

## DIRECTORS' AND OFFICERS' LIABILITY

### VICINITY OF INSOLVENCY CLAIMS

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When a company reaches the point of actual insolvency, directors and officers have fiduciary duties to the company's creditors in addition to shareholders. The principle that directors and officers may owe fiduciary duties to creditors at an earlier point, when the company enters the so-called "vicinity of insolvency" is a more recent development, but one that has gained traction. Unfortunately, "vicinity of insolvency" remains a phrase in search of a definition. Delaware Vice Chancellor Leo E. Strine, Jr.'s recent decision in *Production Resources Group, L.L.C. v. NCT Group, Inc.*<sup>1</sup>, is the most instructive decision issued to date on the nature of insolvency-based creditor claims, and the potential ability of an exculpatory provision in a company's certificate of incorporation to bar creditor claims against directors for alleged breach of the duty of care. His thoughtful analysis departs from federal case law frequently cited by creditors, and has already been adopted by a federal court in the weeks since its issuance.

#### Insolvency-Based Creditor Rights

Directors and officers of a solvent corporation ordinarily owe no fiduciary duties to the company's creditors. The law assumes that creditors in an arm's-length commercial relationship with a company can adequately protect their interests by contract, with potential recourse to additional safeguards in state fraudulent conveyance laws and federal bankruptcy law. Accordingly, "directors do not owe creditors duties beyond [any] relevant contractual terms absent 'special circumstances . . . e.g., fraud, insolvency, or a violation of a statute.'"<sup>2</sup>

Once a company becomes insolvent, the directors and officers in effect become trustees for the creditors, and must preserve corporate assets as a "trust fund" for creditors.<sup>3</sup> Equity recognizes the duty because corporate insolvency alters the traditional economic justification for the requirement that directors manage companies exclusively for the benefit of shareholders: that shareholders ordinarily bear the residual risk associated with corporate operations. When the company is insolvent, declines in the residual value of the corporation are borne by creditors. For purposes of determining when a fiduciary duty to creditors arises, courts

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generally have held that “insolvency” means insolvency in fact rather than insolvency based on institution of bankruptcy proceedings.<sup>4</sup> A company is insolvent if it is (i) “unable to pay its debts as they fall due in the usual course of business,” or (ii) “it has liabilities in excess of a reasonable market value of assets held.”<sup>5</sup>

Directors and officers of a corporation also may owe fiduciary duties to corporate creditors to preserve corporate assets for the benefit of creditors at an earlier point: when a company enters the ill-defined “vicinity” of insolvency.<sup>6</sup> Although vicinity of insolvency fiduciary duties to creditors are now fairly established, they sprang “[s]omewhat oddly” from a Delaware decision, *Credit Lyonnais v. Pathe Comm.*<sup>7</sup> Then-Chancellor Allen wrote in *Credit Lyonnais* 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. . . . [I]n managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act.” But *Credit Lyonnais* did not hold that creditors of a teetering company may predicate an affirmative claim against directors and officers on the fiduciary duties enunciated in the decision. Rather, as Vice Chancellor Strine observed in *Production Resources*, “*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. . . . [b]y providing directors with this shield, creditors would derive a clear benefit because directors, it can be presumed, generally take seriously the company's duty to pay its bills as a first priority.” However, “[c]reative language in a famous footnote in *Credit Lyonnais* was read more expansively by some, not to create a shield for directors from stockholder claims, but to expose directors to a new set of fiduciary duty claims, this time by creditors.”<sup>8</sup>

Vice Chancellor Strine pointed out that recognition of fiduciary duty claims by creditors against directors and officers “is not unproblematic” because it may entail “using the law of fiduciary duty to fill gaps that do not exist.” Noting the covenants, liens and other negotiated contractual protections often in place to protect creditors, as well as potential recourse to the law of fraudulent conveyance and other legal theories, the court suggested that “when creditors are unable to prove that a corporation or its directors breached any of the specific legal duties owed to them, one would think that the conceptual room for concluding that the creditors were somehow, nevertheless, injured by inequitable conduct would be extremely small, if extant.” Nevertheless, relatively permissive pleading standards may result in tenuous creditor claims being sustained if the complaint merely “pleads facts that, if true, suggest that a company is within some imprecise and hard-to-define vicinity of insolvency. This means that creditors will be able to get discovery in situations when it is ultimately determined that the relevant company was not only solvent, but never even within the so-called zone of insolvency.” There is thus much to commend the judicial skepticism displayed in *Production Resources* toward any “judicial endeavor to second-guess good-faith director conduct in the so-called zone.”

