trustees, stand in a fiduciary relation to the corporation and its stockholders where there should be no conflict between duty and self interest).

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² 1991 WL 277613, 17 Del. J. Corp. L. 1099 (Del. Ch. Dec. 30, 1991).

³ For an example of the confusion surrounding creditor's rights, see *Bank of America v. Musselman*, 222 F.Supp.2d 792, 798 (E.D. Va. 2002) (Virginia law recognizes "that directors and officers may be liable to an insolvent company's creditors when the officers abuse their positions during insolvency."). This article argues that directors as such do not owe duties to creditors, but instead continue to owe them to the corporation. Those duties can be enforced by creditors for the corporation when the corporation becomes insolvent. If it escapes insolvency, the corporation will be able to satisfy the claims.

⁴ Nor does this article address the statutory limitations on directors' liabilities established in recent amendments to many states' corporation laws. See, e.g., Del. Code Ann. tit. 8, §102(b)(7) (2002).

⁵ 3 Fletcher, William Meade, et al., *Fletcher Cyclopaedia of the Law of Private Corporations*, §837.50 (perm. ed. rev. vol. 2002); see, e.g., Model Bus. Corp. Act §8.30(a) (2002) ("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.").

⁶ "The business and affairs of a corporation organized under this chapter shall be managed by or under the direction of a board of directors except as may be otherwise provided in this chapter or in its certificate of incorporation." Del. Code Ann. tit. 8, §141(a) (2002); see, e.g., *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996); *Paramount Communications Inc. v. QVC Network Inc.*, 637 A.2d 34, 41-42 (Del. 1994); *Revlon Inc. v. MacAndrews & Forbes Holdings Inc.*, 506 A.2d 173, 179 (Del. 1986); *Aronson v. Lewis*, 473 A.2d 805 (Del. Super. Ct. 1984).

⁷ 3 Fletcher §837.60; Model Bus. Corp. Act §8.30(a) (2002); see *Revlon*, 506 A.2d at 179; *Polk v. Good*, 507 A.2d 531, 536 (Del. 1986); *Smith v. Van Gorkem*, 488 A.2d 858, 872-73 (Del. 1985); *Bovay v. H. M. Byllesby & Co.*, 38 A.2d 808, 813 (Del. 1944); *Guth v. Loft Inc.*, 5 A.2d 503, 510 (Del. 1939).

⁸ *Id.*

⁹ *Van Gorkem*, 488 A.2d at 872; *Zapata Corp. v. Maldonado*, 430 A.2d 779, 782 (Del. Super. Ct. 1981).

traditionally a trustee could not enter self-dealing transactions even if the transaction was fair, corporate directors may “stand on both sides” if the terms of the deal, and the process by which it was negotiated, are entirely fair.¹⁷

While these duties run to the corporation and not directly to shareholders,¹⁸ they are enforceable by an action for the benefit of the corporation by the shareholders, commonly in a derivative action.¹⁹ Shareholders may only pursue this route after the board of directors has failed or refused to pursue the claims.²⁰ Since a shareholder’s derivative action is brought in the right of the corporation, the recovery goes to the corporation and not directly to the shareholders.²¹ Thus, as the holders of the residual interest in the corporation, the shareholders benefit indirectly from any recovery by the corporation.²²

No Duties Owed to Creditors

It is a well-established principle that directors have no fiduciary duties to creditors of the corporation²³ and that creditors cannot pursue a derivative action on behalf of a solvent corporation.²⁴ The rights of the creditors are defined by the terms of their contracts with the corporation (voluntary creditors) and applicable law (for involuntary creditors, such as tort claimants); fiduciary duties are neither created nor

implied for creditors by otherwise applicable law.²⁵ Thus, while creditors may have direct rights against directors based on other wrongs, such as a claim that a director is a recipient of a fraudulent transfer,²⁶ the creditors cannot enforce the corporation’s claims against a director for breach of fiduciary duties. Only shareholders may avail themselves of this remedy.²⁷ Further, creditors have no greater rights than shareholders to assert direct claims for a breach of fiduciary duty.²⁸

