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Litigating Fiduciary Duty Claims in Bankruptcy Court and Beyond: Theory and Practical Considerations in an Evolving Environment

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Introduction

Litigation against directors and officers is ubiquitous in bankruptcy courts. Indeed, charges of director malfeasance and breach of fiduciary duty are leveled at the outset of many bankruptcy cases -- whether in the hallways outside of first day hearings or creditors committee formation meetings, in early hearings, or in pre-petition letter writing campaigns aimed at encouraging or discouraging specific board actions. These charges frequently wind their way into litigation, typically later in the bankruptcy case.

While the bankruptcy world has become accustomed to this practice, it bears noting in a Stern v. Marshall world that breach of fiduciary duty and deepening insolvency are state law concepts, not portions of the Bankruptcy Code.[2] However, the overwhelming majority of litigation is tried in (and reported caselaw is decided by) bankruptcy courts, and thus director and officer litigation claims have become standard "bankruptcy litigation." The reason is fairly straightforward: suits alleging breach of fiduciary duty and the like are much more likely to be filed when a business strategy has failed precisely because it has failed (there isn't much sense in challenging an objectively successful outcome), and the fact that a company has filed a

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[2] Certain opinions hold that the post-petition conduct of a board is governed by a federal common law fiduciary duty. See infra Section III(D). However, charges of post-petition breach of fiduciary duty are rare. Id.

bankruptcy case often means that business strategies can be characterized (not always accurately) as having failed. Moreover, the fact of bankruptcy means that a fiduciary, such as a Chapter 11 or 7 trustee, a creditors committee, or a post-plan confirmation trust set up to pursue litigation claims, typically will be appointed, thereby avoiding the "collective action" problem outside of bankruptcy. And the bankruptcy process itself often makes it easier for these types of suits to be funded, for example by agreed or court ordered carve outs from a secured lender's collateral. Taken together, this means that since no individual creditor has to fund what could be expensive litigation, director and officer claims alleging wrongdoing in the face of insolvency get pursued in bankruptcy cases more often than they do outside bankruptcy.

Thus, while much has been written on the law of fiduciary duties of directors of insolvent companies over the years, this article attempts to add to the existing literature with two focuses. First, it considers the legal concepts from the standpoint of litigation and litigation strategy (as well as board advice), where relevant focusing on bankruptcy court practice. Second, it highlights several developments in the law of fiduciary duties of officers and directors and deepening insolvency that have somewhat changed the landscape in the past several years.

Indeed, the changes have been significant, mostly because in the last several years the Delaware State courts have had before them a handful of cases that have enabled them to consider issues that previously were mostly being litigated in bankruptcy courts. For the better part of 15 years in the 1990s and early 2000s, after the Delaware Court of Chancery's famous decision in Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp.,[3] bankruptcy trustees and creditors committees routinely asserted claims that directors and officers breached their fiduciary duties *to creditors* while the corporation was in the "zone of insolvency." As

[3] 1991 Del. Ch. LEXIS 215, at *108 (Del. Ch. Dec. 30, 1991).

shown below, the concepts of a "zone of insolvency" (as opposed to actual insolvency) and of duties being owed directly to creditors have been rejected in the last few years. These changes must be considered by plaintiffs in the way they frame complaints, and by defendants in determining whether they have a valid motion to dismiss the complaint. Similarly, until approximately 2006, the concept of "deepening insolvency" had been gaining "growing acceptance."[4] But after the Delaware Court of Chancery's Trenwick[5] opinion, that trend has reversed. Still, some bankruptcy courts believe that certain states would consider deepening insolvency as a cause of action, and many courts have considered deepening insolvency to be a valid damages theory.

Another significant area of recent change is the Delaware Court of Chancery's November 2010 pronouncement that creditors of an insolvent limited liability company ("LLC") cannot obtain standing -- even derivative standing -- to sue for breach of fiduciary duty.[6] This, of course, makes LLCs (and limited partnerships) different in this respect than corporations, and as shown below raises questions about the pursuit of claims in a bankruptcy case when the debtor is an LLC or a limited partnership ("LP"). More recently, cases such as Quadrant[7] have grappled with a topic of significance to many companies that wind up in Chapter 11 cases: to what extent can a board that is controlled by an equity holder choose an aggressive business strategy designed to maximize a return to equity holders which puts creditor recovery at risk.

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[4] See, e.g., In re LTV Steel Co., 333 B.R. 397, 422 (Bankr. N.D. Ohio 2005); Official Comm. of Unsecured Creditors v. Credit Suisse First Boston (In re Exide Technologies, Inc.), 299 B.R. 732 (Bankr. D. Del. 2003).

[5] Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P., 906 A.2d 168 (Del. Ch. 2006), aff'd sub nom., Trenwick Am. Litig. Trust v. Billett, 931 A.2d 438 (Del. 2007) (TABLE).

[6] CML V, LLC v. Bax, 6 A.3d 238 (Del. Ch. 2010).

[7] Quadrant Structured Products Co., Ltd. v. Vertin, 2014 WL 5465535 (Del. Ch. Oct. 28, 2014).

Understanding these and other new developments is vital to crafting a complaint that survives a motion to dismiss and to defending such a suit.

These concepts are considered in more detail below, after a background on fiduciary duty law which sets the foundation for how these concepts differ -- or do not differ -- with respect to insolvent companies.

I. Fiduciary Duties of Directors Generally

The concept of fiduciary duties of corporate officers and directors stems back to older trust law: the law imposes fiduciary duties upon those who control property for the benefit of another.[8] Thus, directors and officers of corporations, who are entrusted with overseeing and managing the business affairs of the corporation for its stockholder owners, owe fiduciary duties to stockholders.[9] As set forth below in Section F, in Delaware[10] and many other states, directors and officers of solvent corporations owe fiduciary duties *only* to stockholders, but some states have a "constituency statute," allowing directors to consider the interest of other constituencies as well. Thus, when pursuing a claim in bankruptcy court, it is vital to understand which state's law applies to the claim.

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[8] See, e.g., In re USACafes, L.P. Litig., 600 A.2d 43 (Del. Ch. 1991); Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939).

[9] Guth, 5 A.2d at 510.

[10] In large measure, this article focuses on Delaware law for three reasons: (a) a large percentage of corporations are incorporated in Delaware, so its law has increased importance; (b) it has by far the most extensive, well developed body of case law on these subjects; and (c) largely due to (a) and (b), many courts in other states view Delaware caselaw to be persuasive on these issues. See, e.g., Beard v. Love, 173 P.3d 796, 802 (Okla. Civ. App. 2007); Emprise Bank v. Rumisek, 215 P.3d 621, 633 (Kan. Ct. App. 2009).

The so called "triad" of fiduciary duties are the duties of loyalty, care and good faith[11] (the last of which might not be its own duty, as set forth in Section C below). In most cases, directors are entitled to judicial deference for their business decisions and also are shielded from personal liability by the so-called "business judgment rule." As explained below, the prerequisite for invoking the rule is a business decision made in the absence of potentially conflicting personal interests, with care, and in good faith.

A. Duty of Care

The duty of care requires a director in managing the corporation's affairs to exercise the degree of care that an "ordinarily careful and prudent [person] would use in similar circumstances."[12] The duty of care arises primarily in two scenarios. First, prior to making a business decision, directors must call forth and consider material information reasonably available to them.[13] Second, directors also have a duty to exercise care in overseeing and investigating the conduct of corporate employees, often referred to as the "duty of oversight." Liability for breach of the duty of oversight may be imposed if either "(a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention."[14]

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[11] See, e.g., Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 179 (Del. 1986); Emerald Partners v. Berlin, 726 A.2d 1215, 1221 (Del. 1999).

[12] Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963).

[13] See, e.g., Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (overruled on other grounds by Brehm v. Eisner, 746 A.2d 244 (Del. 2000)); Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

[14] Stone ex. rel. AmSouth Bancorporation v. Ritter, 911 A.2d 362, 370 (Del. 2006) (emphasis omitted); accord In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 970 (Del. Ch. 1996).

B. Duty of Loyalty

The duty of loyalty prohibits a corporate director from engaging in self-dealing or usurping corporate opportunities in the performance of his or her duties as a director.[15] Material financial interests held by a director that conflict with or are potentially in conflict with the interest of the company directly implicate this duty.[16]

C. Duty of Good Faith

Traditionally, Delaware case law referred to a third of the "triad" of fiduciary duties: good faith.[17] More recently, the Delaware Supreme Court clarified that "the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty."[18] That opinion settled a long-running academic debate but likely has little practical effect on a board's deliberations and fiduciary duty litigation, since directors still must act in good faith in discharging their duties of care and loyalty. In other words, citing Stone, a bankruptcy court might dismiss a count titled "breach of duty of good faith" but decline to dismiss a separate count called "breach of duty of loyalty" based on the same conduct; the dismissal of the good faith count likely will have little or no impact on the rest of the litigation.

Additionally, directors may not act in a manner such that they "*knew* that they were making material decisions without adequate information and without adequate deliberation, and

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[15] See, e.g., Guth, 5 A.2d at 510 (finding that corporate directors' fiduciary duty "requires an undivided and unselfish loyalty to the corporation [and] demands that there shall be no conflict between duty and self-interest").

[16] See *infra* Section I(D).

[17] See Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 368 (Del. 1994) (quoting Barkan v. Amsted Indus., Inc., 567 A.2d 1279 (Del. 1989); In re Walt Disney Co. Derivative Litig., 906 A.2d 27 (Del. 2006).

[18] Stone, 911 A.2d at 370.

that they simply did not care if the decisions caused the corporation and its stockholders to suffer injury or loss."[19]

D. The Business Judgment Rule

The business judgment rule is a series of judicially created "presumption[s] that directors are acting independently, in good faith and with due care in making a business decision."[20] Indeed, it is an "elementary precept of corporation law" that "in the absence of facts showing self-dealing or improper motive, a corporate officer or director is not legally responsible to the corporation for losses that may be suffered as a result of a decision that an officer made or that directors authorized in good faith."[21] This is the case even where the court believes that the board's decision, in hindsight, is "substantively wrong, . . . 'stupid,' . . . 'egregious' or 'irrational.'"[22]

The business judgment rule can be rebutted by a showing of a breach of the duty of care, loyalty or good faith.[23] Once the business judgment rule is rebutted, the burden shifts to the directors to prove the transaction was entirely fair to the corporation.[24] The shifting of the burden often can be outcome determinative because that burden is so difficult (but not

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[19] In re Walt Disney Co. Derivative Litig., 825 A.2d 275, 289 (Del. Ch. 2003) (italics in original); accord In re Walt Disney Co. Derivative Litig., 907 A.2d 693, 755 (Del. Ch. 2005), aff'd, 906 A.2d 27 (Del. 2006).

[20] Brazen v. Bell Atl. Corp., 695 A.2d 43, 49 (Del. 1997); accord Aronson, 473 A.2d at 812.

[21] Gagliardi v. Tri Foods Int'l, Inc., 683 A.2d 1049, 1051 (Del. Ch. 1996).

[22] Caremark, 698 A.2d at 967.