### ***Production Resources* Strengthens Director Protection**

The creditor in *Production Resources* had unsuccessfully sought payment of a debt long owed by NCT, and commenced an action seeking the appointment of a receiver for NCT because the company was insolvent. The creditor also alleged that NCT's board and a senior non-director officer committed various breaches of fiduciary duty to the creditor. Denying a motion to dismiss the claim to appoint a receiver, the court held that the complaint adequately alleged a basis for discretionary appointment of a receiver under 8 Del. C. § 291 because the complaint "pled facts that, if true, show that NCT is insolvent, both in the sense that its liabilities far exceed its assets and that it has been unable to pay its debts when they have come due."

Turning to the creditor's fiduciary duty claims, Vice Chancellor Strine dismissed the claims to the extent they were predicated on mismanagement -- duty of care violations -- but sustained the claim based on allegations of deliberate wrongdoing -- duty of loyalty violations. Defendants' successful argument that the mismanagement claims were derivative in nature and therefore subject to the exculpatory provision in NCT's charter led the court to offer a thoughtful analysis of to whom such fiduciary duty claims really belong, and whether a creditor's assertion of such claims may be barred by an exculpatory charter provision.

"[A] logical corollary to the common law principles of the business judgment rule,"<sup>9</sup> Section 102(b)(7) of the Delaware General Corporation Law authorizes Delaware companies to include in the certificate of incorporation a provision "eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages" for breaches of the fiduciary duty of care. The Section 102(b)(7) bar may be raised on a motion to dismiss, or at a later point. A Section 102(b)(7) exculpatory charter provision cannot bar a damages claim based on an alleged breach of the duty of loyalty, or which alleges bad faith or intentional misconduct, and does not affect injunctive proceedings based on gross negligence.<sup>10</sup> As the Delaware Supreme Court has noted, "[f]ollowing the enactment of Section 102(b)(7), the shareholders of many Delaware corporations approved charter amendments containing these exculpatory provisions with full knowledge of their import."<sup>11</sup>

Section 102(b)(7) does not mention claims by creditors. But if a breach of care claim brought by a creditor simply alleges that flawed management decisions caused a decline in corporate assets, the claim in reality belongs to the company itself, subjecting the claim to an exculpatory charter provision.

The creditor in *Production Resources* argued that once a company enters the vicinity of insolvency or becomes insolvent, the directors may not rely on an exculpatory charter clause to insulate them from fiduciary duty of care claims brought by creditors, even if the claims are predicated on an injury to the company and would therefore be classified as derivative. The court disagreed because the creditor's argument misapprehended the distinction between the nature of the claim and standing to prosecute it. Noting that insolvency-based creditor

fiduciary claims “are classically derivative, in the sense that they involve an injury to the corporation as an entity and any harm to the stockholders and creditors is purely derivative of the direct financial harm to the corporation itself,” the court concluded that the corporation’s insolvency “does not turn such claims into direct creditor claims.” Rather, insolvency “simply provides creditors with standing to assert those claims.” The claims belong to the corporation “because even if the improper acts occur when the firm is insolvent, they operate to injure the firm in the first instance by reducing its value, injuring creditors only indirectly by diminishing the value of the firm and therefore the assets from which the creditors may satisfy their claims.” The fact of insolvency, however, “does not change the primary object of the director’s duties, which is the firm itself.”

The court’s holding that the creditor’s mismanagement claims remained derivative compelled the conclusion that the exculpatory clause in the corporate charter barred the claims as a matter of law. “Although § 102(b)(7) itself does not mention creditors specifically, its plain terms apply to all claims belonging to the corporation itself, regardless of whether those claims are asserted derivatively by stockholders or by creditors.” Indeed, the court reasoned that the mandate for director protection assumes heightened importance when creditors allege that director mismanagement caused corporate insolvency: “[T]here is the real danger that a fact-finder, in view of hindsight bias and its knowledge of the fact that the directors’ business strategy did not pan out, will conclude that the directors have acted with less than due care, even if they did not. If the mere fact that creditors have standing to pursue an insolvent corporation’s claim against the directors or that the corporation’s claim has been assigned as an asset to creditors somehow transforms the claim into one not belonging to the corporation, § 102(b)(7) protection might be withdrawn simply because a business strategy failed, hollowing § 102(b)(7) of much of its intended utility.”

