The Creeping Business Judgment Rule

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Fiduciary Duties Owed By Boards of Directors
to Both Solvent and Insolvent Companies

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I. Summary of Fiduciary Duties of a Board of Directors

The responsibilities owed by the directors of a corporation are established by both statutory and common law. The Delaware General Corporation Law (the “DGCL”), for example, creates a board-centric governance structure in which the directors ultimately are responsible for the management of the corporation’s business and affairs, subject to their authorization to delegate certain but not all of those responsibilities to managers and other qualified agents of the corporation. In discharging this responsibility, decisional law holds that the directors owe “unyielding” fiduciary duties: namely, the duties of care and loyalty. These duties are owed to the corporation and to its stockholders, the latter as an undifferentiated whole even where a director is appointed to the board by a particular stockholder or stockholder contingent. “[S]tockholders' best interest must always, within legal limits, be the end. Other

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1 The discussion here focuses on the responsibilities of directors of corporations. Fiduciary and other duties may arise in the context of alternative entities (such as limited liability companies, partnerships, and business trusts), though a considerable amount of flexibility to modify or even eliminate certain duties generally is accorded in these organizational structures. Fiduciary duties in the limited liability company construct are discussed briefly below in Subsection I.C.

2 At the outset of our discussion will focus mainly on Delaware corporate law. Delaware is the predominant jurisdiction for incorpora, and disputes related thereto, and most state have styled their corporate laws in conformity with the DGCL. However, at the conclusion we will briefly address other jurisdictions and their differences to the DGCL.

3 8 Del. C. § 141(a) (“The business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation . . . .”).


5 “The duty to act for the ultimate benefit of stockholders does not require that directors fulfill the wishes of a particular subset of the stockholder base.” In re Orchard Enterprises, Inc. S’holder Litig., C.A. No. 7840-VCL, slip op. ___ (Del. Ch. Feb. 28, 2014) (quoting In re Trados Inc. S’holder Litig., 73 A.3d 17, 38 (Del.Ch. 2013)).
[corporate] constituencies may be considered only instrumentally to advance that end.\(^6\) Broadly stated, the fiduciary duties owed by directors require that they act prudently, loyalty, and in good faith to maximize the corporation’s value over the long-term for the benefit of its stockholders.\(^7\)

\textbf{A. Duty of Loyalty}

The duty of loyalty forbids fiduciaries from using “their position of trust and confidence to further their private interests” or the interests of others not shared by the corporation’s stockholders at large.\(^8\) It requires, “in essence, ‘[] that the best interest of the corporation and its shareholders take[] precedence over any interest possessed by a director . . . and not shared by the stockholders generally.’”\(^9\) Accordingly, a director may not misappropriate assets entrusted to his or her management and oversight, nor may she engage in self-interested transactions with the corporation unless the terms of those transactions are entirely fair.\(^10\)

\(^6\) Leo E. Strine, Jr., Our Continuing Struggle with the Idea that For–Profit Corporations Seek Profit, 47 Wake Forest L.Rev. 135, 147 n.34 (2012).

\(^7\) See, e.g., \textit{Gantler v. Stephens}, 965 A.2d 695, 706 (Del. 2009) (holding that “enhancing the corporation's long term share value” is a “distinctively corporate concern”); \textit{TW Servs., Inc. v. SWT Acq. Corp.}, 1989 WL 20290, at *7 (Del. Ch. Mar. 2, 1989) (Allen, C.) (describing as “non-controversial” the proposition that “the interests of the share-holders as a class are seen as congruent with those of the corporation in the long run” and explaining that “[t]hus, broadly, directors may be said to owe a duty to shareholders as a class to manage the corporation within the law, with due care and in a way intended to maximize the long run interests of share-holders”). See also \textit{eBay Domestic Hldgs., Inc. v. Newmark}, 16 A.3d 1, 34 (Del. Ch.2010); accord \textit{Gheewalla}, 930 A.2d at 101 (“The directors of Delaware corporations have ‘the legal responsibility to manage the business of a corporation for the benefit of its shareholder owners.’”); \textit{Unocal Corp. v. Mesa Petroleum Co.}, 493 A.2d 946, 955 (Del.1985) (citing “the basic principle that corporate directors have a fiduciary duty to act in the best interests of the corporation's stockholders”); see also Leo E. Strine, Jr., et al., Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law, 98 Geo. L.J. 629, 634 (2010) (“[I]t is essential that directors take their responsibilities seriously by actually trying to manage the corporation in a manner advantageous to the stockholders.”).