[23] See, e.g., Cede, 634 A.2d at 345.

[24] See, e.g., Kahn v. Lynch Commc'ns Sys., Inc., 638 A.2d 1110, 1116 (Del. 1994); Cede, 634 A.2d at 361; Shamrock Holdings, Inc. v. Polaroid Corp., 559 A.2d 257 (Del. Ch. 1989).

impossible) to meet.[25] Thus, litigation often centers on the issue of whether the business judgment rule has been rebutted. For example, an entire body of caselaw examines whether a director is "interested" in a transaction due to a financial interest in it,[26] or because a director is "beholden" to other interested directors, either though familial relationships or because the director's financial fortunes are tied in some way (salary and continued employment for an inside director, substantial director, consulting or other fees for others) to the interested director.[27]

In insolvency litigation, often the plaintiff will attempt to plead around the business judgment rule by alleging that a director was a large stockholder (or a designee of a large stockholder, such as an employee of a private equity firm that is a majority stockholder of the debtor) and chose a business strategy that favored stockholders at the expense of creditors. This type of allegation has had mixed success -- some courts have accepted this theory while others have rejected it.[28] Ultimately, it might well be that the distinction turns on the facts of the case.

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[25] Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1279 (Del. 1989).

[26] See, e.g., Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1169 (Del. 1995); Pogostin v. Rice, 480 A.2d 619, 624 (Del. 1984) overruled by Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

[27] See, e.g., Orman v. Cullman, 794 A.2d 5, 25 n. 50 (Del. Ch. 2002).

[28] Compare Official Comm. of Unsecured Creditors v. Tennenbaum Capital Partners, LLC (In re Radnor Holdings Corp.), 353 B.R. 820 (Bankr. D. Del. 2006) (business judgment rule not rebutted by directors' large stockholdings) with In re Hechinger Inv. Co. of Del., 327 B.R. 537, 549 (Bankr. D. Del. 2005), aff'd, 278 Fed. Appx. 125 (3d Cir. 2008). The most recent and perhaps most interesting opinions addressing this subject, the Quadrant opinions, apply the entire fairness standard when the controlling stockholder caused the corporation to enter into transactions with the controlling stockholder, but the business judgment rule when the controlled board makes business decisions that, while characterized as risky and standing to benefit only shareholders, have some rationale basis of increasing firm value. See Quadrant Structured Products Co., Ltd. v. Vertin, 2014 WL 5099428 (Del. Ch. Oct. 1, 2014) (Del. Ch. Oct. 1, 2014); Quadrant, 2014 WL 5465535 (Del. Ch. Oct. 28, 2014).

E. Pleading Standards Concerning the Business Judgment Rule Differ in State and Federal Courts

Interestingly, in deciding a motion to dismiss, the standard for determining whether the plaintiff has pleaded sufficient facts to overcome the business judgment rule differs between federal courts (including bankruptcy courts) on the one hand and the Delaware Court of Chancery on the other, even though their respective versions of Rule 8 are substantially similar. Delaware courts require plaintiffs to plead "with particularity facts showing that the challenged decision was not the result of a valid business judgment."[29] In contrast, Federal courts only require the plaintiff to "make out a claim upon which relief can be granted," i.e., notice pleading, recognizing that "[i]f more facts are necessary to resolve or clarify the disputed issues, the parties may avail themselves of the civil discovery mechanisms under the Federal Rules."[30] Thus, the Third Circuit Court of Appeals has held that Delaware's stricter pleading standard when the business judgment rule is in play does not apply in federal courts, even when the federal court considers a motion to dismiss a complaint that implicates Delaware's business judgment rule.[31] While this standard has been criticized as altering substantive state law,[32] several courts have

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[29] See Stanziale v. Nachtomi (In re Tower Air, Inc.), 416 F.3d 229, 234 (3d Cir. 2005).

[30] Id. at 237, quoting Alston v. Parker, 363 F.3d 229, 233 n.6 (3d Cir. 2004) (internal citations omitted).

[31] See id. at 232.

[32] See IT Group, Inc. v. D'Aniello, 2005 U.S. Dist. LEXIS 27869, at *30, 33 n.10 (D. Del. Nov. 15, 2005) (Delaware's pleading requirements for breach of fiduciary duty claims are "an entirely deliberate decision of substantive Delaware law" rather than mere procedure. Applying federal pleading standards to such claims "chang[es] the scope of Delaware fiduciary duty claims by weakening a substantive presumption."). It should be noted that the District Court judge who authored the IT Group opinion subsequently was elevated to the Third Circuit Court of Appeals.

adopted the Third Circuit's approach and apply federal pleading standards to determine whether a plaintiff pleaded sufficient facts to overcome the business judgment rule.[33]

However, that does not necessarily mean that it is easier for a plaintiff to survive a motion to dismiss a fiduciary duty claim in Federal court as opposed to the Delaware state courts. After all, in Federal courts, plaintiffs must assure compliance with the recent Supreme Court pronouncements of Twombly and Iqbal,[34] which in some sense raise federal pleading standards by requiring a "plausible" basis for the relief sought. The Delaware Supreme Court has rejected the Twombley/Iqbal "plausibility" standard for cases filed in Delaware state courts.[35] Thus, an odd dichotomy exists: a plaintiff choosing to file a fiduciary duty suit in Delaware state court need not meet the plausibility standard, but does need to plead with particularity why the business judgment rule is rebutted, while a plaintiff choosing to file in Federal court has the opposite burden.

As set forth below, the business judgment rule continues to operate with full force (and may be rebutted upon the same showing) when the plaintiff is a trustee, creditors committee or creditor and the allegation is a breach of fiduciary duty to the insolvent enterprise.[36]

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[33] See, e.g., Kunelius v. Town of Stow, 588 F.3d 1, 19 (1st Cir. 2009); Responsible Person of Musicland Holding Corp. v. Best Buy Co. (In re Musicland Holding Corp.), 398 B.R. 761, 788 (Bankr. S.D.N.Y. 2008); In re Nat'l Century Fin. Enter., Inc., 504 F. Supp. 2d 287, 312-13 (S.D. Ohio 2007)(applying federal (rather than Ohio) procedural law to determine the sufficiency of breach of fiduciary duty claims); Rafool v. Goldfarb Corp. (In re Fleming Packaging Corp.), 370 B.R. 774, 785-86 (Bankr. C.D. Ill. 2007); Campbell v. Cathcart (In re Derivium Capital, LLC), 380 B.R. 407, 417 (Bankr. D.S.C. 2006); Panos v. Sullivan (In re Sabine, Inc.), 2006 Bankr. LEXIS 381, at *22 (Bankr. D. Mass. Feb. 27, 2006).

[34] Bell Atlantic Corp. v. Twombly, 550 U.S. 544 (2007); Ashcroft v. Iqbal, 129 S. Ct. 1937 (2009).

[35] See Cambium Ltd. v. Trilantic Capital Partners III L.P., 36 A.3d 348 (Del. 2012); Central Mortgage Company v. Morgan Stanley Mortgage Capital Holdings LLC, 27 A.3d 531 (Del. 2011).

[36] See *infra* Section III(3)(A)(3).

F. Directors' Fiduciary Duties in a Solvent Corporation

The fiduciary obligations of a director of a solvent corporation are owed to the corporation itself.[37] Those same fiduciary obligations extend to the corporation's stockholders because, as owners of the business enterprise, they are the ultimate beneficiaries of the corporation's growth and increased value.[38] In many states, including Delaware, directors of a solvent corporation owe no fiduciary obligation to the corporation's creditors.[39] Courts in these states have rejected efforts to expand the fiduciary obligations of directors of solvent corporations to creditors, finding that a creditor's rights are fixed by contract with the corporation.[40] Delaware courts have emphasized that "creditors are usually better able to protect themselves than dispersed shareholders."[41] Indeed, in Delaware, favoring a creditor over a stockholder of a solvent corporation (absent a legal obligation to do so) may constitute a breach of the director's fiduciary obligation.[42]

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[37] See, e.g., Guth, 5 A.2d at 510.

[38] See, e.g., Revlon, 506 A.2d at 179; Van Gorkom, 488 A.2d at 872; Aronson, 473 A.2d at 811.

[39] See, e.g., Simons v. Cogan, 549 A.2d 300, 304 (Del. 1988) ("Before a fiduciary duty arises, an existing property right or equitable interest supporting such a duty must exist"); Katz v. Oak Indus. Inc., 508 A.2d 873, 879 (Del. Ch. 1986) (duties to creditors of solvent company are contractual, rather than fiduciary, in nature); U.S. Bank Nat'l Ass'n v. U.S. Timberlands Klamath Falls, L.L.C., 864 A.2d 930, 947 (Del. Ch. 2004), vacated on other grounds, 875 A.2d 632 (Del. 2005) (stating that "the general rule is that the directors of a debtor company do not owe the creditors any duty beyond the relevant contractual terms") (citations omitted).

[40] See, e.g., Katz, 508 A.2d at 879; Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504, 1524-25 (S.D.N.Y. 1989); Simons, 549 A.2d at 303.

[41] Big Lots Stores, Inc. v. Bain Capital Fund VII, LLC, 922 A.2d 1169, 1180 (Del. Ch. 2006).

[42] See Revlon, 506 A.2d at 182-84.

However, thirty two states currently have "constituency statutes."[43] These statutes largely were adopted in the 1980s and early 1990s in response to holdings like Revlon that, when faced with takeover overtures or similar decisions, directors (of solvent companies) only were permitted to consider what was in the best interests of stockholders, rather than what is in the best interests of, for example, the community in which the corporation has its principal operations, creditors, employees, retired employees and beneficiaries, the environment, etc.[44] Typical constituency statues permit, but do not require, directors to consider such constituencies in addition to the interests of stockholders in making business decisions.

II. Fiduciary Duties of Directors of a Troubled Corporation

A. Duty Owed to the Corporation as a Whole

When a corporation becomes insolvent, directors continue to owe a fiduciary duty to the corporation as a whole. However, unlike for a solvent corporation, what is in the best interests of an insolvent corporation might not be what is in the best interests of stockholders.[45] Until recently, Delaware cases therefore often stated that upon insolvency, the class of constituencies to whom directors owe duties expands to include creditors.[46] As detailed below, more recent

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[43] 2 Model Business Corporation Act Annotated, § 8.30(3)(A) (4th Ed. 2013) (noting that thirty-two states have constituency statutes); see, e.g., 15 Pa. Cons. Stat. §§ 515-517, 1715-1717 (1995); Ohio Rev. Code Ann. § 1701.59(E) (West 1999); Wis. Stat § 180.0827 (2002). The American Bar Association's Revised Model Business Corporation Act does not contain a constituency statute. See, generally, Jonathan D. Springer, *Corporate Constituency Statutes: Hollow Hopes and False Fears*, 1999 Ann. Surv. Am. L. 85, 95-96 (1999).

[44] See, e.g., Ohio Rev. Code Ann. § 1701.59(E); N.Y. Bus. Corp. Law § 717(b) (McKinney 2003).

[45] See N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007); Production Resources Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 791 (Del. Ch. 2004).