Rights as Insolvency

Where a bankruptcy case has commenced, there are again several well-established principles: The bankruptcy estate succeeds to the corporation’s rights against its directors;²⁹ where a trustee has been appointed, he or she can enforce the estate’s claims against the directors;³⁰ and, if the debtor remains in possession in a chapter 11 case, the debtor-in-possession (DIP) has the power to assert the estate’s claims against the directors.³¹

In the recent *Cybergeneics*³² case, the Third Circuit discussed the recourse available to creditors where the debtor-in-possession (DIP) fails or refuses to pursue a claim available to the estate. Many other appellate courts have addressed this issue in the context of avoidance claims under Bankruptcy Code §§544 to 549.³³ The

avoidance claim cases give the creditors a remedy to pursue the claim on behalf of the estate with the recovery flowing to the estate; this parallels the way in which a shareholder’s derivative action operates with a solvent corporation.³⁴ However, this does not eradicate the duty of the trustee or the DIP to preserve as well as marshal the assets of the estate once the creditors have been paid in full.³⁵ This is true since, if an estate ultimately proves to be solvent, any available surplus assets available after satisfying the claims of the creditors in full flow to the shareholders.³⁶

Enforcement of Fiduciary Duties of Estate Representatives

Like a shareholder’s ability in a solvent corporation to prosecute a suit against directors for violations of fiduciary duty, individual creditors can bring an action against the estate representative of an insolvent corporation for a breach of his or her fiduciary duty. This encompasses suits by the estate for the benefit of all creditors, but does not include suits by individual creditors for their own benefit.³⁷ Thus, a claim for breach of fiduciary duty is an action brought by the estate for the benefit of the creditors generally in the nature of a surcharge action against the trustee of any trust.³⁸ Recognizing the greater difficulties creditors and trustees face in holding a fiduciary accountable, some courts shift the burden to the fiduciary to show the fairness of the transaction.³⁹

¹⁷ *Cinerama Inc. v. Technicolor Inc.*, 663 A.2d 1134, 1148 (Del. Ch. 1994). The court also noted that “while trustees may be surcharged for negligence, a corporate director is only considered to have breached his duty of care in instances of gross negligence.” *Id.*

¹⁸ *Guth*, 5 A.2d at 510; *Danielewicz v. Arnold*, 769 A.2d 274, 283 (Md. App. 2001) (quoting *Waller v. Waller*, 49 A.2d 449 (Md. 1946)).

It is a general rule that an action at law to recover damages for an injury to a corporation can be brought only in the name of the corporation itself acting through its directors, and not by an individual stockholder.... The reason for this rule is that the cause of action for injury to the property of a corporation or for impairment or destruction of its business is in the corporation...hence the stockholder’s derivative right can be asserted only through the corporation.

¹⁹ See *In re Reliance Acceptance Group Inc.*, 235 B.R. 548, 554 (D. Del. 1999); *Levien v. Sinclair Oil Corp.*, 1975 WL 1952, at *3 (Del. Ch. Aug. 12, 1975); *Reeves v. Transport Data Communications Inc.*, 318 A.2d 147, 149 (Del. Ch. 1974) (“A derivative action is in reality one brought by a stockholder on behalf of the corporation, not to redress a wrong done to him individually, but to obtain recovery or relief in favor of the corporation and all similar stockholders so as to compensate the corporation for some wrong done to it as a whole”); *Cantor v. Sachs*, 162 A. 73, 76 (Del. Ch. 1932).

²⁰ *Kamen v. Kemper Financial Services Inc.*, 500 U.S. 90, 95-96 (1991); *Ross v. Bernhard*, 396 U.S. 531, 534-35 (1970); *Elf Atochem North America Inc. v. Jaffari*, 727 A.2d 286, 294 (Del. 1999) (LLC derivative action); *Taormina v. Taormina Corp.*, 78 A.2d 473, 475 (Del. Ch. 1951); *Cantor*, 162 A. at 76.