\(^8\) \textit{Guth v. Loft, Inc.}, 5 A.2d 503, 510 (Del. 1939).


\(^10\) The business judgment rule, entire fairness and intermediary standards of review are discussed in Section II below.
The duty of loyalty implicates director “independence” and “disinterestedness.” As to the former, the duty of loyalty requires that directors maintain independence in their deliberations and decision-making:

Independence means that a director’s decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences. While directors may confer, debate, and resolve their differences through compromise, or by reasonable reliance upon the expertise of their colleagues and other qualified persons, the end result, nonetheless, must be that each director has brought his or her own informed business judgment to bear with specificity upon the corporate merits of the issues without regard for or succumbing to influences which convert an otherwise valid business decision into a faithless act.11

A controlled director – that is, one who by virtue of a material personal, professional, or financial relationship is beholden to another interested person or contingent – is not an independent director. So, where a director holds a lucrative position as an officer of the company that predisposes her to be dominated by a substantial stockholder,12 or where a director succumbs to the intimidation tactics (such as the threat of a lawsuit) of an influential stockholder’s board appointee, a director may be deemed to lack independence.13

Regarding the latter, a director is interested in a matter under consideration if he or she “expects to derive a material personal financial [or other] benefit from the transaction that does not devolve on all stockholders generally.”14 Thus, by way of illustration, where an inside director stands to receive a material change-in-control payment as the result of a transaction

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14 eBay Domestic Holdings, Inc. v. Newmark, 16 A.3d 1, 41 (Del. Ch. 2010).
under consideration, or where she stands to lose her job as an officer of the corporation if the transaction is not consummated, that director is deemed to be interested.\textsuperscript{15}

The duty of loyalty also encompasses a subsidiary duty of good faith.\textsuperscript{16} While difficult to define in absolute terms, a “failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation.”\textsuperscript{17} Thus, the absence of good faith may be shown where directors “\textit{knew} that they were making material decisions without adequate information and without adequate deliberation, and that they simply did not care if the decision caused the corporation and its stockholders to suffer injury or loss.”\textsuperscript{18} The Delaware Supreme Court has articulated three categories of fiduciary misconduct that are “candidates for the ‘bad faith’ pejorative label.” They are:

- conduct undertaken with an actual intent to harm the corporation;
- action undertaken with a lack of due care rising to gross negligence but without malevolent intent; and
- intentional dereliction of duty reflecting a conscious disregard for one’s responsibilities.\textsuperscript{19}

\textbf{B. Duty of Care}

The duty of care requires directors to “use that amount of care which ordinarily careful and prudent [individuals] would use in similar circumstances.”\textsuperscript{20} This in turn requires that

\begin{footnotesize}
\begin{enumerate}
\item See, e.g., \textit{In re Answers Corp. S’holders Litig.}, Consol. C.A. No. 6170-VCN, slip op. 24 (Del. Ch. Apr. 11, 2012) (inference of interestedness pleaded where complaint alleged that CEO director stood to lose his job unless he completed change in control transaction).
\item \textit{In re Walt Disney Co. Derivative Litig.}, 906 A.2d 27, 67 (Del. 2006). See also \textit{Gagliardi v. TriFoods Int’l, Inc.}, 683 A.2d 1049, 1051 n. 2 (Del.Ch.1996) (defining a “bad faith” transaction as one “that is authorized for some purpose other than a genuine attempt to advance corporate welfare or is known to constitute a violation of applicable positive law”).
\item \textit{Disney}, 825 A.2d 275, 289.
\item \textit{Disney}, 906 A.2d 64-66.
\end{enumerate}
\end{footnotesize}
directors “consider all material information reasonably available in making business
decisions.”21 While there is no fixed process by which directors discharge their duty of care, the
time spent in the deliberative process and the information and experts relied on are among the
factors considered when directorial action is challenged in court.22 Generally, directors should
obtain and consider pertinent information; solicit and consider the advice of experts where
necessary; ask questions of management and others, and test assumptions where appropriate;
fully understand the terms of important transactions; engage in candid discussion; stay apprised
of the corporation’s financial and operational performance and monitor internal controls; monitor
the performance of management; and probe conditions that may (for example) signal a failure of
internal controls or compliance with applicable law.