[46] While certain bankruptcy courts or courts in other states interpreted this to mean that a "shift" occurred such that corporate directors no longer owe a fiduciary duty to stockholders upon insolvency, e.g., Fed. Deposit Ins. Corp. v. Sea Pines Co., 692 F.2d 973, 976-77 (4th Cir. 1982), that was never Delaware law. But see Quadrant, 2014 WL 5099428, at *8 (Del. Ch. Oct. 1, 2014) (noting that the

cases dispelled the notion of duties being owed directly to creditors, but nevertheless continue to acknowledge that upon and after insolvency, creditor interests matter.

B. Why Insolvency Effects the Analysis

One rationale for considering creditors' interests upon insolvency is the "trust fund" theory, which analogizes that the directors of an insolvent company hold the company's assets in trust for the benefit of creditors.[47] This "strand of authority [is] by no means universally praised."[48] Among other things, the theory works better to explain why self dealing transactions may be wrongful upon insolvency than in providing a basis to consider creditors' interests in ordinary third party transactions.[49] Arguably, the Delaware Court of Chancery has now expressly rejected the trust fund doctrine.[50] A second rationale, the "at risk" theory, contemplates that as a corporation approaches insolvency, corporate directors may adopt

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Delaware Supreme Court's Bovay opinion "could be interpreted" to have provided for such a shift). Rather, pre-Gheewalla Delaware decisions held that upon insolvency, directors' fiduciary duties expand to include both creditors and stockholders. See, e.g., Geyer v. Ingersoll Publ'ns Co., 621 A.2d 784, 789 (Del. Ch. 1992). Indeed, the Chancery Court has stated that "while it is true that a board of directors of an insolvent corporation or one operating in the vicinity of insolvency has fiduciary duties to creditors and others as well as to its stockholders, it is not true that our law countenances, permits, or requires directors to conduct the affairs of an insolvent corporation in a manner that is inconsistent with principles of fairness or in breach of duties owed to the stockholders." Adlerstein v. Wertheimer, 2002 Del. Ch. LEXIS 13, at *35 (Del. Ch. Jan. 25, 2002).

[47] See, e.g., Bovay v. H.M. Byllesby & Co., 38 A.2d 808, 813 (Del. 1944); Asmussen v. Quaker City Corp., 156 A. 180, 181 (Del. Ch. 1931); American Nat'l Bank of Austin v. MortgageAmerica Corp. (In re MortgageAmerica Corp.), 714 F.2d 1266, 1268-69 (5th Cir. 1983); Clarkson Co. Ltd. v. Shaheen, 660 F.2d 506, 512 (2d Cir. 1981).

[48] Production Resources, 863 A.2d at 791.

[49] See, e.g., Berg & Berg Enter., LLC v. Boyle, 178 Cal. App. 4th 1020, 1041 (Cal. Ct. App. 2009).

[50] See Quadrant, 2014 WL 5099428, at *20 (Del. Ch. Oct. 1, 2014) (characterizing the count of the complaint which it dismissed as "[i]n effect ... assert[ing] a variant of Bovay's trust fund doctrine and holding that the count did not state a claim.")

inappropriately high-risk strategies to save value for stockholders.[51] In doing so, directors may put creditors, who at that point likely are the true residual claimants to and beneficiaries of the corporation, at risk if they were solely charged with maximizing value for stockholders.[52] At least one commentator has opined that this type of extraordinary risk taking is appropriate, and that directors should continue to act solely in the interests of stockholders if there is any chance -- even a small one -- that the high risk strategy would pay off.[53] That does not appear to be consistent with at least Delaware law, which holds that a board is "ordinarily ... free to take economic risk for the benefit of the firm's equity owners, so long as the directors comply with their fiduciary duty to the firm by selecting and pursuing with fidelity and prudence *a plausible strategy* to maximize the firm's value."[54] Of course, what constitutes a "plausible strategy' itself also turns on the facts and can be a subject of disagreement, as the Quadrant case, discussed below, aptly demonstrates.

C. The Origin and Demise of the "Zone of Insolvency" and the Concept of Duties Being Owed Directly to Creditors

The Credit Lyonnais court stated in a footnote that when operating a solvent company

> in the vicinity of insolvency, circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act.[55]

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[51] Donald S. Bernstein & Amit Sibal, Current Developments: Fiduciary Duties of Directors & Corporate Governance in the Vicinity of Insolvency, 819 PLI/Comm. 653, 658 (April 2001).

[52] See Credit Lyonnais, 1991 Del. Ch. LEXIS 215, at *108 n.55.

[53] Sabin Willet, Gheewalla and the Director's Dilemma, 64 BUS. LAW. 1087 (Aug. 2009).

[54] Gheewalla, 930 A.2d at 100 (quoting Production Resources, 863 A.2d at 790) (emphasis supplied).

[55] Credit Lyonnais, 1991 Del. Ch. LEXIS 215, at *108 n.55.

The court concluded that "[a]t least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise."[56]

Many courts and commentators read this footnote to hold that creditors affirmatively have the right to enforce fiduciary duties owed to them by filing suit against directors and officers, as long as the company is in the so-called "zone of insolvency."[57] This led to a multitude of complaints, mostly filed in bankruptcy courts, by creditors committees, litigation trusts or trustees, against directors for breach of fiduciary duties for alleged failure to prefer the interests of creditors over stockholders of troubled, but arguably solvent, companies.[58]

In Production Resources, the Delaware Court of Chancery called into question whether Credit Lyonnais actually provided a mechanism for creditor recoveries. The court stated that "Credit Lyonnais provided a shield to directors from stockholders who claimed that the directors had a duty to undertake extreme risk so long as the company would not technically breach any legal obligations."[59] This shield helps creditors because "directors, it can be presumed, generally take seriously the company's duty to pay its bills as a first priority."[60] The court stated that the cases that "somewhat oddly ... read [Credit Lyonnais] as creating a new body of creditor's rights law"[61] are "not unproblematic."[62] After noting several theoretical problems with imposing on

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[56] Id. at *108.

[57] See, e.g., Official Comm. of Unsecured Creditors v. Reliance Capital Group, Inc. (In re Buckhead America Corp.), 178 B.R. 956, 968-69 (D. Del. 1994) (denying a motion to dismiss because a complaint alleged that even if the company was not insolvent, it was at least in the zone of insolvency).

[58] See, e.g., id.; In re Hechinger, 327 B.R. 537; Radnor Holdings, 353 B.R. 820.

[59] Production Resources, 863 A.2d at 788.

[60] Id.

[61] Id. at 787-88.

directors fiduciary duties to creditors of not-yet insolvent corporations, the Court concluded that it "doubt[ed] the wisdom of a judicial endeavor to second-guess good-faith director conduct in the so-called zone."[63] Production Resources, however, did not state the "zone of insolvency" has become irrelevant. Indeed, the court, by explaining its prior holding in Credit Lyonnais, reaffirmed that directors and officers are permitted (but not required) to take into account the interests of creditors, as well as stockholders, when determining what is in the corporation's best interests once a company has entered the zone of insolvency -- a significant change from the primary tasks of officers and directors when a company is financially healthy. That change was intended to reflect the "shield" to directors against suits by stockholders, as contemplated by Credit Lyonnais. Additionally, the Production Resources opinion notes that "once a firm becomes insolvent, there is little doubt that creditors can press derivative claims arguing that directors' pre-insolvency conduct injured the firm."[64]

Three years after Production Resources was decided, the Delaware Supreme Court in North American Catholic Educational Programming Foundation, Inc. v. Gheewalla[65] held:

> When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners.[66]

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[62] Id. at 789.

[63] Id. at 790 n.57.

[64] Production Resources, 863 A.2d at 789 n.56 (emphasis supplied).

[65] Gheewalla, 930 A.2d at 101.

[66] Id. (emphasis added).

Thus, under Gheewalla, a creditor of a marginally solvent Delaware corporation operating in the zone of insolvency may not bring a direct nor a derivative suit for breach of fiduciary duty. Courts in other states have followed suit. For example, in Berg & Berg Enterp., LLC v. Boyle, the California Court of Appeals held that "there is no fiduciary duty prescribed under California law that is owed to creditors by directors of a corporation solely by virtue of its operating in the 'zone' or 'vicinity' of insolvency."[67]

While the Gheewalla court was not presented with the issue of whether the board could use the zone of insolvency as a "shield" against stockholder suits if the board determined to favor a course of action preferred by creditors, its "for the benefit of its stockholder owners" language has created some confusion as to whether the "shield" of the zone of insolvency remains viable.[68] The zone of insolvency could still be a relevant concept if it still permits the "shield." Especially after the Quadrant opinion, litigators might be better served by framing these types of issues in terms of what the business judgment rule does and does not permit, rather than whether a shield is available for favoring one set of interests over another.

Despite this case law, the zone of insolvency cannot be entirely ignored[69] because some opinions (especially outside of Delaware state courts) issued after Production Resources have

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[67] Berg & Berg, 178 Cal. App. 4th at 1041.

[68] See Russell C. Silberglied and Jonathan P. Friedland, "Did the Delaware Supreme Court Break the 'Directors' Shield'?," 24 No. 10 Bankr. Strategist 1 (Aug. 2007).

[69] Decision making in the zone also cannot ignore creditors' interests -- whether a duty exists at that moment or not -- because "once a firm becomes insolvent, there is little doubt that creditors [or a trustee or creditors committee] can press derivative claims arguing that directors' *pre-insolvency* conduct injured the firm". Production Resources, 863 A.2d at 789 n.56, (emphasis supplied). This rule has developed because "if creditors lack standing to assert claims that pre-date the point of insolvency, then the number of possible plaintiffs will be few: stockholders will lack the incentive, and creditors will lack the standing." Quadrant, 2014 WL 5099428 at *15 (Del. Ch. Oct. 1, 2014).

continued to emphasize the zone of insolvency.[70] However, now that Gheewalla has had more time to be understood and digested by the legal community, the distinction between merely being financially troubled as opposed to insolvent has come into focus. In one recent opinion, the Delaware Bankruptcy Court granted a motion to dismiss a complaint which alleged that the defendant's "misconduct propelled the Debtors into insolvency, which ultimately led to the filing of its bankruptcy cases" some time later.[71] That allegation amounted to an admission that the company was not insolvent at the time of the alleged misconduct and did not become insolvent immediately upon the occurrence of the alleged misconduct, so it could not suffice to confer standing under Gheewalla.

Gheewalla separately confirmed that upon actual insolvency, directors owe fiduciary duties to the corporation itself.[72] The court recognized that upon insolvency, what is in the best interests of the corporation often departs from what is in the best interests of stockholders, noting that "[w]hen a corporation is insolvent . . . its creditors take the place of the shareholders as the residual beneficiaries of any increase in value."[73] Thus, the directors' duty is "to maximize the value of the insolvent corporation for the benefit of all those having an interest in it" -- whether creditors or stockholders.[74] A breach of that duty may be enforced by a creditor (or presumably

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[70] See, e.g., In re Hechinger, 327 B.R. at 548 (denying a motion for summary judgment and stating that plaintiff could recover at trial if it met its burden of proving "that Hechinger was operating in the vicinity of insolvency" at the time of the alleged misconduct).

