

**FIDUCIARY DUTIES IN DISTRESSED CORPORATIONS:  
AVOIDING DIRECTOR LIABILITY IN THE ZONE OF INSOLVENCY**

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**I. INTRODUCTION**

The legal landscape for corporate directors has radically changed in the past five years. In the wake of spectacular failures such as Enron, Global Crossing, Parmalat, and WorldCom, directors of failed corporations now face increased scrutiny by bankruptcy courts, bankruptcy trustees, creditors committees, and individual creditors. This scrutiny often focuses on whether the directors properly discharged their fiduciary duties to the corporate enterprise, including its creditors, as the distressed corporation entered the “zone of insolvency.” This paper analyzes those fiduciary duties and suggests practical ways for directors to avoid liability for breaching such duties.

**II. FIDUCIARY DUTIES IN A SOLVENT CORPORATION**

As a corporation approaches insolvency, the fiduciary duties that its directors owe to the corporation, as well as its shareholders, expand to include creditors. Thus, it is essential to review the nature, scope, and limitations of such duties in a solvent corporation before addressing them in the insolvency context.

**A. To Whom Are Fiduciary Duties Owed?**

Directors of a solvent corporation owe fiduciary duties to both the corporation and its shareholders.<sup>1</sup> Directors ordinarily do not owe such duties to creditors.<sup>2</sup> Nor do they owe

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<sup>1</sup> See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985). Although this conference is being held in Texas, this paper focuses largely on Delaware law because (a) many public corporations (and those hoping to be public) are organized in Delaware; (b) a federal court in Texas would apply Delaware law to matters involving the internal affairs of a Delaware corporation, including the duties of its directors; and (c) Delaware courts have produced an extensive and reasonably cohesive body of corporate law relevant to the subject of this paper.

<sup>2</sup> See, e.g., *Geyer v. Ingersoll Publications Co.*, 621 A.2d 784, 787 (Del. Ch. 1992) (“[T]he general rule is that directors do not owe creditors duties beyond the relevant contractual terms absent ‘special circumstances’, e.g., fraud . . . or a violation of a statute.”).

fiduciary duties to holders of stock options or convertible debentures prior to the purchase or conversion of those interests.<sup>3</sup> It is presumed that creditors, like optionees, and debenture holders, are capable of protecting themselves through the contractual agreements that govern their relationships with the corporation.<sup>4</sup> Creditors may also rely upon important protections under fraudulent conveyance law and federal bankruptcy law.<sup>5</sup> Directors of a solvent corporation, therefore, owe fiduciary duties only to the corporation and those who bear the residual risk associated with its operations, the shareholders.<sup>6</sup>

### **B. What Fiduciary Duties Are Owed?**

Directors generally owe three kinds of fiduciary duties to the corporation and shareholders: (1) due care; (2) loyalty; and (3) good faith.<sup>7</sup> Traditionally, the duties of care and loyalty have received more attention from courts and commentators. Many courts, in fact, have considered the duty of good faith to be subsumed within the duty of loyalty.<sup>8</sup> More recent decisions, however, have confirmed that directors owe three distinct fiduciary duties.<sup>9</sup>

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<sup>3</sup> See *FS Photo, Inc. v. Picturevision Inc.*, 61 F. Supp. 2d 473, 484 (E.D. Va. 1999); *Powers v. British Vita, P.L.C.*, 969 F. Supp. 4, 5 (S.D.N.Y. 1997); *Simons v. Cogan*, 549 A.2d 300, 302-03 (Del. 1988).

<sup>4</sup> See *Production Resources Group, LLC v. NCT Group, Inc.*, 863 A.2d 772, 787 (Del. Ch. 2004).

<sup>5</sup> See *id.*

<sup>6</sup> This does not mean that directors should decline any consideration of creditors and other constituencies. Rather, it means that directors should be “primarily focused on generating economic returns that will exceed what is required to pay bills in order to deliver a return to the company’s stockholders.” *Id.*; see also *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 176 (Del. 1986) (indicating that directors can consider interests of other constituencies if they are rationally related to furthering the interests of shareholders).