Breaches of the duty of care typically are not found where directors merely fail to follow
best practices; rather, breaches of fiduciary duty are found where there has been conduct that is
grossly negligent or directors have acted with reckless indifference to stockholder concerns or in
a manner that is completely irrational relative to their decision-making process.23 Particularly
egregious breaches of the duty of care also may constitute a breach of the duty of loyalty.24

C. LLC Fiduciary Duties

The Delaware Limited Liability Company Act (the “LLC Act”) does not provide
expressly that managers of Delaware limited liability companies (“LLCs”) owe the common law

20 In re Walt Disney Co. Derivative Litig., 907 A.2d 693, 749 (Del. Ch. 2005), aff’d, 906 A.2d 27
(Del. 2006).
21 Disney, 907 A.2d 693, 749.
24 See Stone v. Ritter, 911 A.2d 362 (Del. 2006) (breach of duty of loyalty may be found where
directors fail to implement any reporting or information system controls, or having implemented such a
system fail to monitor or oversee its operations).
fiduciary duties of care and loyalty owed by directors and officers of Delaware corporations. However, the LLC Act expressly does provide that fiduciary duties may be eliminated or restricted in the operating agreement: “To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement, the member’s or manager’s or other person’s duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement....” The LLC Act also permits the LLC agreement to exculpate managers for liability for breaches of duties, including fiduciary duties. Certain members of the Court of Chancery and the Delaware Supreme Court have expressed the view that such fiduciary duties must exist as a matter of law, as there existence is a precondition to the ability to eliminate or restrict them in accordance with the LLC Act. While the gravity of authority appears to favor this view, the question is not yet settled in Delaware.

25 6 Del. C. § 18-1101(c).
26 6 Del. C. § 18-1101(e).
27 See Auriga Capital Corporation v. Gatz Properties, LLC, 2012 WL 361677 (Del. Ch. Jan. 27, 2012), the Delaware Court of Chancery found that, unless eliminated or restricted in the LLC agreement, managers of LLCs owe default fiduciary duties; Feeley v. NHAOCG, LLC, 62 A.3d 649, 663 (Del. Ch. 2012) (stating, “[T]he LLC Act creates myriad opportunities for LLC agreements that range from the minimalistic to the ill-formed to the simply incomplete. In authorizing this level of informality, the LLC Act resembles its partnership forebears, where agreements likewise can be formed orally or by implication and where fiduciary duties are an important part of the entity landscape.”); see also Gotham Partners, L.P. v. Hallwood Realty Partners, L.P., 817 A.2d 160 (Del. 2002) (Delaware Supreme Court questions whether the fiduciary duties of a general partner can be fully eliminated by the partnership agreement under the statutory text of the LLC Act).
28 See Judicial Scrutiny of Fiduciary Duties in Delaware Limited Partnerships and Limited Liability Companies, 32 Del. J. Corp. L. 1 (2007) (Then Delaware Chief Justice Myron T. Steele concludes that managers of Delaware LLCs should not owe traditional fiduciary duties unless the parties to the LLC agreement agree that fiduciary duties exist.).
II. Applicable Standards of Review for Transactions Under Delaware Law

A. Overview

While the standards of conduct described above define what directors and officers are expected to do and not do, their conduct is reviewed by the courts using established standards of review. Stated differently, “[t]he standard of review is the test that a court applies when evaluating whether directors have met the standard of conduct.” It has also been described as the lens through which the court views the fiduciary’s challenged conduct. There are “three tiers of review for evaluating director decision-making: the business judgment rule, enhanced scrutiny, and entire fairness.” The initial determination of which standard of review applies is a threshold question, and is critical as the standard of review will often be determinative of the outcome of any dispute over fiduciary duties.