[71] Lightsway Litig. Servs., LLC v. Yung, III (In re Tropicana Entertainment, LLC), 2014 WL 6704445, at *10 (Bankr. D. Del. Nov. 25, 2014).

[72] Gheewalla, 930 A.2d at 101.

[73] Id. Note that this "residual beneficiary" concept is not necessarily accurate if the corporation only is cash flow insolvent but balance sheet solvent or only marginally balance sheet insolvent. In such a case, the residual beneficiary of enough of an increase in value might well be stockholders.

[74] Id. at 103.

a creditors committee) with derivative standing, but not by a direct claim.[75] In other words, a creditor, as among the class of residual beneficiaries, can derivatively enforce the directors' duties to the company, but there is no duty owed directly to any individual creditor.

Similarly, the Court of Chancery has confirmed that there is no duty to "do what was best for a particular *class* of . . . creditors."[76] That guidance is helpful, because language in certain caselaw that talks about the "interests of creditors" oversimplifies the situation facing most boards of insolvent companies -- that they have at least one if not more classes of secured debt as well as unsecured trade debt, and the holders of each tranche of debt have very different -- sometimes directly adverse -- interests and goals. Of course, the quoted language from Shandler v. DLJ Merchant Banking only refers to fiduciary duties of the board, but the board still must comply with other provisions of the law, which in a Chapter 11 case of course includes the absolute priority rule.[77]

The distinctions described in the preceding paragraphs need to be borne in mind when framing a complaint and presenting a defense; describing the fiduciary duty as being owed to the wrong class or person can result in case dismissal.[78] However, it is not clear whether these

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[75] Id. See also Cellco P'ship v. Bane (In re Bane), 426 B.R. 152, 158 (Bankr. W.D. Pa. Mar. 31, 2010) (calling "preposterous" an argument that creditors can have direct standing where stockholders would not "given . . . that, after a corporation becomes insolvent, all a creditor really does is to step into the shoes of such corporation's shareholders (whose shares are worthless)").

[76] Shandler v. DLJ Merchant Banking, Inc., 2010 Del. Ch. LEXIS 154 (Del. Ch. July 26, 2010) (emphasis supplied).

[77] See 11 U.S.C. § 1129(b)(2)(B)(ii).

[78] See, e.g., Vichi v. Koninklijke Philips Electronics N.V., 2009 Del. Ch. LEXIS 209 (Del. Ch. Dec. 1, 2009) (dismissing complaint in part because it pleaded that officer owed fiduciary duties to creditor rather than to company, thereby impermissibly asserting a direct claim); U.S. Bank Nat'l Assoc. v. Stanley, 297 S.W.3d 815 (Tex. App. 2009) (same); Official Committee of Unsecured Creditors of Tousa, Inc. v. Technical Olympics, S.A. (In re Tousa, Inc.), 437 B.R. 447 (Bankr. S.D. Fla. Oct. 4, 2010) (denying motion to dismiss because claims were properly asserted as derivative claims, not direct claims of creditors).

distinctions make a practical difference to a board of directors that is considering a variety of business decisions: whether the directors should be acting in the best interests of creditors as a whole on the one hand or the best interest of the company, the residual beneficiaries of which are creditors on the other, probably makes little difference in most instances.[79]

In Berg & Berg, the California Court of Appeals similarly confirmed that directors of an insolvent California corporation owe duties to the corporation.[80] The court declined to create a "broad, paramount fiduciary duty of due care or loyalty that directors of an insolvent corporation owe to the corporation's creditors solely because of a state of insolvency."[81] However, it did leave open the door for a limited class of such claims:

> We accordingly hold that the scope of any extra-contractual duty owed by corporate directors to the insolvent corporation's creditors is limited in California, consistent with the trust-fund doctrine, to the avoidance of actions that divert, dissipate or unduly risk corporate assets that might otherwise be used to pay creditors claims. This would include acts that involve self-dealing or the preferential treatment of creditors.[82]

The Berg & Berg court did not specify whether such claims are direct or derivative, but since it phrased the duty as being owed "to the insolvent corporation's creditors," it appears that a limited set of *direct* claims are envisioned in California, unlike in Delaware. In contrast, the

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[79] The Gheewalla court was concerned about the board's ability to negotiate with a particular creditor, and whether owing fiduciary duties to creditors would interfere with the ability to negotiate. Id. at 103. It is not clear that conceptualizing fiduciary duties as being owed to the creditor body as a whole would interfere with a board's ability to negotiate with one particular creditor.

[80] Berg & Berg, 178 Cal. App. 4th at 1041 (declining to adopt a "broad, paramount fiduciary duty of due care or loyalty" owing to creditors in part because doing so "would conflict with and dilute the statutory and common law duties that directors already owe to shareholders *and the corporation*." (emphasis supplied)).

[81] Id.

[82] Id. (emphasis in original omitted; new emphasis supplied).

Tennessee Supreme Court has adopted Gheewalla in full, so creditors of insolvent Tennessee corporations only may bring derivative claims.[83]

Because Gheewalla holds that even derivative claims are not available to creditors of solvent companies operating in the zone, but are available to creditors of insolvent companies, and Berg & Berg likewise permits limited fiduciary duty claims upon insolvency but not in the zone, the key question has shifted from whether the company is close to insolvent (i.e., in the "zone") to whether it is insolvent in fact.[84] That is not an easy question to answer, as often post-hoc valuations will differ by wide margins.[85] The former chief justice of the Delaware Supreme Court advises that a board "need[s] the best financial and legal advice obtainable in order to determine on which side of the solvency line the corporation is sitting."[86]

D. Balancing Competing Interests of the Various Constituencies

Thus, directors and officers of an insolvent corporation owe fiduciary duties to the corporation as a whole, and prudence dictates considering the interests of creditors as well as stockholders in determining what is in the corporation's best interests. That often creates a

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[83] Sanford v. Waugh & Co., 328 S.W. 3d 836, 2010 Tenn. LEXIS 1151 (Tenn. Supr. Dec. 17, 2010).

[84] Silberglied & Friedland, 24 No. 10 Bankr. Strategist at 21-22. See also Burch v. Huston (In re US Digital, Inc.), 2011 Bankr. LEXIS 20, at *44 (Bankr. D. Del. Jan. 5, 2011) ("the Director Defendants cannot have breached their fiduciary duty to US Digital and its creditors while operating in the 'zone of insolvency' because they did not owe such a duty under Delaware law. However, as Gheewalla makes clear, when US Digital became insolvent, the Director Defendants owed fiduciary duties to US Digital and its creditors."); In re Tropicana, 2014 WL 6704445, at *10 (Bankr. D. Del. Nov. 25, 2014) (dismissing complaint because it only alleged that actions "propelled the debtors into insolvency" some time later, not that the debtors were insolvent at the time).

[85] Silberglied & Friedland, at 21-22. See also Berg & Berg, 178 Cal. App. 4th at 1041 (noting the "practical problems with creating [a broad duty to creditors], among them a director's ability to objectively and concretely determine when a state of insolvency actually exists such that his or her duties to creditors have been triggered.").

[86] E. Norman Veasey, "Counseling the Board of Directors of the Company in Distress," presentation made at the American College of Bankruptcy Conference (Mar. 15, 2008), at p. 15.

tension. Indeed, the Delaware Supreme Court's directive to "maximize the value of the insolvent corporation for the benefit of all those having an interest in it"[87] to a certain degree begs the question: long term value or short term value? For example, efforts to maximize the corporation's ability to pay its debts may, in some instances, conflict with maximizing the long term value of the company, and thus the value of the stockholders' interest in the corporation (e.g., by using current cash flow to make investments for future growth).[88] Therefore, directors of a financially troubled company often walk a fine line in striking a balance between the interests of creditors and those of stockholders, or between various classes of creditors, and litigation often involves after-the-fact second guessing of that balance.[89]

When presented with such conflicting interests among constituents, the directors should "choose a course of action that best serves the entire corporate enterprise rather than any single group interested in the corporation."[90] What that means in a given case turns on the facts of the case, but it is important to understand that non-conflicted decisions based on adequate information usually are not second guessed by courts merely because the directors chose a course of action that one set of stakeholders did not favor. In this respect, a court's review of directors' choices of what actions to take upon insolvency would be approached no differently than a court's review of any other business decision of a solvent or insolvent company – the business judgment rule applies unless it has been rebutted, such as by a showing that the decision was a

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[87] Gheewalla, 930 A.2d at 103.

[88] See Equity-Linked Investors, L.P. v. Adams, 705 A.2d 1040, 1041 (Del. Ch. 1997).

[89] This is one reason why the business judgment rule is so important in this context. See *infra* Section E.

[90] Geyer, 621 A.2d at 789.

product of gross negligence or self interest.[91] Indeed, the Gheewalla court's holding that directors can choose to take on risk if they select a "plausible strategy"[92] itself is consistent with a gross negligence standard of review.

Thus, the Delaware Court of Chancery has held that directors did not breach their fiduciary duties to stockholders in allowing a creditor, who agreed voluntarily to pay off the company's unsecured creditors, to foreclose on the debtors' property, because the directors "reasonably believed that a bankruptcy filing [which was the option advocated by the stockholders] would produce negative returns for all . . . constituencies, including its stockholders."[93] Similarly, the Court of Chancery held that directors did not breach their fiduciary duties to stockholders in selling operating assets for less than the amount of the company's debt, assuring no return to equity, because there was no competing bidder and the company's cash flow crisis would have imminently resulted in a bankruptcy filing.[94] Applying Delaware law, a New York court similarly held that Bear Stearns' directors did not breach their fiduciary duties to stockholders in selling at a low price to JP Morgan, in part because other alternatives would have been risky to creditors, the company was insolvent or nearly insolvent, and creditors likely would not have recovered anything in a bankruptcy case.[95]

There are, of course, some notable exceptions. For example, in Omnicare v. NCS, the Delaware Supreme Court held that a board breached its fiduciary duties by agreeing to a lock up

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[91] See Smith v. Van Gorkom, 488 A. 2d 858, 873 (Del. 1985).

[92] 930 A. 2d at 100.

[93] See Odyssey Partners, L.P. v. Fleming Cos., 735 A.2d 386, 420 (Del. Ch. 1999).

[94] Blackmore Partners, L.P. v. Link Energy LLC, 2005 Del. Ch. LEXIS 155 (Del. Ch. Oct. 14, 2005).