²¹ *MAXXAM Inc./Federated Development Shareholders Litigation*, 698 A.2d 949, 956 (Del. Ch. 1996) (“The stockholder plaintiff’s claim for redress in a derivative action is not personal. It is derivative, and exists solely because of the plaintiff’s interest as a shareholder.”); *Eshleman*, 2 A.2d at 912-913.

²² *Taormina*, 78 A.2d at 476; *Keenan v. Eshleman*, 2 A.2d 904, 912 (Del. Ch. 1938).

²³ *Fletcher* §849; *Geyer v. Ingersoll Publications Co.*, 621 A.2d 784, 787; *Simons v. Cogan*, 549 A.2d 300, 303 (Del. 1988) (holder of convertible debentures); *Katz v. Oak Industries Inc.*, 508 A.2d 873, 879 (Del. Ch. 1986) (while recognizing a duty of good faith and fair dealing as a matter of contract law); Del. Code Ann. tit. 8 §327 (2002) (status as shareholder as necessary allegation in any derivative action); *Harff v. Kerkorian*, 324 A.2d 215, 222 (Del. Ch. 1974), *rev’d in part on other grounds*, 347 A.2d 133, 134 (Del. 1975); *Barnett, Christopher L.*, “Health and the ‘Insolvency Exception’: An Unnecessary Expansion of the Doctrine?” 16 *Bankr. Dev. J.* 441, 445-446 (2000).

²⁴ Del. Code Ann. tit. 8, §327 (2002); *Harff*, 324 A.2d at 220 (creditors “lack standing under Delaware law to sue derivatively because they are not stockholders”).

²⁵ *Harff*, 324 A.2d at 222 (“The general rule is that directors do not owe creditors duties beyond the relevant contractual terms absent special circumstances...e.g., fraud, insolvency or a violation of a statute....”); *Continental Ill. Nat’l Bank and Trust Co. of Chicago v. Hunt Int’l Resources Corp.*, 1987 WL 55826, at *4 (Del. Ch. Feb. 27, 1987) (“[A] debenture holder may not maintain a claim for breach of fiduciary duty (as distinguished from fraud) against the issuing corporation and its directors. The proposition...that the relationship between a corporation and its directors and debenture holders is contractual, not ‘fiduciary,’ in nature is well settled in this state.”); *see also Prudential-Bache Securities Inc. v. Franz Mfg. Co.*, 531 A.2d 953, 955 (Del. Super. Ct. 1987); *Jebwab v. MGM Grand Hotels Inc.*, 509 A.2d 584, 593 n. 5 (Del. Ch. 1986) (duties to holders of preferred stock); *Katz*, 508 A.2d at 879; *Revlon Inc.*, 506 A.2d at 182.

²⁶ *Mobilificio San Giacomo S.P.A. v. Stoffi*, 1996 WL 924508, at *11, n. 5 (D. Del. Oct. 29, 1996); *Geyer*, 621 A.2d at 787; *Simons*, 549 A.2d at 302; *Continental Ill. Nat’l Bank and Trust Co. of Chicago*, 1987 WL 55826, at *4; *Harff*, 324 A.2d at 222. *See also Barnett*, *supra* note 22 at 445-446.

²⁷ *Id.*

²⁸ *Shaffer*, Andrew D., “Corporate Fiduciary—Insolvent: The Fiduciary Relationship Your Corporate Law Professor (Should Have) Warned You About,” 8 *ABI Law Review* 479, 556 (2003) (“A creditor should not have more rights than the shareholder. The creditor is partially ‘replacing’ the shareholder as a beneficiary party. A creditor of an insolvent corporation does not own the corporation any more than a solvent corporation’s shareholders.”).