B. Business Judgment Rule Protection – the Default Standard of Review

The business judgment rule is “Delaware’s default standard of review,” and provides fiduciaries with significant protection in making decisions by presuming that they act on an informed basis and with the honest belief that their decisions are in the best interests of the corporation. Under the business judgment rule, a court will not second-guess the fiduciary’s decision as long as it has any rational business purpose, even if the decision ends up being

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30 Id. at 35-36.
31 Id. at 21.
33 See In re Walt Disney Company Derivative Litigation, 906 A.2d 27, 52-53 (Del. 2006) (describing the initial determination as a “threshold” issue); see also Trados at 21 (describing the threshold inquiry into the standard of review as an “ab initio” question).
34 Trados at 43.
flawed in hindsight and has a significant adverse effect on the corporation.\textsuperscript{35} The business judgment rule, however, can be overcome by showing that the fiduciary had a conflict of interest in the transaction or was not disinterested or independent.\textsuperscript{36} If the presumption is overcome, the courts will review the decision under either the entire fairness standard of review or enhanced scrutiny standard of review.

\textbf{C. Entire Fairness Review – Heighten Review of Transactions}

When a fiduciary is interested or not independent in the transaction, entire fairness applies.\textsuperscript{37} A “director’s interest may be shown by demonstrating a potential personal benefit or detriment to the director as a result of the decision.”\textsuperscript{38} Separate from the issue of whether a fiduciary is disinterested and independent, entire fairness review is also triggered when a fiduciary engages in a grossly negligent decision-making process in evaluating or entering into a transaction, including by failing to consider material facts when making the decision.\textsuperscript{39}

Under entire fairness, “‘the burden . . . shifts to the director defendants to demonstrate that the challenged act or transaction was entirely fair to the corporation and its shareholders.’”\textsuperscript{40} “‘The concept of fairness has two basic aspects: fair dealing and fair price.’”\textsuperscript{41} “Fair dealing

\begin{footnotes}
\footnotetext[35]{\textit{In re Dollar Thrifty Shareholders Litigation}, 14 A.3d 583, 598 (Del. Ch. 2010).}
\footnotetext[37]{\textit{Id.} at 43-44; see also \textit{Beam v. Stewart}, 845 A.2d 1040, 1049 (Del. 2004); \textit{Mills Acquisition Co. v. Macmillan, Inc.}, 559 A.2d 1261, 1280 (Del. 1989).}
\footnotetext[38]{\textit{Beam}, 845 A.2d at 1049; \textit{Rales v. Blasband}, 634 A.2d 927, 933 (Del. 1993) (“‘Directorial interest exists whenever divided loyalties are present, or a director has received, or is entitled to receive, a personal financial benefit from the challenged transaction which is not equally shared by the stockholders.”’ (citation omitted)); \textit{Aronson v. Lewis}, 473 A.2d 805, 812 (Del. 1984).}
\footnotetext[39]{\textit{Brehm v. Eisner}, 746 A.2d 244, 264 n.66 (Del. 2000).}
\footnotetext[40]{\textit{Reis}, 28 A.3d at 459 (quoting \textit{In re Walt Disney Co. Deriv. Litig.}, 906 A.2d 27, 74 (Del. 2006)); see also \textit{Mills Acquisition Co. v. Macmillan, Inc.}, 559 A.2d 1261, 1280 (Del. 1989) (“When faced with such divided loyalties, directors have the burden of establishing the entire fairness of the transaction to survive careful scrutiny by the courts.”).}
\footnotetext[41]{\textit{Id.} (quoting \textit{Weinberger v. UOP, Inc.}, 457 A.2d 701, 711 (Del. 1983)).}
\end{footnotes}
embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained.”42 This fairness determination also does not turn on the fiduciary’s good faith. Indeed, “[n]ot even an honest belief that the transaction was entirely fair will be sufficient to establish entire fairness. Rather, the transaction itself must be objectively fair, independent of the board’s beliefs.”43