[95] In re Bear Stearns Litig., 870 N.Y.S.2d 709, 736-67 (N.Y. Sup. Ct. 2008).

and a no shop provision in a merger agreement with no "fiduciary out" clause with Genesis, thereby ultimately resulting in the board recommending a merger to stockholders that turned out to be at a lower price than a later emerging, competing offer that provided more for stockholders.[96] The company was insolvent and previous offers made by the competing offeror, Omnicare, had involved bankruptcy sales.[97] Genesis instead offered a going-concern sale outside of bankruptcy court but insisted upon the merger agreement containing no "fiduciary out" clause. In approving the Genesis deal, the board concluded that the risk of loss of this deal if the board insisted on a fiduciary out (which Genesis was unwilling to give) – and thereby possibly having no deal and risking the ability to pay creditors – was not warranted when weighed against the uncertainty of ever receiving a possibly superior proposal.[98] However, the Delaware Supreme Court held that the board was required to contract for an effective "fiduciary out" clause in order to exercise its continuing fiduciary duties to minority stockholders.[99]

While some were surprised by Omnicare, there is no requirement to prefer creditors (or preferred stockholders)[100] over common stockholders solely because the company is on the brink of insolvency.[101] Rather, the board is entitled to choose a range of options, so long as the board

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[96] Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914 (Del. 2003).

[97] Id. at 921.

[98] Id. at 925.

[99] Id. at 939.

[100] Seee *infra* Section III(B).

[101] See Equity-Linked Investors, L.P., 705 A.2d at 1041; Adlerstein, 2002 Del. Ch. LEXIS 13, at *35 ("while it is true that a board of directors of an insolvent corporation or one operating in the vicinity of insolvency has fiduciary duties to creditors and others as well as to its stockholders, it is not true that our law countenances, permits, or requires directors to conduct the affairs of an insolvent corporation in a manner that is inconsistent with principles of fairness or in breach of duties owed to the stockholders.").

acts in good faith and in an informed manner.[102] Perhaps the most vivid example of this is the recent Quadrant opinion. The company was insolvent and had ceased operations and its only remaining activity was investing its securities. The plaintiff/creditor alleged that the board, dominated by interested directors, re-invested the funds into riskier securities, thereby jeopardizing creditor recoveries and solely benefiting the out-of-the-money stockholders, who hoped the riskier investments would pan out and provide a return to equity. The Court held that unless the business judgment rule was rebutted[103] -- and it held that it was not -- this theory did not state a claim.[104]

While Quadrant demonstrates that directors -- even ones who benefit from risk taking -- can win litigation raising such claims, excessive risk taking might not be advisable for directors of troubled companies. As the former Chief Justice of the Delaware Supreme Court has written, "directorial focus on the best interests of corporate viability and a skeptical view of the wisdom of aggressive risk-taking would seem to be the best advice for fiduciaries of a corporation that is close to the line."[105] Two other considerations should be noted. First, while the Quadrant opinion dismissed the counts relating to risky investment strategy, it denied a motion to dismiss several counts alleging that the company's direct transactions with insiders were not entirely fair.[106] Second, just because an action might be permissible as a matter of fiduciary duty law does not necessarily make it advisable or immune from a different cause of action. For example, upon insolvency or earlier under the "unreasonably small capital" test, risky transactions can be

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[102] See Production Resources, 863 A.2d at 788 n.52.

[103] See *infra* Section E.

[104] Quadrant, 2014 WL 5099428 at *17, 25 (Del. Ch. Oct. 1, 2014).

[105] Veasey, *supra*, at p. 15.

[106] Quadrant, 2014 WL 5465535, at *1 (Del. Ch. Oct. 28, 2014)

second guessed as fraudulent transfers, and a company risks violations of covenants in loan documents or bond indentures.

E. The Business Judgment Rule in Creditor Cases

Gheewalla confirms that the nature of fiduciary duties do not change upon insolvency. Rather, simply the identity of the constituencies who benefit from those duties change, as described above. Accordingly, "[t]he debtor has a duty to use reasonable care in making decisions but once those decisions are made, the debtor is protected by the business judgment rule."[107] Thus, regardless of the identity of the person or entity which files suit -- stockholder or creditor -- the business decisions of the directors of an insolvent corporation are given the same degree of judicial deference as business decisions of the directors of solvent companies.[108] "Because the fact of insolvency does not change the primary object of the directors' duties, which is the firm itself, the business judgment rule remains important and provides directors with the ability to make a range of good faith, prudent judgments about the risks they should undertake on behalf of troubled firms."[109] Thus, for example, "even when [a company is] insolvent, the board [is] entitled to exercise a good faith business judgment to continue to operate the business if it believed that was what would maximize …value."[110]

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[107] Veasey, *supra*, at p. 15.

[108] Angelo, Gordon & Co. v. Allied Riser Commc'ns Corp., 805 A.2d 221, 229 (Del. Ch. 2002) ("there is room for application of the business judgment rule" in suits commenced by creditors); Production Resources, 863 A.2d at 790 n.57 (same); Continuing Creditors' Comm. of Star Telecomms. Inc. v. Edgecomb, 385 F. Supp. 2d 449, 465 (D. Del. 2004). Cf. Berg & Berg, 178 Cal. App. 4th at 1044 (holding that the business judgment rule barred a complaint filed by a creditor).

[109] In re Hechinger, 327 B.R. at 549 (quoting Production Resources, 863 A.2d at 788 n.53) (internal quotation marks omitted).

[110] Shandler, 2010 Del. Ch. LEXIS 154, at *56.

While the application of the business judgment rule assures that courts will not second guess business decisions of a disinterested board of directors which acts in an informed manner and in good faith, creditors nevertheless can prove liability in the same manner as can stockholders of a Delaware corporation who seek to rebut the business judgment rule.[111] One popular theory in many complaints argues that the board's decisions were conflicted and improperly colored by consideration of one or more directors' equity ownership interests. This theory has been met with mixed success. For example, in Hechinger, the Court held that the business judgment rule had been rebutted for purposes of a motion for summary judgment by allegations that the board favored the interests of equity over creditors because certain board members owned 65% of the company's outstanding voting stock.[112] In contrast, in Radnor, a post-trial opinion, the Court applied the business judgment rule to the directors' decision to take on more debt to fund a new project over allegations that the board was "swinging for the fences" due to its members' ownership of nearly all of the company's common equity -- in other words, an allegation that the board was willing to risk creditor recoveries in the hopes that the new business venture would make the company return to solvency and provide value to the stockholders, which were themselves.[113]

Quadrant raises the point most directly. The insolvent company already ceased its operating business, and was left with securities that were required under its operating guidelines

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[111] In at least one bankruptcy court opinion, the plaintiff argued that the business judgment rule is an affirmative defense and therefore may not be considered on a motion to dismiss, and the court assumed without deciding that the plaintiff was correct but nevertheless dismissed the complaint. Heard v. Perkins, 441 B.R. 701 (N.D. Ala. 2010). But the cases considering the business judgment rule on a motion to dismiss are too numerous to recite.

[112] In re Hechinger, 327 B.R. at 500

[113] Radnor Holdings, 353 B.R. at 843.

to be invested in AAA rated investments. An acquirer bought the equity of the company at a discount, controlled the board, and implemented a plan to change the governing documents to permit riskier investments. A bondholder sued under a Gheewalla theory, and argued that the business judgment rule did not apply because the only beneficiary of the decision to make riskier investments was the equity holder which controlled the board; after all, equity was out of the money, so if the risky investments did not pan out, the equity holder lost nothing. The Court rejected this theory, holding:

> I do not believe that Quadrant can rebut the business judgment rule by alleging that the Board has decided to pursue a relatively more risky business strategy to benefit it sole common stockholder, EBF. Although the Company is insolvent, and although the directors are dual-fiduciaries, the Board does not face a conflict between the interest of the primary residual claimants (the creditors) and the interests of the secondary residual claimants (the stockholders).[114]

From a litigation standpoint, the Court provided guidance on what must be pleaded and later proved to rebut the business judgment rule in this context:

> It is not enough, however, for a plaintiff simply to argue in the abstract that a particular director has a conflict of interest or is acting in bad faith because she is affiliated with a particular type of institution that may be pursuing a particular business strategy or have a particular interest. There must be specific allegations and later, actual evidence sufficient to permit a finding that the director faced a conflict or acted with an improper purpose on the facts of the case.[115]

While there is no post-Gheewalla (or for that matter, post-Credit Lyonnais) opinion addressing the subject, an interesting issue is whether the business judgment rule also could be rebutted on an allegation that the directors breached their duty of care by not informing themselves as to whether the company was insolvent and therefore erroneously operating as if

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[114] Quadrant, 2014 WL 5099428 at *25 (Del. C. Oct. 1, 2014).

[115] Id. at 23.

their duties were solely to the stockholders. Cases from other contexts demonstrate that directors should be mindful of the issue.[116]

F. Determination of Insolvency

As set forth above, under Delaware law the fiduciary duty to the corporation expands beyond the consideration of only stockholders upon insolvency, and under California law a limited fiduciary duty is owed to creditors upon insolvency. Thus, determining when a corporation has become insolvent is the starting point of analyzing the fiduciary responsibilities of directors of a financially troubled company.

What constitutes insolvency is a subject on which entire articles have been written, and thus is beyond the scope of this article.[117] For present purposes, it is important to note that there are two standard measures of insolvency: the balance sheet test and "equitable insolvency." Under Delaware law, a company is insolvent if it fails either test. Thus, when determining whether a director's expanded fiduciary duties are triggered, both tests should be considered.[118] Moreover, even though the balance sheet test is a "misnomer" and the balance sheet is only the

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[116] See, e.g., Burroughs v. Fields, 546 F.2d 215, 217 (7th Cir. 1976) (finding fraud because, when the company was on the brink of insolvency and a duty might be owed to creditors, a director paid a commission to himself, "at a time when he knew or should have known the condition of the corporation"); United States v. Spitzer, 261 F. Supp. 754, 755 (S.D.N.Y. 1966) (any director, officer or stockholder who controls the affairs of the corporation is assumed to be aware of all outstanding claims against the debtor and can be held liable for failure to inform himself or herself of such claims or acting in disregard of such information), see also USDigital, 2011 Bankr. LEXIS 20, at *46 ("The Trustee has also alleged sufficient facts indicating that the Director Defendants lacked good faith in their decision to spin-off Infinidi Media and without considering the effect the spin-off would have on the creditors of USDigital.").

[117] See Robert J. Stearn, Jr. & Cory Kandestin, "Delaware's Solvency Test: What Is it and Does it Make Sense? A Comparison of Solvency Tests Under the Bankruptcy Code and Delaware Law", 36 Del. J. Corp. Law 165 (2011).

[118] See LaSalle, 82 F. Supp. 2d at 291; see also U.S. Bank, 864 A.2d at 947-48.

"starting point" of that test,[119] if the company's balance sheet on its face reflects insolvency, a court is very unlikely to grant a motion to dismiss a complaint where the board attempts to argue that duties were owed only to the stockholders.[120]

III. Special Issues in Fiduciary Duty Claims

A. Wholly Owned Subsidiaries

Directors of solvent, wholly owned Delaware subsidiaries owe their fiduciary duties exclusively to the parent.[121] Thus, the board of a solvent, wholly owned subsidiary company would be justified in "tak[ing] action in aid of its parent's business strategy" as long as that action would not "violate legal obligations owed to others," even if those actions made the subsidiary "less valuable as an entity."[122]

Some courts have read this proposition broadly and held that a subsidiary's board's duties do not change if the subsidiary is insolvent; that is, such courts have held that even where the subsidiary is insolvent, the directors of the wholly owned subsidiary should govern the subsidiary solely for the benefit of the parent.[123] More recent opinions have rejected this theory.[124] Thus, the more prudent approach (and more accepted litigation position) is that

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[119] In re Trans World Airlines, Inc., 180 B.R. 389, 405 n.22 (Bankr. D. Del. 1994), rev'd on other grounds, 203 B.R. 890 (D. Del. 1996), rev'd in part on other grounds, 134 F.3d 188 (3d Cir. 1998). The test itself compares the fair market value of assets to the face amount of debt, and is not based on a GAAP accounting balance sheet model.