²⁹ 11 U.S.C. §541 (2003); *Harrigan v. Bergdoll*, 270 U.S. 560, 564 (1926) (action to receive unpaid stock subscription) (“If the liability is to the corporation, it passes like other choses in action to the trustee in bankruptcy.”); *see also Shaffer*, *supra* note 27 at 556.

³⁰ *Pepper v. Litton*, 308 U.S. 295, 307 (1939) (“[T]hat standard of fiduciary obligation is designed for the protection of the entire community of interests in the corporation—creditors as well as shareholders” [footnote omitted]); *In re Hechinger Investment Co. of Delaware*, 285 B.R. 601, 610-11 (D. Del. 2002); *In re Healthco Intern. Inc.*, 195 B.R. 971, 985 (Bankr. D. Mass. 1996).

³¹ 11 U.S.C. §1107 (2003); *Schock Bros. Inc. v. Raskin*, 1991 WL 166076, at *1 (Del. Super. Ct. July 24, 1991).

³² *Official Committee ex rel. Cybergeneics v. Chinery*, 330 F.3d 548 (3d Cir. 2003).

³³ *See, e.g., Id.*; *In re Gibson Group Inc.*, 66 F.3d 1436 (6th Cir. 1995) (holding that, under certain circumstances, a creditor or creditors’ committee may have derivative standing to bring an avoidance action under §§547, 548); *see also Fogel v. Zell*, 221 F.3d 955, 965 (7th Cir. 2000) (stating “if a trustee unjustifiably refuses a demand to bring an action to enforce a colorable claim of a creditor, the creditor may obtain the permission of the bankruptcy court to bring the action in place of, and in the name of, the trustee”).

³⁴ *Cybergeneics*, 330 F.3d at 566-69; *In re Hechinger Investment Co. of Delaware*, 274 B.R. 71, 89-90 (D. Del. 2002).

According to Chancellor Allen in *Credit Lyonnais Bank Nederland N.V. v. Pathe Comm. Corp.* (citation omitted), in insolvency, the directors’ (and assumedly controlling shareholders’) fiduciary duties are to multiple constituencies. Allen stated that in insolvency, the duty runs not directly to the creditors but to the “community of interest” (citation omitted). It thus appears that while this duty does not necessarily place creditor interests ahead of the interests of stockholders, it requires the board to maximize the corporation’s long-term wealth-creating capacity.

Phelan, Robin E., et al., “If Their Business Judgment Was so Good, How Come They’re in Bankruptcy and Other Perplexing Mysteries of the Business Judgment Rule: Corporate Governance Issue for the Financially Troubled Company,” 10 *J. Bankr. L. & Prac.* 471, 476 (2001); *In re Reliance Acceptance Group*, 235 B.R. at 554; *Odyssey Partners L.P. v. Fleming Cos. Inc.*, 735 A.2d 386, 417 (Del. Ch. 1999); *Geyer*, 621 A.2d at 787; *Credit Lyonnais*, 1991 WL 277613, at *34.

³⁵ *Commodity Futures Trading Com’n v. Weintraub*, 471 U.S. 343, 355 (1985). (“A creditor should not have more rights than the shareholder. The creditor is partially ‘replacing’ the shareholder as a beneficiary party. A creditor of an insolvent corporation does not own the corporation any more than a solvent corporation’s shareholders.”); *see also Matter of NuGelt Inc.*, 142 B.R. at 666; *U.S. ex rel. Willoughby v. Howard*, 302 U.S. 445, 450 (1938). 11 U.S.C. §726 (2003); *In re Healthco*, 195 B.R. at 985.

³⁶ Bankruptcy Code §726(a)(6), 11 U.S.C. §726 (a)(6) (2002).

