

**RECOVERING FROM THE “BAD GUYS” AND
THEIR ADVISORS — FIDUCIARY DUTIES TO CREDITORS,
DEEPENING INSOLVENCY, AND *IN PARI DELICTO***

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I. INTRODUCTION

In the past ten years, bankruptcy trustees, creditors committees, and individual creditors have increasingly pursued litigation to augment the distribution of bankruptcy estate assets. That litigation often focuses on the debtor’s former officers, directors, and professional advisors. The success of such litigation, however, usually hinges on three ever-evolving doctrines that are somewhat unique to the bankruptcy world: (1) fiduciary duties to creditors; (2) deepening insolvency; and (3) *in pari delicto*. The first two doctrines may supplement the available claims and remedies, but the third doctrine may entirely preclude any recovery from the former professional advisors. This paper provides an overview of these important doctrines.

II. FIDUCIARY DUTIES TO CREDITORS

Officers and directors owe well-established fiduciary duties to their corporation and its shareholders. As the corporation approaches insolvency, these fiduciary duties 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.

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A. Fiduciary Duties in a Solvent Corporation

1. To Whom Are Fiduciary Duties Owed?

Officers and directors of a solvent corporation owe fiduciary duties to both the corporation and its shareholders.² They ordinarily do not owe such duties to creditors.³ Nor do they owe fiduciary duties to holders of stock options or convertible debentures prior to the purchase or conversion of those interests.⁴ 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.⁵ Creditors may also rely upon important protections under fraudulent conveyance law and federal bankruptcy law.⁶ Officers and 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.⁷

² See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985). Although this seminar 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.

³ 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.”).

⁴ 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).

⁵ See *Production Resources Group, LLC v. NCT Group, Inc.*, 863 A.2d 772, 787 (Del. Ch. 2004).

⁶ See *id.*

⁷ This does not mean that officers and directors should decline any consideration of creditors and other constituencies. Rather, it means that they 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).

2. What Fiduciary Duties Are Owed?

Officers and directors⁸ have generally been said to owe three kinds of fiduciary duties to the corporation and shareholders: (1) due care; (2) loyalty; and (3) good faith.⁹ 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.¹⁰ Other courts, including the Delaware Chancery Court, have indicated that good faith is a separate and distinct fiduciary duty.¹¹ The Delaware Supreme Court, however, recently confirmed that good faith constitutes “a subsidiary element” of the duty of loyalty.¹²

a. Duty of Care

Officers and 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, officers and directors must act on an informed basis after due consideration and deliberation of the relevant issues.¹³ They must inform themselves of all “material information reasonably available to them.”¹⁴ Directors may inform themselves by relying on corporate records, as well as

⁸ Few Delaware cases directly address the distinction between the duties owed by a director and the duties owed by a non-director officer. Most cases combine the discussion of officer and director obligations, generally concluding that their fiduciary duties are the same. Officers, however, probably owe an additional duty to inform the board of directors regarding matters that require director oversight. *See, e.g.,* A. Gilchrist Sparks, III & Lawrence A. Hamermesh, *Common Law Duties of Non-Director Corporate Officers*, 48 BUS. LAW. 215, 226-28 (1992).

⁹ *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.*

¹⁰ *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 . . .”).

¹¹ *See, e.g., In re Walt Disney Co. Derivative Litig.*, 825 A.2d 275, 289 (Del. Ch. 2003).

¹² *See Stone v. Ritter*, 911 A.2d 362, 369-70 (Del. 2006) (en banc).

¹³ *See Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 367 (Del. 1993).

¹⁴ *Id.*

information, opinions, and statements of corporate officers, employees, and third-party professionals.¹⁵ Second, having become informed, officers and directors must then act with the requisite care in the discharge of their duties.¹⁶ Specifically, officers and directors must exercise the care that ordinarily prudent persons would use in similar circumstances.¹⁷

b. Duty of Loyalty

The duty of loyalty requires officers and 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.¹⁸ 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 officers and directors to disclose all material information to shareholders when seeking shareholder action.¹⁹

c. 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 officer and director liability.²⁰ 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

¹⁵ See DEL. CODE ANN. tit. 8, § 141(c).

¹⁶ *Cede*, 634 A.2d at 367 (citing *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)).

¹⁷ See *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963).

¹⁸ *Cede*, 634 A.2d at 361.

¹⁹ 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. 1955).

²⁰ 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).

reliance on the management-hired expert's opinion regarding the fairness of the merger price.²¹ Not surprisingly, this holding has generated significant concern that directors possessing specialized expertise will be held to higher standards under Delaware law.²² 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).²³

More recently, in June 2006, the Delaware Supreme Court addressed the duty of good faith in the long-running and much-followed *Disney* litigation.²⁴ The Supreme Court upheld the Delaware Chancery Court's opinion that Disney's board did not act in bad faith by hiring 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.²⁵

²¹ *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.

²² *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).

²³ Veasey & Di Guglielmo, *supra* note 19, at 1445.

²⁴ *In re Walt Disney Co. Deriv. Litig.*, No. 411, 2006 WL 1562466, at *24 (Del. June 8, 2006).