[120] Production Resources, 863 A.2d at 775; Quadrant, 2014 WL 5099428, at *11-12, 30-32 (Del Ch. Oct. 1, 2014).

[121] Anadarko Petroleum Corp. v. Panhandle E. Corp., 545 A.2d 1171 (Del. 1988).

[122] Trenwick, 906 A.2d at 201 n. 91 & 93.

[123] See, e.g., Collins v. Kohlberg & Co. (In re Southwest Supermarkets, L.L.C.), 315 B.R. 565 (Bankr. D. Ariz. 2004).

[124] See, e.g., In re Teleglobe Commc'ns Corp., 493 F.3d 345, 366-67 (3d Cir. 2007); In re Scott Acquisition Corp., 344 B.R. 283, 286-87 (Bankr. D. Del. 2006) (collecting cases); In re Tronox, Inc., 429

directors of an insolvent subsidiary should consider the interests of the subsidiary as a whole (including creditors), not only the parent.[125] To the extent that they do not, a lawsuit by a creditor, a committee or a trustee alleging breach of fiduciary duties could survive a motion to dismiss. In addition, in at least one recent case, a court refused to dismiss claims against the parent's directors who caused the subsidiary to act in ways inimical to the best interests of the subsidiary and its creditors.[126]

B. Preferred Stock

Most of this article focuses on insolvent companies, where caselaw provides derivative standing to creditors under the theory that creditors are the residual beneficiary of an increase in value. For troubled but marginally solvent companies that have preferred stock with a liquidation preference, the residual beneficiary of an increase or decrease in firm value instead could be the preferred stockholders. Bankruptcy practitioners often refer to the level on the corporate capitalization table where the firm's value runs out as the "fulcrum security".

In a recent post-trial opinion, In re Trados,[127] the Court of Chancery was faced with a company whose fulcrum security was either preferred stock or common stock. The opinion is most noteworthy for its rejection of any notion that preferred stockholders as a tranche were entitled to special protection as the residual beneficiaries of increased value. Rather, it held that

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B.R. 73 (Bankr. S.D.N.Y. 2010); Official Committee of Unsecured Creditors of Tousa, Inc. v. Technical Olympics, S.A. (In re Tousa, Inc.), 437 B.R. 447 (Bankr. S.D. Fla. Oct. 4, 2010); In re Tropicana, 2014 WL 6704445, at *10 (Bankr. D. Del. Nov. 25, 2014).

[125] See Official Committee of Unsecured Creditors v. American Tower Corp. (In re Verestar, Inc.), 343 B.R. 444, 473-74 (Bankr. S.D.N.Y. 2006) ("Any situation where a wholly-owned and controlled subsidiary enters the zone of insolvency obviously requires all responsible parties to act with the utmost care and responsibility.").

[126] See Tousa, 437 B.R. 447 at n.44 and accompanying text.

[127] In re Trados Inc. S'holder Litig., 73 A.3d 17 (Del. Ch. 2013).

preferred stockholders are simply stockholders for purposes of any fiduciary duty analysis, and any rights that were different than the rights afforded to common stockholders were strictly contractual in nature and could not give rise to any additional fiduciary duty.[128]

C. Limited Liability Companies and Limited Partnerships

As a general, default rule (i.e., if the governing documents are silent on the point), the managers of an LLC and the general partner of an LP owe the same fiduciary duties -- care, loyalty, and arguably good faith -- as do the directors of a corporation to its shareholders.[129] However, the fiduciary duty analysis for such "alternative entities" differ from corporations in two fundamental ways.

First, a recent Delaware opinion held that unlike with respect to corporations, creditors of an insolvent Delaware LLC may *not* obtain standing to sue derivatively for breach of fiduciary duty.[130] The court held that section 18-1002 of Delaware's LLC Act[131] limits standing to pursue derivative claims to holders of membership interests in the LLC or their assignees. Creditors are neither, and thus may not obtain derivative standing. The court recognized that this created a distinction between corporations and LLC's, but held that "[t]o limit creditors to their bargained-for rights and deny them the additional right to sue derivatively comports with the contractarian environment created by the LLC Act."[132] The court explained other ways, some unique to LLCs,

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[128] Id. at 38-42.

[129] See, e.g., Blackmore Partners, L.P. v. Link Energy LLC, 864 A.2d 80 (Del. Ch. 2004); Paul M. Altman and Srinivas M. Raju, "Delaware Alternative Entities and the Implied Covenant of Good Faith & Fair Dealing Under Delaware Law," 60 The Business Lawyer, 1469, 1470 (Aug. 2005).

[130] CML V, LLC v. Bax, 6 A.3d 238 (Del. Ch. Nov. 3, 2010), aff'd, 2011 Del. LEXIS 480 (Del. Sept. 2, 2011).

[131] 6 Del. C. § 18-1002. The standing section of the Delaware Revised Uniform Limited Partnership Act is identicalally worded in the relevant portion. 6 Del. C. § 17-1002.

[132] 6 A.3d at 250.

that creditors may protect themselves without the need to pursue fiduciary duty claims derivatively.[133]

Thus, when a plaintiff is considering filing a fiduciary duty claim or defense counsel first starts planning a defense, the first question to ask is whether the debtor is an LP or an LLC. If it is, issues of standing must be analyzed. If the trustee or debtor in possession filed the suit, it is not a "derivative" case; the company, either through its managers (i.e., board) or its court appointed trustee, is simply asserting its own claim. Furthermore, a litigation trust created pursuant to a plan likely may prosecute such a claim without it being considered a derivative claim, if the plan assigned the estate's claim to the trust.

But what about a creditors committee? The leading cases that have permitted a creditors committee (or an individual creditor) to pursue claims that otherwise belong to the estate and are controlled by the debtor in possession have stated that the committee was obtaining "derivative" standing and/or suing on behalf of the estate or debtor.[134] Future cases will undoubtedly consider whether, notwithstanding CML v. Bax, a bankruptcy court has the equitable power to grant such derivative standing to a creditors committee of an LLC or LP debtor – which obviously is not a "member."[135]

Second, no matter who has standing to sue, the fiduciary duty analysis itself differs for alternative entities because they are creatures of contract, and the broadly permissive statutes

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[133] Id. at 250-54.

[134] See, e.g., Official Committee of Unsecured Creditors of Cybergenics Corp. v. Chinery, 330 F.3d 538 (3d Cir. 2003); Unsecured Creditors Committee of STN Enerp., Inc. v. Noyes, 779 F.2d 901 (2d Cir. 1985); Canadian Pacific Forests Ltd. v. JD Irving, Ltd., 66 F.3d 1436 (6th Cir. 1995).

[135] See Russell C. Silberglied, "LLC's Are Different: Creditors of Insolvent LLC's Do *Not* Have Standing to Sue for Breach of Fiduciary Duty, But Can a Creditors' Committee Be Granted Standing?" 20 J. Bankr. L. Prac. 2, Art. 3 (Apr. 2011).

enable LLCs and LPs to modify default rules concerning fiduciary duties in the partnership or operating agreement. Thus, the Delaware Revised Uniform Limited Partnership Act permits modifying and even completely eliminating fiduciary duties:

> To the extent that, at law or in equity, a partner or other person has duties (including fiduciary duties) to a limited partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement, the partner's or other person's duties may be expanded or restricted or eliminated by provisions in the partnership agreement; provided that the partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing.[136]

Delaware's LLC Act has a nearly verbatim provision.[137] It should be noted that the Uniform Acts, and therefore the LP and LLC acts of most states other than Delaware, permit restriction, but not outright elimination, of fiduciary duties.[138]

Sometimes, attempts to modify default fiduciary duties can lead to unintended consequences. For example, in the General Growth Properties case,[139] the operating agreement attempted to modify fiduciary duties in aide of making the LLC "bankruptcy remote." Thus, the operating agreement provided: "to the extent permitted by law...the Independent Managers shall consider only the interests of the Company, *including its respective creditors*, in acting or otherwise voting on the matters [including filing for bankruptcy]." This language seems to indicate that the parties to the operating agreement contemplated that even if the LLC were solvent, the interests of creditors would be considered in an effort to keep the entity bankruptcy remote (because as a special purpose entity, the LLC would have one main creditor which would

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[136] 6 Del. C. §17-1101(d).

[137] 6 Del. C. §18-1101(c).

[138] Altman & Raju, "Delaware Alternative Entities and the Implied Covenant of Good Faith & Fair Dealing Under Delaware Law," 60 The Business Laywer, at 1473.

[139] In re General Growth Properties, Inc., 409 B.R. 43 (Bankr. S.D.N.Y. 2009).

not favor a bankruptcy filing). The court held, however, that the provision operated differently because "it also provided, appropriately, that the Independent Managers can act only to the extent permitted by applicable law, which is deemed to be the corporate law of Delaware."[140] Because the LLC was solvent, the Court held that under Gheewalla, fiduciary duties were owed only to the stockholder – and not to creditors. Accordingly, the Court interpreted the operating agreement in a way that in fact did not alter the default rules of fiduciary duties, notwithstanding the apparent attempt to do so.

Accordingly, when litigating a claim of breach of fiduciary duty involving an LP or an LLC, it is crucial to consult the operating or partnership agreement to determine if default fiduciary duties have been modified or eliminated.

D. Choice of Law

This article has focused primarily on Delaware law, even though fiduciary duty issues typically are raised in federal bankruptcy courts. Of course, as a gating issue, litigants must be aware of which state's law applies to the claims alleged. The internal affairs doctrine "requires that the law of the state of incorporation should determine issues relating to internal corporate affairs."[141] "Internal corporate affairs involve those matters which are peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders."[142] The fiduciary relationship between director, corporation and its constituencies

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[140] 409 B.R. at 64 (emphasis in original).

[141] McDermott Inc. v. Lewis, 531 A.2d 206, 215 (Del. 1987); accord Edgar v. MITE Corp., 457 U.S. 624, 645 (1982); In re Topps Co. S'holders Litig., 924 A.2d 951, 960 (Del. Ch. 2007).

[142] McDermott, 531 A.2d at 214; see also Restatement (Second) of Conflict of Laws § 313 cmt. a.

is the *sine qua non* of internal corporate affairs, so the law of the state of incorporation controls fiduciary duty issues.[143]

However, occasionally courts apply a different state's laws. For example, one bankruptcy court opinion held that New Jersey law applied to a direct claim by a creditor against directors of a Delaware corporation for breach of fiduciary duty.[144] While this likely was simply an "outlier" opinion, it is worth noting, particularly because the law of other states could -- and in Stanziale, did -- differ from Delaware law as described herein.