³⁷ *In re Reliance Acceptance Group*, 235 B.R. at 554; *In re Healthco*, 195 B.R. at 985; *In re Hechinger Inv. Co. of Delaware*, 274 B.R. 71, 90-91 (D. Del. 2002) (denying directors’ motion to dismiss claim for breach of fiduciary duties to creditors brought by creditors’ committee on behalf of the estate); *Pereira v. Cogan*, 294 B.R. 449, 519-21 (S.D.N.Y. 2003) (enforcement of directors’ fiduciary duties “in the vicinity of insolvency” by the corporation’s chapter 7 trustee); *In re Toy King Distributors Inc.*, 256 B.R. 1, 167-215 (Bankr. M.D. Fla. 2000) (same; Florida law).

³⁸ *See generally In re Gorski*, 766 F.2d 723 (2d Cir. 1985) (imposing surcharge on trustee for breach of his fiduciary duty); *In re San Juan Hotel Corp.*, 847 F.2d 931 (1st Cir. 1988) (trustee can be held liable and surcharged for damages by either the estate or a creditor for damages incurred in the willful and deliberate violation of the trustee’s fiduciary obligation).

A determination that the estate (as opposed to a creditor or shareholder) can assert a claim depends on the type of injury asserted. A creditor or a shareholder may sue for an individual wrong suffered at the hands of directors.⁴⁰ However, if the injury is common to all, a creditor or shareholder may bring a derivative suit.⁴¹ For example, if the director or estate representative has breached his fiduciary duty by failing to exercise due care in the operation of the business or liquidation of its assets and some value has been lost, that is a common injury for which the remedy is an action by the corporation or, in the alternative, by the shareholders or creditors derivatively.⁴² The same is equally true of a breach of the duty of loyalty where the director or estate representative has profited at the expense of the corporation.⁴³ Other injuries may give rise to direct actions by the shareholders or creditors for the injuries that they have suffered in their individual capacity, but these injuries are by definition not consequences of a director's breach of a fiduciary duty, since if they were, the injury would be common; thus, a derivative action would lie.⁴⁴

The conclusion that flows from this analysis is that to speak of a shift of fiduciary duties to creditors is a misnomer. The fiduciary duties are always owed to the corporation, the shift occurs in the class of parties interested in the corporation that can assert the corporation's claim. In a solvent corporation, the duties are for the benefit of

the residual interest-holders who are the shareholders; in an insolvent corporation, the creditors.⁴⁵ The *Credit Lyonnais* case, which actually characterizes the directors' duty as to the "corporate enterprise," simply recognizes that the creditors become the residual interest-holders as the corporation enters the zone of insolvency.⁴⁶

Definition of Duties

Beyond the exercise of due care and the avoidance of self-dealing, the definition of the behavior that fiduciary duties proscribe is a second area of ambiguity. References to the "trust fund doctrine" for insolvent corporations confuse this analysis.⁴⁷ The "trust fund doctrine" principle is often articulated as requiring the directors to hold the assets of an insolvent corporation "in trust" for the creditors.⁴⁸ This may appear to suggest that the assets may not be employed in the business or subjected to any other risk. Thus, to comply with the trust fund doctrine, directors of insolvent corporations may feel compelled to simply reduce their assets to cash and distribute it to the creditors. But that summary misstates the rules applicable to common law trusts.⁴⁹

Trustees must invest the assets prudently, but the trustee need not avoid any risk.⁵⁰ In fact, the trustee is under a duty to invest the assets in common equities and other forms of investment where there is a risk of loss in order to preserve the assets and maximize return.⁵¹ Just as it would be imprudent for the trustee of a common law trust simply to invest all the assets in Treasury securities or insured bank deposits,⁵² the same principle applies to the trustees or the directors of an insolvent corporation. They may properly conclude that the interests of stakeholders in the corporation are best preserved by continuing to operate the business, while simultaneously recognizing that doing so may incur debts and create risks.⁵³ The hypothetical posed by the court in *Credit Lyonnais* is consistent with this analysis.⁵⁴

⁴⁵ *Credit Lyonnais*, 1991 WL 277613, at *34 (in the zone of insolvency, the duties normally owed to shareholders are transferred to corporate creditors as part of the "community of interest" that sustains the corporation).