Vice Chancellor Strine’s dismissal of creditor duty of care claims departs with certain federal decisions that employed reasoning with which Vice Chancellor Strine “disagree[d] entirely.” In *Pereira v. Cogan*,<sup>12</sup> for example, Judge Sweet held that an exculpatory clause in a corporate charter did not foreclose a Chapter 7 bankruptcy trustee’s assertion of duty of care claims brought for the benefit of the corporate debtor’s creditors because the clause, “both by its terms and in accordance with the underlying policy rationale, allocates the risk of loss between the parties to the articles of incorporation, *i.e.*, the shareholders and directors. The clause does not allocate this risk with respect to third parties, such as the creditors for whose benefit the Trustee has brought the instant suit.” Similarly, the court in *In re Ben Franklin Retail Stores, Inc.*,<sup>13</sup> applying Delaware law, held that an exculpatory charter provision did not bar a Chapter 7 trustee from bringing breach of fiduciary duty claims against the directors of a corporate debtor because creditors are not parties to the contract embodied in the charter, and “[n]othing in the exculpatory provision prevents suits brought by the creditors or those acting on their behalf.” Unpersuaded, Vice Chancellor Strine noted these decisions “frankly admit” that “bankruptcy trustees pursue fiduciary duty claims when the conduct at issue is alleged to have injured the corporation as an entity, and therefore the harm affects the entire class of the company’s creditors, rather than a specific creditor.” Yet these cases inexplicably “suggest that

a due care claim belonging to the corporation turns into something else when the right to pursue that claim ends up in the hands of a bankruptcy trustee.”<sup>14</sup>

Adopting *Production Resources*, a Delaware federal district court in *Continuing Creditors' C'tee of Star Telecomm., Inc. v. Edgecomb*,<sup>15</sup> recently rejected the *Pereira* line of authority and held that duty of care, gross negligence and corporate waste claims against directors and officers asserted by the creditors' committee in the Star Telecommunications bankruptcy failed “as a matter of law because the exculpation clause protects the . . . Directors and Officers against” such claims. The exculpatory clause in *Edgecomb* resulted in the dismissal of care-based claims against directors and officers based on their participation in decisions, or failing to prevent decisions, that resulted in an allegedly ill-advised acquisition, the expansion of the debtor's business and facilities in a manner that left it unable to pay its debts and continue as a going concern, short-term financial obligations that burdened the debtor, alleged neglect of the operations of the debtor while management attempted to close a failed merger, and the purported disregard of the need for an independent audit committee.

Properly viewed, most care-based creditor claims call for simple application of the principle that a transferee (the creditor) takes no greater rights than its transferor (the company). As Vice Chancellor Strine asked rhetorically: “By what equitable notion should creditors who retain the right to prove that a director is liable for fraudulent conveyance, misrepresentation, tortious interference with contract or breach of other legal duties to them, or for a non-exculpated breach of fiduciary duty towards the corporation, be granted a care-based claim that the corporation itself had contractually relinquished and that may never be pressed by the stockholders of a solvent firm?”

<sup>1</sup> 863 A.2d 772 (Del. Ch. 2004).

<sup>2</sup> *Geyer v. Ingersoll Publications Co.*, 621 A.2d 784, 787 (Del. Ch. 1992).

<sup>3</sup> See, e.g., *Federal Deposit Ins. Corp. v. Sea Pines Co.*, 692 F.2d 973, 977 (4th Cir. 1982); *In re Xonics, Inc.*, 99 B.R. 870, 872 (Bankr. N.D. Ill. 1989) (under Delaware law, “[w]hen a corporation is insolvent its officers and directors stand in a position of trust not only to the corporation and its shareholders, but also to its creditors.”).

<sup>4</sup> *Geyer*, 621 A.2d at 787-90.

<sup>5</sup> *Id.* at 789.

<sup>6</sup> *Geyer*, 621 A.2d at 787; *Credit Lyonnais Bank v Pathe Comm.*, 1991 WL 277613 (Del. Ch. Dec. 30, 1991).

<sup>7</sup> 1991 WL 277613 (Del. Ch. Dec. 30, 1991).

<sup>8</sup> *Production Resources*, 863 A.2d at 789.

<sup>9</sup> *Emerald Partners v. Berlin*, 787 A.2d 85, 91 (Del. 2001).

<sup>10</sup> *Malpiede v. Townson*, 780 A.2d 1075, 1095 (Del. 2001) (“Our jurisprudence since the adoption of the statute has consistently stood for the proposition that a Section 102(b)(7) charter provision bars a claim that is found to state only a due care violation.”); see also *Emerald Partners*, 787 A.2d at 90 n.25.

<sup>11</sup> *Emerald Partners*, 787 A.2d at 90.

<sup>12</sup> 2001 WL 243537, at \*9-10 (S.D.N.Y. Mar. 8, 2001).

<sup>13</sup> 2000 WL 28266 (N.D. Ill. Jan. 11, 2000).

<sup>14</sup> *Production Resources*, 863 A.2d at 794 n.68.

<sup>15</sup> 2004 WL 2980736, at \*12 (D. Del. Dec. 21, 2004).