An issue also occasionally arises about whether any fiduciary based challenge to the post-petition conduct of a board is governed by state or federal common law. While the Bankruptcy Code does not address fiduciary duties, courts have held that debtors in possession ("DIP") and those who control the DIP have fiduciary duties just as a chapter 7 or 11 trustee would.[145] Several bankruptcy courts have referred to this as a separate fiduciary duty imposed on a DIP

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[143] Teleglobe, 493 F.3d at 386 ("Under the internal affairs doctrine, anyone controlling a Delaware corporation is subject to Delaware law on fiduciary obligations to the corporation and other relevant stakeholders."); In re Fedders N. Am., Inc., 405 B.R. at 539 ("Few, if any, claims are more central to a corporation's internal affairs than those relating to alleged breaches of fiduciary duty by a corporation's directors and officers."). See also Tronox, 429 B.R. at 104 (applying internal corporate affairs doctrine to charge of breach of fiduciary duty against promoters of newly incorporated entity).

[144] Stanziale v. Dalmia (In re Allserve Sys. Corp.), 379 B.R. 69, 79 (Bankr. D.N.J. 2007).

[145] See, e.g., Commodity Futures Trading Comm. v. Weintraub, 471 U.S. 343, 355 (1985); Wolf v. Weinstein, 372 U.S. 633, 649 (1963); In re Brook Valley IV, 347 B.R. 662, 672-73 (B.A.P. 8th Cir. 2006) (highlighting that, "'[t]he United States Supreme court has made clear that a debtor in possession, like a chapter 11 trustee, owes the estate and its creditors a general duty of loyalty.' '[I]n practice these fiduciary responsibilities fall not upon the inanimate corporation, but upon the officers and managing employees who must conduct the Debtor's affairs under the surveillance of the court.'") (internal citations omitted), aff'd sub nom In re Brook Valley VII, Joint Venture, 496 F.3d 892 (8th Cir. 2007); Ramette v. Bame (In re Bame), 251 B.R. 367, 373 (Bankr. D. Minn. 2000) (explaining that, "[t]he DIP is a fiduciary for the bankruptcy estate and assumes virtually all of the rights and responsibilities of a bankruptcy trustee").

and its directors, rather than fiduciary duties under state law.[146] But the source of such a separate duty is unclear.[147] Some have pointed to 11 U.S.C. § 1107(a), but that section merely states that a DIP "shall perform all the functions and duties . . . of a trustee serving in a case under this chapter". "Duties", of course, does not necessarily mean "fiduciary duties", and the source of the "duties . . . of a trustee serving in a case under this chapter" is Section 1106(a) of the Bankruptcy Code, which does not mention fiduciary duties.

But while an interesting academic subject, whether a separate "federal" fiduciary duty should attach to directors of a DIP matters little, for two reasons. First, the overwhelming percentage of litigation concerns pre-petition conduct of directors, not post-petition conduct. That is hardly surprising, since post-petition transactions out of the ordinary course of business have to be approved *ex ante* by the bankruptcy court,[148] so the grounds to second guess such decisions *ex post* are slim if extant. Indeed, where there is a faithless DIP, the remedy usually is the appointment of a trustee under Section 1112(b) to remove the fiduciary or the appointment of an examiner under Section 1104(c).[149] Second, while a minority of cases disagree, the majority of courts hold that the fiduciary duties of a DIP are similar or the same as those of an officer and

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[146] See, e.g., LaSalle Nat'l Bank v. Perelman, 82 F. Supp. 2d 279 (D. Del. 2000) (analyzing separately counts of pre-petition breach under Delaware law and post-petition breach under federal common law).

[147] See, e.g., In re Bame, 251 B.R. at 373 (recognizing that "the exact scope of a DIP's fiduciary duties is subject to some debate").

[148] See 11 U.S.C. § 363.

[149] See John William Butler, Jr., Chris L. Dickerson and Stephen S. Neuman, "Preserving State Corporate Governance in Chapter 11: Maximizing Value Through Traditional Fiduciaries", 18 American Bankruptcy Instit. L. Rev. 337, 350-51 (Spring 2010).

director outside of bankruptcy.[150] Thus, even if there is a distinction between whether federal or state fiduciary duties are owed, the distinction might be without a difference.

It is worth noting that the recently released report of the "American Bankruptcy Institute Commission to Study Chapter 11 Reform" considered and rejected a proposal to federalize fiduciary duty standards inside of Chapter 11:

> If the Bankruptcy Code imposed separate duties on a debtor in possession's directors, officers, or similar managing persons, those duties might differ from the duties owed by those individuals under state law. Although federal preemption principles might resolve such conflicts from a legal perspective, the conflict could cause substantial confusion and uncertainty for directors, officers, and similar managing persons. The Commission agreed that state law adequately governs fiduciary duties and should continue to govern the fiduciary duties of directors, officers, and similar managing persons in bankruptcy.[151]

The Report, of course, is not law but a series of recommendations. Nevertheless, it is indicative of the view that the law today does not provide for preemption nor should it.

E. Exculpation

Section 102(b)(7) of Delaware's General Corporation Law, and statutes of many states modeled on Delaware law,[152] permit a corporation to include in its certificate of incorporation a provision that exculpates its directors from personal liability "to the corporation or its stockholders" for monetary damages for breach of the fiduciary duty of care. Because claims for breach of fiduciary duty brought by or on behalf of creditors must be derivative in nature,[153] they

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[150] See, e.g., LaSalle, 82 F. Supp. 2d at 292; In re Schipper, 933 F.2d 513, 515 (7th Cir. 1991); In re Integrated Resources, Inc., 147 B.R. 650, 658 (S.D.N.Y. 1992). But see C.R. Bowles and John Egan, The Sale of the Century or a Fraud on Creditors?: The Fiduciary Duty of Trustees and Debtors in Possession Relating to the "Sale" of a Debtor's Assets in Bankruptcy, 28 U. MEM. L. REV. 781, 793 (1998) (noting minority of cases holding that the fiduciary duty of a DIP instead is governed by the standards of the fiduciary duties owed by a trustee).

[151] "Commission to Study the Reform of Chapter 11, Final Report and Recommendations," American Bankruptcy Institute, 25 (2014), https://abiworld.app.box.com/s/vvircv5xv83aavl4dp4h.

[152] See, e.g., Cal. Corp. Code § 204(a)(4) (1990); Model Business Corporation Act § 2.02(b)(4).

[153] Gheewalla, 930 A.2d at 103.

are claims of "the corporation" for which the corporation's directors are exculpated from personal liability to the extent they involve the duty of care.[154] Thus, Section 102(b)(7) and other states' equivalents provide the same protection from suits filed by creditors, trustees or committees as they do in suits filed by stockholders of a solvent company.[155]

Claims for violation of the duty of loyalty, or for acts taken in bad faith, are not covered by Section 102(b)(7). Moreover, some courts have held that even a duty of care claim should not be dismissed on section 102(b)(7) grounds where duty of loyalty claims are pleaded in the same complaint.[156] There is some disagreement on this point.[157]

Courts often grapple with the issue of what stage of litigation to consider a Section 102(b)(7) exculpation defense. In general, federal courts have declined to consider this defense on a motion to dismiss, because exculpation is an affirmative defense and it is rare that a plaintiff would note such a certificate of incorporation's provision in its complaint.[158] The Delaware Supreme Court, in contrast, has permitted the consideration of an exculpation clause on a motion

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[154] Production Resources, 863 A.2d at 793-94; Continuing Creditors' Comm. of Star Telecomms., 385 F. Supp. 2d 449; Miller v. Greystone Business Credit II, L.L.C. (In re USA Detergents, Inc.), 418 B.R. 533 (Bankr. D. Del. 2009).

[155] As set forth above, while the California Court of Appeals did not directly address the issue in Berg & Berg, it appears that the limited fiduciary duty it permitted is a direct claim by creditors, not a derivative claim. See Berg & Berg, 178 Cal. App. 4th at 1041. If so, the logic of Production Resources' Section 102(b)(7) holding would not apply to the application of Cal. Corp. Code § 204(a)(4).

[156] In re Bridgeport Holdings, Inc., 388 B.R. 548 (Bankr. D. Del. 2008); USA Detergents, 418 B.R. at 544-45.

[157] See, e.g., In re Frederick's of Hollywood, Inc. S'holders Litig., 2000 Del. Ch. LEXIS 19, at *21 (Del. Ch. Jan. 31, 2000) (dismissing duty of care claim under Section 102(b)(7) and then considering duty of loyalty claim separately).

[158] See, e.g., In re Tower Air Inc., 416 F.3d 229 (3d Cir. 2005); Ad Hoc Comm. of Equity Holders of Tectonic Network, Inc. v. Wolford, 554 F. Supp. 2d 538, 561 (D. Del. 2008); Mervyn's Holdings, LLC v. Lubert-Adler Group IV, LLC (In re Mervyn's), 2010 Bankr. LEXIS 670 (Bankr. D. Del. Mar. 17, 2010) (applying to a California LLC exculpation provision).

to dismiss if the certificate of incorporation is indisputably authentic and the safeguards of Rule 56 are met.[159] Some courts also will look to an exculpation clause in dismissing a duty of care claim that is not "intertwined" with other claims that would survive a motion to dismiss.[160]

IV. Deepening Insolvency

The theory of "deepening insolvency" is closely analogous to a claim of breach of fiduciary duty.[161] Deepening insolvency is a fairly recently created tort (if it is a tort).[162] It is defined as "an injury to [a debtor's] corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life."[163] The theory posits that the defendant -- typically the board, a majority stockholder, a lender, an auditor, or someone else with a "deep pocket" -- should have taken action to liquidate or wind down the company and did not; as a result, the company was less valuable at the time it ultimately was shut down, and therefore less money is available to distribute to creditors than would have been but for the prolongation of the corporate existence.

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[159] Malpiede v. Townson, 780 A.2d 1075, 1093 (Del. 2001).

[160] Official Committee of Unsecured Creditors v. Goldman Sachs Credit Ptnrs. (In re Fedders N. Am., Inc.), 405 B.R. 527, 543 (Bankr. D. Del. 2009).

[161] See, e.g., Kittay v. Atl. Bank of New York (In re Global Serv. Group LLC), 316 B.R. 451, 460 (Bankr. S.D.N.Y. 2004). See also Rafool v. Goldfarb Corp. (In re Fleming Packaging Corp.), 2005 Bankr. LEXIS 1740, at *29-32 (Bankr. C.D. Ill. Aug. 26, 2005) (dismissing deepening insolvency count of complaint as redundant of breach of fiduciary duty claim).

[162] For a history of the development of deepening insolvency, see, e.g., Hugh M. McDonald, Todd S. Fishman & Laura Martin, Lafferty's Orphan: The Abandonment of Deepening Insolvency, AM. BANKR. INST. J., Dec. 2007/Jan. 2008, *available at* http://findarticles.com/p/articles/mi_qa5370/is_200712/ai_n21300137.

[163] Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 347 (3d Cir. 2001).