⁴⁶ *Id.*

⁴⁷ *Pepper*, 308 U.S. at 306; *Federal Deposit Ins. Corp. v. Sea Pines Co.*, 692 F.2d 973, 976-77 (4th Cir. 1982); *Davis v. Woolf*, 147 F.2d 629, 633 (4th Cir. 1945) ("The law by the great weight of authority seems to be settled that when a corporation becomes insolvent, or in a failing condition, the officers and directors no longer represent the stockholders, but by the fact of insolvency become trustees for the creditors and that they cannot by transfer of its property or payment of cash prefer themselves or other creditors"); *Gochenour v. George & Francis Ball Foundation*, 35 F.Supp. 508, 515 (S.D. Ind. 1940), *aff'd*, 117 F.2d 259 (7th Cir. 1941); *Arnold v. Knapp*, 84 S.E. 895, 899 (W.Va. 1915); *In re Brockway Mfg. Co.*, 35 A. 1012, 1013 (Me. 1896).

⁴⁸ *Pepper*, 308 U.S. at 306; *Federal Deposit Ins. Corp.*, 692 F.2d at 976-77; *Davis*, 147 F.2d at 633; *Gochenour*, 35 F.Supp. at 515; *Arnold v. Knapp*, 84 S.E. at 899; *In re Brockway Mfg. Co.*, 35 A. at 1013.

⁴⁹ "A trustee has a duty to invest and manage property held in a fiduciary capacity in accordance with the prudent investor standard." N.Y. Est. Powers & Trust Law §11-2.3(a) (McKinney 2003).

⁵⁰ *See, e.g., Id.*

⁵¹ *Id.*

⁵² *Id.*

The court there says that the directors cannot risk the assets that are available to satisfy the claims of the creditors on a speculative venture in the hope of generating a return for shareholders.⁵⁵

This principle is clarified when contrasted with the laws of England (and other jurisdictions that base their corporation laws on the English model). English laws (and their derivatives) expressly place personal liability on directors for debts incurred if the corporation trades while insolvent.⁵⁶ This has led directors to the early filing of formal liquidation proceedings in these jurisdictions in order to protect against personal liability. A cost of this practice, however, is that in the rush to early filing, these directors could possibly sacrifice the great reorganization value of these businesses.⁵⁷ The one U.S. case to explicitly address the issue found "no duty to liquidate upon insolvency, untempered by the business-judgment rule."⁵⁸

What the doctrine does mean is that the directors cannot prefer their interests or the interests of shareholders over the interests of creditors. Practically, this translates into a prohibition on paying themselves compensation in excess of the value of their services, paying debts due to themselves when claims of third-party creditors entitled to the same legal priority go unpaid, and distributing property to shareholders as a return of their capital before the creditors are paid in full.⁵⁹

Conclusion

To refer, without further definition, to the fiduciary duties of directors of corporations in the vicinity of insolvency provides no real guidance. In fact, it may mislead a recipient of the advice on what behavior the duty actually proscribes. Simply put, a director of a corporation in the vicinity of insolvency has a duty of care and a duty of loyalty enforceable by creditors for the benefit of the corporation.⁶⁰ Beyond using due care in making decisions and avoiding self-dealing, the director must seek to preserve

⁵³ A bankruptcy trustee is expressly authorized to continue the operation of the business even in a chapter 7 liquidation case if he believes it prudent to do so. 11 U.S.C. §721.

⁵⁴ 1991 WL 277613, at *34.

⁵⁵ *Id.* at *34, n.55.

⁵⁶ Insolvency Act 1986, Chapter 45, §217 (1986).

⁵⁷ More recently, some legal advisors in these jurisdictions have counseled their clients that the directors may continue to trade if their clients have a reasonable belief that the company can trade out of its difficulties and pay the debts incurred.