<sup>7</sup> See *Emerald Partners v. Berlin*, 787 A.2d 85, 90 (Del. 2001). In addition to these duties, courts often refer to a director’s duty of obedience under Texas law. See *Gearhart Indus., Inc. v. Smith Int’l, Inc.*, 741 F.2d 707, 719 (5th Cir. 1984). The duty of obedience essentially forbids *ultra vires* acts. See *id.*

<sup>8</sup> See *In re Gaylord Container Corp. Shareholders Litig.*, 753 A.2d 462, 475 n.41 (Del. Ch. 2000) (stating that the duty of good faith is only “a subset or a ‘subsidiary requirement’ that is subsumed within the duty of loyalty”); see also *Resolution Trust Corp. v. Acton*, 844 F. Supp. 307, 313 (N.D. Tex. 1994) (“The duty of loyalty requires that officers and directors act in good faith . . .”).

<sup>9</sup> See, e.g., *In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275, 289 (Del. Ch. 2003).

## 1. Duty of Care

Directors have an obligation to act with the requisite degree of care in their dealings with the corporation. This duty of care has two basic components. First, directors must act on an informed basis after due consideration and deliberation of the relevant issues.<sup>10</sup> Directors must inform themselves of all “material information reasonably available to them.”<sup>11</sup> They may rely on corporate records, as well as information, opinions, and statements of corporate officers, employees, and third-party professionals.<sup>12</sup> Second, having become informed, directors must then act with the requisite care in the discharge of their duties.<sup>13</sup> Specifically, directors must exercise the care that ordinarily prudent persons would use in similar circumstances.<sup>14</sup>

## 2. Duty of Loyalty

The duty of loyalty requires directors to exercise “undivided and unselfish loyalty to the corporation” and to hold the best interests of the corporation and its shareholders above any personal interests.<sup>15</sup> This duty imposes an obligation to avoid self-dealing, conflict-of-interest situations and transactions, as well as the usurpation of corporate opportunities. The duty of loyalty also encompasses a corollary duty of disclosure, which requires directors to disclose all material information to shareholders when seeking shareholder action.<sup>16</sup>

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<sup>10</sup> See *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 367 (Del. 1993).

<sup>11</sup> *Id.*

<sup>12</sup> See DEL. CODE ANN. tit. 8, § 141(e).

<sup>13</sup> *Cede*, 634 A.2d at 367 (citing *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)).

<sup>14</sup> See *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963).

<sup>15</sup> *Cede*, 634 A.2d at 361.

<sup>16</sup> See, e.g., *Stroud v. Grace*, 606 A.2d 75, 84 (Del. 1992). A breach of the duty of disclosure, however, does not necessarily constitute a breach of the duty of loyalty. See *Cinerama, Inc. v. Technicolor, Inc.*, 66 A.2d 1156 (Del. 1995).

### 3. Duty of Good Faith

Over the past ten years, courts and commentators have increasingly explored the concept of good faith as a potential standard for director liability.<sup>17</sup> In 2004, for example, the Delaware Chancery Court held an outside director liable in connection with a going-private transaction because his “specialized financial expertise” raised a question of his good-faith reliance on the management-hired expert’s opinion regarding the fairness of the merger price.<sup>18</sup> Not surprisingly, this holding has generated significant concern that directors possessing specialized expertise will be held to higher standards under Delaware law.<sup>19</sup> Former Chief Justice Norman Veasey has explained this holding as follows:

When purporting to rely on another expert in a transaction where a director knows that the expert’s opinion is questionable, the director could be at greater risk of liability than other directors. This is not because of the director’s status as an expert. It is simply that a director with such expertise cannot rely in good faith on another expert’s particular opinions under section 141(e).<sup>20</sup>

More recently, in June 2006, the Delaware Supreme Court addressed the duty of good faith in the long-running and much-followed *Disney* litigation.<sup>21</sup> The Supreme Court upheld the Delaware Chancery Court’s opinion that Disney’s board did not act in bad faith by hiring

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<sup>17</sup> See, e.g., *In re Caremark Int’l Inc. Derivative Litig.*, 698 A.2d 959, 969-70 (Del. Ch. 1996) (stating that “sustained or systematic failure of the board to exercise oversight” will establish a lack of good faith); Hillary A. Sale, *Delaware’s Good Faith*, 89 CORNELL L. REV. 456 (2004); Thomas Rivers, Note, *How to Be Good: The Emphasis on Corporate Directors’ Good Faith in the Post-Enron Era*, 58 VAND. L. REV. 631 (2005).

<sup>18</sup> *In re Emerging Communications, Inc. Shareholders Litig.*, No. Civ.A. 16415, 2004 WL 1305745, at \*39 (Del. Ch. June 4, 2004). Justice Jacobs of the Delaware Supreme Court authored this opinion, while sitting by designation as Vice Chancellor pursuant to Delaware statute. See *id.* at \*39 n.184. The director in question was an investment banker with extensive experience in the telecommunications sector.