Until 2006, deepening insolvency was gaining "growing acceptance" in bankruptcy courts.[164] However, more recently, federal courts have scaled back deepening insolvency claims.[165] Moreover, the Delaware Court of Chancery in Trenwick categorically rejected deepening insolvency as an independent theory for liability against directors, holding that it does not state a course of action any more than "shallowing profitability" does.[166] The Court held that an insolvent company may, "with due diligence and good faith, pursue[] a business strategy that it believes will increase the corporation's value, but that also involves the incurrence of additional debt," and that in doing so it does not become the guarantor of that strategy's success.[167] Furthermore, "[t]hat the strategy results in continued insolvency and an even more insolvent entity does not in itself give rise to a cause of action. Rather, in such a scenario the directors are protected by the business judgment rule. To conclude otherwise would fundamentally transform Delaware law."[168] The Delaware Supreme Court affirmed "on the basis of and for the reasons assigned by the Court of Chancery."[169]

However, this does not mean that defendants now may forget deepening insolvency as a relic of the past, or that plaintiffs will abandon the theory.[170] First, certain courts have held that

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[164] See, e.g., LTV Steel, 333 B.R. 397; In re Exide Technologies, Inc., 299 B.R. 732.

[165] See, e.g., Seitz v. Detweiler, Hershey & Assocs. (In re CitX Corp.), 448 F.3d 672 (3d Cir. 2006) (limiting deepening insolvency to claims of actual fraud and limiting its availability as a damages model); Radnor Holdings, 353 B.R. at 849 (rejecting deepening insolvency as a damages model).

[166] Trenwick, 906 A. 2d at 174.

[167] Id. at 205.

[168] Id.

[169] Trenwick Am. Litig. Trust v. Billett, 931 A.2d 438 (Del. 2007) (TABLE).

[170] See Russell C. Silberglied, "Don't Throw Away Your Deepening Insolvency Materials Just Yet...Damages Under Thabault v. Chait, and Harmonizing Brown Schools with Radnor Holdings and Post-CitX Case Law," Norton Annual Survey of Bankruptcy Law, 123 (2009).

deepening insolvency is a proper damages model for an independent tort, such as breach of fiduciary duty.[171] The Third Circuit Court of Appeals held, in CitX, that deepening insolvency is not a valid damages model under Pennsylvania law when the underlying cause of action is malpractice, and questioned whether it was a valid model for any cause of action.[172] While cases decided soon after CitX interpreted it as barring deepening insolvency as a measure of damages for any type of claim,[173] the Brown Schools court held that "the Third Circuit's holding in CitX was that the company's deepening insolvency was not a viable theory of damages for the particular claim before that Court, a negligence claim for accounting malpractice," and denied a motion to dismiss because plaintiffs in Brown Schools instead alleged claims for breach of fiduciary duty.[174] Moreover, the Third Circuit later rejected an appellant accounting firm's argument that the plaintiff's damages model was impermissible because it referenced the deepening of the company's insolvency.[175] The court determined that even though the plaintiff had mentioned the phrase "deepening insolvency," its damages model actually was a traditional conception of tort damages.[176] Regardless of label,

> [w]hen a plaintiff brings an action for professional negligence and proves that the defendant's negligent conduct was the proximate cause of a corporation's increased liabilities, decreased fair market value, or lost profits, the plaintiff may recover damages in

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[171] See, e.g., In re: The Brown Schools, 386 B.R. 37, 45-48 (Bankr. D. Del. 2008); In re Global Serv. Group, LLC, 316 B.R. at 458; Alberts v. Tuft (In re Greater Southeast Cmty. Hosp. Corp. I), 353 B.R. 324, 333 (Bankr. D.D.C. 2006).

[172] In re CitX, 448 F.3d at 677.

[173] See, e.g., Radnor Holdings, 353 B.R. at 849; In re Troll Commc'ns, 385 B.R. 110, 122 (Bankr. D. Del. 2008).

[174] Brown Schools, 386 B.R. at 48.

[175] Thabault v. Chait, 541 F.3d 512 (3d Cir. 2008).

[176] Id. at 520.

accordance with state law.[177]

Thus, actual damages proximately caused by wrongdoing are recoverable under a traditional theory of damages, even if they are also damages for a company's deepened insolvency.[178]

Chait confirms, then, that a company's deepened insolvency can form the basis of damages in appropriate circumstances if other factors are also present, but that damages cannot be proven simply by pointing to a company's deepened insolvency, i.e., just by demonstrating that a company is more insolvent after the wrongdoing than it was before. The deepened insolvency does not speak for itself; it must be caused by the wrongdoing and proven under a state law cause of action.[179]

Even when there is causation, some opinions have declined to employ a deepening insolvency measure of damages because, at most, the creditors rather than the company itself are damaged by an already insolvent company's incurrence of additional debt or decline in value of assets.[180] Such cases posit that because a trustee may not assert the claims of creditors but only the company's claims, damages to creditors by deepened insolvency are irrelevant.[181] However, other Courts have acknowledged that the fact that damages that the company would receive inure to the benefit of creditors should not change the analysis: "Realistically, a corporation is a

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[177] Id.

[178] The converse is also true: without proximate causation, courts are not likely to permit deepening insolvency type damages. See, e.g., Hays v. Curry (In re Maxxis Group, Inc.), 2009 Bankr. LEXIS 4249, at *32 (Bankr. N.D. Ga. Sept. 30, 2009) ("Mr. Pennington's damage analysis is more akin to deepening insolvency damages than establishing that damages were proximately caused by the breach, as Georgia law provides.").

[179] Silberglied, "Don't Throw Away Your Deepening Insolvency Materials Just Yet...," at 129.

[180] See, e.g., Kirschner v. K&L Gates LLP, 2010 Pa. Dist. & Cnty. Dec. LEXIS 387 (Pa. Com. Pl. Dec. 28, 2010) (citing Sabin Willett, The Shallows of Deepening Insolvency, 60 Bus. Law. 549 (2005)).

[181] Id. (citing Caplin v. Marine Midland Grace Trust Co. of N.Y., 92 S. Ct. 1678 (1972)).

conduit for its stakeholders, but that does not affect the corporation's legal rights."[182] The law remains unsettled on this point.

Second, litigants need to continue to be aware of deepening insolvency because while Trenwick has proven to be persuasive authority,[183] it is only binding authority where Delaware law applies (or in the law of other states that have adopted Trenwick). Thus, for example, the Third Circuit recently reversed the dismissal of a deepening insolvency cause of action asserted under Pennsylvania law, holding that the complaint indeed stated a claim for deepening insolvency.[184] Certainly one would think that if deepening insolvency charges were leveled at officers and directors, such claims would be governed by the internal affairs doctrine and therefore Delaware law would apply if the entity was incorporated in Delaware.[185] But where the allegation is made against a lender, auditor or other deep pocket, presumably a Restatement/most significant relationship conflicts analysis would be performed, which rarely will result in application of Delaware law.[186]

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[182] Fehribach v. Ernst & Young LLP, 493 F.3d 905, 909 (7th Cir. 2007).

[183] See RSL Commc'ns PLC v. Bildirici, 649 F. Supp. 2d 184, 206-07 (S.D.N.Y. 2009) (applying New York law); Wheland Foundry, LLC v. Metal Techs., Inc. (In re Wheland Foundry, LLC), 2008 Bankr. LEXIS 4638, at *11-12 (Bankr. E.D. Tenn. July 29, 2008) (applying Georgia law); Liquidating Trustee of the Amcast Unsec. Creditor Liquidating Trust v. Baker (In re Amcast Indus. Corp.), 365 B.R. 91, 118 (Bankr. S.D. Oh. 2007) (applying Ohio law).

[184] Official Committee of Unsecured Creditors of Lemington Home for the Aged v. Baldwin (In re Lemington Home for the Aged), 659 F.3d 282, 2011 U.S. App. LEXIS 19312 (3d Cir. Sept. 21, 2011).

[185] See, e.g., Cohain v. Klimley, 2010 U.S. Dist. LEXIS 98870 (S.D.N.Y Sept. 20, 2010) (applying New York law to deepening insolvency claim against directors and officers because the state of incorporation was New York).

[186] Where deepening insolvency is claimed against someone other than a director or officer, the defendant should consider an *in pari delicto* defense. See Lafferty, 267 F.3d at 34-55 (affirming dismissal of a deepening insolvency claim due to *in pari delicto* defense). The defense is not available, however, when the defendant is a director or officer. See Am. Int'l Group, Inc. Consol. Deriv. Litig., 976 A.2d 872, 876 (Del. Ch. June 17, 2009). This article about directors, officers and other fiduciaries, therefore, does not focus on the various exceptions to that rule, such as the adverse interest exception and

Third, parties should familiarize themselves with deepening insolvency when litigating breach of fiduciary duty claims because some courts have dismissed breach of fiduciary duty claims on the basis that they are "disguised" deepening insolvency charges.[187] Other courts have disagreed and held that claims of breach of the duty of loyalty, even if they resemble deepening insolvency claims, should not be dismissed on that basis.[188] But duty of care claims are more likely to be rejected on the basis that they are too akin to a discredited deepening insolvency theory:

> Duty of care violations more closely resemble causes of action for deepening insolvency because the alleged injury in both is the result of the board of directors' poor business decision. To defeat such an action, a defendant need only prove that the process of reaching the final decision was not the result of gross negligence. Therefore, claims alleging a due care violation could be viewed as a deepening insolvency claim by another name.[189]

Thus, deepening insolvency retains its relevance even after cases like Trenwick.

Conclusion

As this article shows, the law of fiduciary duties of directors and officers of troubled companies and the law of deepening insolvency have undertaken somewhat of a metamorphosis over the past decade. Some changes were seismic, such as Trenwick's rejection of deepening insolvency, Gheewalla's rejection of the concept of the zone of insolvency and of direct fiduciary duties being owed to creditors, and to a lesser extent Bax's holding that creditors of an LLC cannot obtain standing to pursue breach of fiduciary duty claims. Other developments are

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the innocent wrongdoer exception, and how they vary from state to state. See generally Official Committee of Unsecured Creditors of Allegheny Health Educ. & Res. Ctr. v. PriceWaterhouseCoopers, LLP, 989 A.2d 313 (PA Supr. 2010).

[187] See Radnor Holdings, 353 B.R. at 842.

[188] Brown Schools, 386 B.R. at 47.

[189] Id. at 46-47.

more subtle, but advance significantly an understanding of how Delaware law should be interpreted in some fairly typical but not always litigated situations, such as Quadrant's rejection of a theory that the business judgment rule can be rebutted upon a showing that a dominated board took on risk that only benefitted equity that its members owned, and Trados' holding that preferred stockholders are not owed special fiduciary duties in addition to the duties owed to common stockholders, even if preferred stock is the fulcrum security.

All of these cases will now be interpreted by bankruptcy judges across the country, because insolvent entities often wind up in bankruptcy court and litigation in bankruptcy courts is frequent. How bankruptcy courts will apply the learning of these cases and plug the gaps of issues not yet raised will be interesting to follow over the next cycle of bankruptcy filings.