²⁵ *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.*

The Delaware Supreme Court endorsed this statement as “a legally appropriate, although not exclusive, definition of fiduciary bad faith.”²⁶ 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.²⁷ Rather, a degree of director culpability beyond gross negligence must exist before the duty of good faith is violated.²⁸ 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.²⁹

In November 2006, the Delaware Supreme Court once again addressed the so-called fiduciary duty of good faith.³⁰ The court confirmed that good faith is “a subsidiary element” of the duty of loyalty.³¹ Two doctrinal consequences flow from the court’s analysis. First, only care and loyalty violations give rise to liability directly, whereas bad faith conduct does so “indirectly” as a component of the duty of loyalty.³² Second, the duty of loyalty is not limited to cases involving financial conflicts of interest.³³

3. 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

²⁶ *Walt Disney*, 2006 WL 1562466, at *27.

²⁷ *Id.* at *25-26.

²⁸ *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.”).

²⁹ *Id.* at *25-26 (citing DEL. CODE ANN. tit. 8, §§ 102(b)(7), 145(a) & (b)).

³⁰ *See Stone v. Ritter*, 911 A.2d 362 (Del. 2006) (en banc).

³¹ *Id.* at 369-70.

³² *Id.*

³³ *Id.*

the action taken was in the best interests of the corporation.”³⁴ This presumption applies unless the plaintiff can show that the directors breached one of their fiduciary duties in connection with the challenged transaction.³⁵ The business judgment rule, for example, vanishes to the extent that the directors engaged in a self-dealing transaction.³⁶ The rule also does not apply if the directors make “an unintelligent or unadvised judgment.”³⁷ Nor does the rule apply if the directors simply have not exercised any business judgment at all.³⁸ 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.³⁹

The business judgment rule may not apply to corporate officers.⁴⁰ The Delaware Supreme Court frequently states that the rule covers officers and directors when it recites the rule in actions involving only directors.⁴¹ That court, however, has never squarely held that the business judgment rule applies to corporate officers acting in that capacity.⁴² Indeed, the policy rationales for deference to directors do not necessarily apply with the same force to officers.⁴³

³⁴ *Emerald Partners v. Berlin*, 787 A.2d 85, 90 (Del. 2001) (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)).

³⁵ *See id.* at 91.

³⁶ *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).

³⁷ *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.’”).

³⁸ *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”).

³⁹ *Emerald Partners*, 787 A.2d at 91.

⁴⁰ *See generally* Lyman P.Q. Johnson, *Corporate Officers and the Business Judgment Rule*, 60 BUS. LAW. 439 (2005) (asserting that the business judgment rule does not and should not be extended to officers in the same broad manner in which it is applied to directors).

⁴¹ *See, e.g., Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1162 (Del. 1995).

⁴² *See Johnson, supra* note 40, at 443.

⁴³ *See id.* at 466.

For example, corporate officers — unlike directors — probably do not need to receive the protection of the business judgment rule to induce them to serve and take appropriate risks on behalf of the corporation.⁴⁴ Indeed, the highly incentive-based compensation of officers already encourages such behavior.

4. What Exculpatory Clauses May Apply?

Delaware statutory law (like the law of most jurisdictions, including Texas)⁴⁵ 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.⁴⁶ 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 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.⁴⁷

Corporate officers, unlike directors, probably receive no protection from such exculpatory clauses, as most courts hold that such clauses expressly apply only to directors.⁴⁸ One Delaware federal court, however, has held that an exculpatory clause protected both

⁴⁴ See *id.* at 458-59.

⁴⁵ See TEX. CIV. STAT. ANN. art. 1302-7.06B

⁴⁶ DEL. CODE ANN. tit. 8, § 102(b)(7).

⁴⁷ *Id.*

⁴⁸ 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).

directors and officers, but without explaining its rationale or addressing any contrary cases.⁴⁹ 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.⁵⁰

B. Fiduciary Duties in a Near-Insolvent Corporation

Officers and directors must act on behalf of a broader constituency, including creditors, as their corporation approaches insolvency. This impacts how officers and 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.

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

Delaware courts have long held that officers and directors owe fiduciary duties to creditors once the corporation actually becomes insolvent.⁵¹ Recent decisions continue to recognize this rule.⁵² 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 proposition⁵³

This rule evolved from the "trust fund" doctrine, which developed to prevent inequity in the distribution of corporate assets upon dissolution.⁵⁴ Under that doctrine, directors of an insolvent

⁴⁹ *Continuing Creditors' Comm. of Star Telecomms. Inc. v. Edgecomb*, 385 F. Supp. 2d 449, 464 (D. Del. 2004).

⁵⁰ *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).

⁵¹ *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).

⁵² *See, e.g., Production Resources Group, LLC v. NCT Group, Inc.*, 863 A.2d 772, 790-91 (Del. Ch. 2004).

⁵³ *Id.* (citing *Geyer v. Ingersoll Publications Co.*, 621 A.2d 784, 787 (Del. Ch. 1992)).