<sup>19</sup> See E. Norman Veasey & Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance from 1992-2004? A Retrospective on Some Key Developments*, 153 U. PENN. L. REV. 1399, 1445 (2005); David H. Cook, *The Emergence of Delaware’s Good Faith Fiduciary Duty: In re Emerging Communications, Inc. Shareholders Litig.*, 43 DUQ. L. REV. 91, 110 (2004).

<sup>20</sup> Veasey & Di Guglielmo, *supra* note 19, at 1445.

<sup>21</sup> *In re Walt Disney Co. Deriv. Litig.*, No. 411, 2006 WL 1562466, at \*24 (Del. June 8, 2006).

Michael Ovitz, firing him only 14 months later, and awarding him a \$130 million severance package. The Chancery Court had defined bad faith as follows:

Upon long and careful consideration, I am of the opinion that the concept of *intentional dereliction of duty, a conscious disregard for one's responsibilities*, is the appropriate (although not the only) standard for determining whether fiduciaries have acted in good faith.<sup>22</sup>

The Delaware Supreme Court endorsed this statement as “a legally appropriate, although not exclusive, definition of fiduciary bad faith.”<sup>23</sup> The Court also explained that a director’s breach of the duty of care does not automatically result in a breach of the duty of good faith.<sup>24</sup> Rather, a degree of director culpability beyond gross negligence must exist before the duty of good faith is violated.<sup>25</sup> This distinction is critical because, unlike a mere breach of the duty of care, a violation of the duty of good faith can expose directors to personal liability that is not subject to any indemnification provisions or exculpatory clauses in the certificate or articles of incorporation.<sup>26</sup>

### **C. When Does the Business Judgment Rule Apply?**

The business judgment rule is “a presumption that, ‘in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that

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<sup>22</sup> *In re Walt Disney Co. Deriv. Litig.*, No. Civ.A. 15452, 2005 WL 2056651, at \*36 (Del. Ch. Aug. 9, 2005), *aff'd*, 2006 WL 1562466 (Del. June 8, 2006) (emphasis added). The Chancery Court provided three specific examples of bad faith: (a) “where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation”; (b) “where the fiduciary acts with the intent to violate applicable positive law”; and (c) “where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating conscious disregard for his duties.” *Id.*

<sup>23</sup> *Walt Disney*, 2006 WL 1562466, at \*27.

<sup>24</sup> *Id.* at \*25-26.

<sup>25</sup> *Id.* at \*25 (“[T]he answer is that grossly negligent conduct, without more, does not and cannot constitute a breach of the fiduciary duty of good faith.”).

<sup>26</sup> *Id.* at \*25-26 (citing DEL. CODE ANN. tit. 8, §§ 102(b)(7), 145(a) & (b)).

the action taken was in the best interests of the corporation.”<sup>27</sup> This presumption applies unless the plaintiff can show that the directors breached one of their fiduciary duties in connection with the challenged transaction.<sup>28</sup> The business judgment rule, for example, vanishes to the extent that the directors engaged in a self-dealing transaction.<sup>29</sup> The rule also does not apply if the directors make “an unintelligent or unadvised judgment.”<sup>30</sup> Nor does the rule apply if the directors simply have not exercised any business judgment at all.<sup>31</sup> Once the presumption of the business judgment rule is rebutted, the burden shifts to the directors to demonstrate that the challenged transaction was “entirely fair” to the corporation and its shareholders.<sup>32</sup>

#### **D. What Exculpatory Clauses May Apply?**

Delaware statutory law (like the law of most jurisdictions, including Texas)<sup>33</sup> allows shareholders to adopt provisions in the certificate (or articles) of incorporation that limit or even eliminate director liability for monetary damages to the corporation or its shareholders related to any breach of the fiduciary duty of care.<sup>34</sup> These exculpatory clauses are designed to encourage capable persons to serve as directors by providing them with the freedom to make risky, good faith business decisions without fear of personal liability. These clauses, however, cannot

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<sup>27</sup> *Emerald Partners v. Berlin*, 787 A.2d 85, 90 (Del. 2001) (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)).

<sup>28</sup> *See id.* at 91.

<sup>29</sup> *See e2 Creditors' Trust v. Farris (In re e2 Communications, Inc.)*, 320 B.R. 849, 860 (Bankr. N.D. Tex. 2004) (Houser, J.) (stating that the business judgment rule is no defense to breach of loyalty allegations).