⁵⁸ *In re RSL Com Primecall Inc.*, 2003 WL 22989669, at *8 (Bankr. S.D.N.Y. Dec. 11, 2003); *see, also, In re Ben Franklin Retail Stores Inc.*, 225 B.R. 646, 655-56 (Bankr. N.D. Ill. 1998) (finding no breach of duty by directors who incurred debt while they attempted unsuccessfully to restore the corporation to financial health).

⁵⁹ *Board of Trustees of Teamsters v. Foodtown Inc.*, 296 F.3d 164, 173 (3d Cir. 2002); *Askanse v. Fatjo*, 1993 WL 208440 at *1, 5 (S.D. Tex. April 23, 1993).

⁶⁰ *Bennett Restructuring Fund L.P.*, 2003 WL 178753, at *20; *Geyer*, 621 A.2d at 787-788; *Credit Lyonnais*, 1991 WL 277613, at *34.

³⁹ *In re Healthco*, 195 B.R. at 984.

⁴⁰ *See, e.g., Wisconsin Truss v. Donnelly*, 1981 WL 139539, at *2 (Wis. App. Nov. 24, 1981) (stating "creditor may sue a corporation's directors or officers only when the creditor has suffered an injury resulting from the direct tort of the corporation's officers or directors").

⁴¹ *Ford Motor Co. v. Minges*, 473 F.2d 918, 921 (4th Cir. 1973) (when a harm has been caused to the corporation through a director's actions, the "right of action [for fraud or negligent mismanagement] belongs to the corporation and may be maintained only in name of the corporation or its receiver if it is insolvent."); *Geyer*, 621 A.2d at 789; *In re Reliance Acceptance Group Inc.*, 235 B.R. at 554; *Hayes v. Gross*, 982 F.2d 104 (3d Cir. 1992); *John P. Kennedy v. Venrock Associates*, 348 F.3d 584, 589-90 (7th Cir. 2003).

⁴² Insolvency creates a fiduciary duty whereby the directors are "to maximize the assets of their financially distressed corporation in order to protect the common interests of all creditors of the corporation in being paid." *Bennett Restructuring Fund L.P. v. Hamburg*, 2003 WL 178753, at *20 (Conn. Super. Ct. Jan. 2, 2003) (applying Delaware law); *Speer v. Dighton Grain Inc.*, 624 P.2d 952, 961 (Kan. 1981); *State v. Allstadt*, 61 S.W.2d 473, 475 (Tenn. 1933).

⁴³ *See, e.g., Demoulas*, 677 N.E.2d at 179 (stating that directors "are bound to act with absolute fidelity and must place their duties to the corporation above every other financial or business obligation").

⁴⁴ "Where a creditor of a corporation has sustained an identifiable loss peculiar and personal to himself by reason of fraud or negligent mismanagement of a corporation's business by its directors, he has a cause of action against directors for recovery of his personal loss, and such recovery will inure to him personally and not to other creditors of corporation." *Minges*, 473 F.2d at 920-921; *see, also, In re Reliance Acceptance Group Inc.*, 235 B.R. at 554; *see, also, Official Committee of Unsecured Creditors v. R.F. Lafferty & Co. Inc.*, 267 F.3d 340 (3d Cir. 2001) (claim against shareholders; this article does not otherwise discuss whether deepening insolvency is a separate theory of liability or simply a measure of damages for breach of duty); a claim of fraud has not been recognized as a breach of a fiduciary duty and thus cannot be brought by a creditor as a derivative suit against a corporation. *Geyer*, 621 A.2d at 789; *Bennett Restructuring Fund L.P.*, 2003 WL 178753, at *20; *but, cf. Board of Trustees of Teamsters v. Foodtown Inc.*, 296 F.3d 164, 169, 175 (3d Cir. 2002) (claim that directors breached their fiduciary duties to the company's employee benefit plan by preferring their claims to the pension contributions is enforceable by pension plan trustees, not the bankruptcy trustee, since it alleges a particularized duty and injury).

and maximize the assets of the corporation for its stakeholders and thus he need not immediately liquidate the assets for distribution to creditors. ■

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