<sup>30</sup> *Van Gorkum*, 488 A.2d at 872. *But see Roth v. Mims*, 298 B.R. 272, 282 (N.D. Tex. 2003) (Lindsay, J.) (stating that the business judgment rule “provides that the negligence of directors, no matter how unwise or imprudent, does not constitute a breach of duty if the acts were ‘within the exercise of their discretion and judgment.’”).

<sup>31</sup> *See Aronson*, 473 A.2d at 813; *see also Resolution Trust Corp. v. Acton*, 844 F. Supp. 307, 314 (N.D. Tex. 1994) (Sanders, J.) (stating that the business judgment rule does not apply to “an obvious and prolonged failure to exercise oversight or supervision”).

<sup>32</sup> *Emerald Partners*, 787 A.2d at 91.

<sup>33</sup> *See* TEX. CIV. STAT. ANN. art. 1302-7.06B

<sup>34</sup> DEL. CODE ANN. tit. 8, § 102(b)(7).

exculpate four kinds of conduct: (1) breach of the duty of loyalty; (2) any act or omission not in good faith or which involves intentional misconduct or knowing violation of law; (3) unlawful payment of dividends or stock redemption; and (4) any transaction from which the director derived an improper personal benefit.<sup>35</sup>

Corporate officers, unlike directors, probably receive no protection from such exculpatory clauses, as most courts hold that such clauses expressly apply only to directors.<sup>36</sup> One Delaware federal court, however, has held that an exculpatory clause protected both directors and officers, but without explaining its rationale or addressing any contrary cases.<sup>37</sup> To the extent that an individual serves as both an officer and director, the exculpatory clause will likely apply only to those actions taken in the capacity of a director.<sup>38</sup>

### III. FIDUCIARY DUTIES IN A NEAR-INSOLVENT CORPORATION

Directors must act on behalf of a broader constituency, including creditors, as a corporation approaches insolvency. This impacts how directors should properly discharge their fiduciary duties and who has standing to pursue claims for any breach of those duties in an insolvent or near-insolvent corporation.

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<sup>35</sup> *Id.*

<sup>36</sup> See *Century Elec. Mfg., Inc. v. DePetrillo (In re Century Elec. Mfg., Inc.)*, 345 B.R. 33, 35 (Bankr. D. Mass. 2006); *In re LTV Steel Co.*, 333 B.R. 397, 413 (Bankr. N.D. Ohio 2005); *Pereira v. Cogan*, 294 B.R. 449, 534 (S.D.N.Y. 2003), *vacated and remanded on other grounds*, 413 F.3d 330 (2d Cir. 2005).

<sup>37</sup> *Continuing Creditors' Comm. of Star Telecomms. Inc. v. Edgecomb*, 385 F. Supp. 2d 449, 464 (D. Del. 2004).

<sup>38</sup> See *Alberts v. Tufts (In re Greater Southeast Community Hosp. Corp.)*, 333 B.R. 506, 528 (Bankr. D.D.C. 2005) (noting that one of the defendants may be immunized from a breach of fiduciary duty claim in his capacity as a director, but may remain liable in his capacity as an officer); see also *Arnold v. Society for Sav. Bancorp, Inc.*, 650 A.2d 1270, 1288 (Del. 1994) (stating that plaintiffs must "highlight . . . specific actions" that the defendant "undertook as an officer (as distinct from actions as a director)" in order to avoid the exculpatory provision).

### A. Are Fiduciary Duties Owed to Creditors of a Near-Insolvent Corporation?

Delaware courts have long held that directors owe fiduciary duties to creditors once the corporation actually becomes insolvent.<sup>39</sup> Recent decisions continue to recognize this rule.<sup>40</sup> Indeed, in the much-discussed *Production Resources* decision, the Delaware Chancery Court expressly reaffirmed this rule:

When a firm has reached the point of insolvency, it is settled that under Delaware law, the firm's directors are said to owe fiduciary duties to the company's creditors. This is an uncontroversial proposition . . . .<sup>41</sup>

This rule evolved from the "trust fund" doctrine, which developed to prevent inequity in the distribution of corporate assets upon dissolution.<sup>42</sup> Under that doctrine, directors of an insolvent corporation must act as trustees tasked with preserving the remaining assets for the benefit of creditors before making any distributions to shareholders.<sup>43</sup>

In addition to the trust fund doctrine, courts have increasingly applied an "at risk" theory to support the expansion of fiduciary duties to the creditors of a corporation approaching insolvency.<sup>44</sup> This theory, of course, originated in the landmark *Credit Lyonnais* decision nearly fifteen years ago.<sup>45</sup> In that decision, the Delaware Chancery Court recognized that "the

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<sup>39</sup> See, e.g., *Bovay v. H.M. Byllesby & Co.*, 38 A.2d 808, 812-23 (Del. 1944); *Geyer v. Ingersoll Publications Co.*, 621 A.2d 784, 787 (Del. Ch. 1992).

<sup>40</sup> See, e.g., *Production Resources Group, LLC v. NCT Group, Inc.*, 863 A.2d 772, 790-91 (Del. Ch. 2004).

<sup>41</sup> *Id.* (citing *Geyer v. Ingersoll Publications Co.*, 621 A.2d 784, 787 (Del. Ch. 1992)).

<sup>42</sup> The trust fund doctrine, which originated in Justice Story's opinion in *Wood v. Dummer*, 30 Fed. Cas. 435, 439-40 (C.C.D. Me. 1824), was upheld by the Supreme Court in *Sawyer v. Hoag*, 84 U.S. 610, 620 (1873).

<sup>43</sup> See *Bovay*, 38 A.2d at 812.

<sup>44</sup> See, e.g., *Official Comm. of Bond Holders of Metricom, Inc. v. Derrickson (In re Metricom, Inc.)*, No. C 02-04756, 2004 WL 2151336, at \*3 (N.D. Cal. Feb. 25, 2004); *Official Comm. of Unsecured Creditors of Hechinger Inv. Co. v. Fleet Retail Fin. Group (In re Hechinger Inv. Co.)*, 274 B.R. 71, 89 (D. Del. 2002).

<sup>45</sup> *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, Civ. A. No. 12150, 1991 WL 277613, at \*34 & n.55 (Del. Ch. Dec. 30, 1991).

possibility of insolvency can do curious things to incentives, exposing creditors to the risk of opportunistic behavior.”<sup>46</sup>

To make its point, the *Credit Lyonnais* court posed a hypothetical situation in which a solvent debtor, threatened with the possibility of insolvency, had an incentive to engage in risky behavior so that shareholders could maximize the opportunity to recover their investments.<sup>47</sup> In these circumstances, the court concluded, the harm from such behavior falls only on the creditors, who are the residual risk holders of a corporation in the zone of insolvency. The court, therefore, determined that expanding fiduciary duties to include creditors at a time when shareholders might be out of the money would eliminate any temptations to take excessive risks adverse to the creditors.<sup>48</sup>

The Delaware Chancery Court recently revisited many of these issues in the *Production Resources* case.<sup>49</sup> In that case, the court articulated the following key concepts:

- Directors do not owe an entirely different set of fiduciary duties to creditors in the zone of insolvency.<sup>50</sup> Rather, directors have the same duty to maximize the economic value of the corporation.<sup>51</sup> The pursuit of that end, however, should be tempered by the recognition that creditors, not shareholders, bear the residual risk.<sup>52</sup> The court, for example, noted that

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<sup>46</sup> *Id.* at \*34 n.55.

<sup>47</sup> *Id.* Courts and commentators sometimes say that the directors are essentially gambling with the creditors' money under these facts. See, e.g., *In re Hechinger Inv. Co.*, 274 B.R. at 90. Though it may be hard to imagine directors or officers literally putting cash into slot machines, there are some reported examples of precisely that kind of behavior. See *Dwyer v. Jones (In re Tri-State Paving, Inc.)*, 32 B.R. 2, 3 (Bankr. W.D. Pa. 1982) (describing officers who gambled the debtor's remaining funds in Las Vegas in an attempt "to win enough money . . . to pay the corporate-debtor's creditors"); see also Laura Lin, *Shift of Fiduciary Duty upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 VAND. L. REV. 1485, 1491 n.19 (1993) (reporting that the founder of Federal Express successfully adopted such a strategy during an early period of financial difficulty).

<sup>48</sup> *Credit Lyonnais*, 1991 WL 277613, at \*34 n.55.

<sup>49</sup> *Production Resources Group, LLC v. NCT Group, Inc.*, 863 A.2d 772 (Del. Ch. 2004).

<sup>50</sup> *Id.* at 791.

<sup>51</sup> *Id.*

<sup>52</sup> *Id.* at 788-91. The court explained "the efficient liquidation of an insolvent firm might well be the method by which the firm's value is enhanced in order to meet the legitimate claims of its creditors." *Id.* at 791 n.60.