D. Enhanced Scrutiny Review – Intermediate Level of Review

Enhanced scrutiny review applies to certain types of transactions which, due to their nature or importance, warrant a higher level of examination than simply business judgment review.44 Courts apply enhanced scrutiny “to specific, recurring, and readily identifiable situations involving potential conflicts of interest where the realities of the decisionmaking context can subtly undermine the decisions of even independent and disinterested directors.”45 For instance, enhanced scrutiny applies in “every case in which a fundamental change of corporate control occurs or is contemplated.”46 Thus, enhanced scrutiny review applies both to a sale and a transaction related to a sale.47 This intermediate level of review “‘[is] rooted in a concern that the board might harbor personal motivations in the sale context that differ from what is best for the corporation and its stockholders. Most traditionally, there is the danger that

42 Trados, 73 A.3d at 56 (quoting Weinberger, 457 A.2d at 711).
44 Id.
45 Trados, 73 A.3d at 43.
46 Paramount Comm’s Inc. v. QVC Network Inc., 637 A.2d 34, 46 (Del. 1994).
47 See Macmillan, 559 A.2d at 1285-86 (stating that while lockup agreements are “not per se unlawful under Delaware law,” “when it involves ‘crown jewel’ assets careful board scrutiny attends the decision”); see also In re El Paso Corp. S’holder Litig., 41 A.3d 432, 439 (Del. Ch. 2012) (“[T]he potential sale of a corporation has enormous implications for corporate managers and advisors, and a range of human motivations, including but by no means limited to greed, can inspire fiduciaries and their advisors to be less than faithful.”).
top corporate managers will resist a sale that might cost them their managerial posts, or prefer a sale to one industry rival rather than another for reasons having more to do with personal ego than with what is best for stockholders.”

If enhanced scrutiny review is triggered, the “defendant fiduciaries [must] show that they acted reasonably to obtain for their beneficiaries the best value reasonable available under the circumstances, which may be no transaction at all.”

E. Exculpatory Provisions

Various states permit corporations to include provisions in their certificates of incorporation that eliminate or limit the personal liability of directors or stockholders for monetary damage arising from breaches of the duty of care. Such exculpatory provisions typically do not protect fiduciaries from “any breach of duty of loyalty to the corporation or its stockholders;” “acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of the law;” or, among others, “for any transaction from which [he] derived an improper personal benefit.” Further, these types of exculpatory provisions typically protect only directors and not officers from personal liability.

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48 Trados, 73 A.3d at 44 (quoting In re Dollar Thrifty S’holder Litig., 14 A.3d 573, 597 (Del. Ch. 2010)).

49 Trados, 73 A.3d at 44.

50 See e.g., 8 Del. C. § 102(b)(7); see also Stone ex rel. AmSouth Bancorporation v. Ritter, 911 A.2d 362, 367 (Del. 2006) (stating that defendant corporation’s certificate of incorporation could exculpate directors from monetary liability for a breach of the duty of care, but not for a breach of the duty of loyalty).

51 8 Del. C. § 102(b)(7).

52 See Gantler v. Stephens, 965 A.2d 695, 709 n.37 (Del. 2009) (“Although legislatively possible, there currently is no statutory provision authorizing comparable exculpation of corporate officers.”).
III. The Origins of the Zone of Insolvency

A. Credit Lyonnais Bank Nederland, N.V.

In 1991, then-Chancellor Allen in Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp. “penned his famous . . . aside”\textsuperscript{53} where he stated:

The possibility of insolvency can do curious things to incentives, exposing creditors to risk of opportunistic behavior and creating complexities for directors. . . Such directors will recognize that in 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 corporate 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.\textsuperscript{54}

The Credit Lyonnais decision was ultimately a breach of contract decision stemming from a corporate governance fight over the control of MGM after a failed leveraged buyout.\textsuperscript{55} During this prolonged corporate battle, MGM found itself subject to an involuntary bankruptcy and teetered on the edge of bankruptcy for quite some time.\textsuperscript{56} In rejecting an argument by the majority shareholder (owner of 98.5% of the equity) that the executive committee of the board was violating its fiduciary duties by engaging in actions against the will of the majority shareholder, Chancellor Allen stated:

In these circumstances where the company was in bankruptcy until May 28 and even thereafter the directors labored in the shadow of that prospect, Mr. Ladd and his associates were appropriately mindful of the potential differing interests between the corporation and its 98% shareholder. At 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.\textsuperscript{57}


\textsuperscript{55} Id. at *1-3, *12-16, *22.

\textsuperscript{56} Id. at *9, *55.

\textsuperscript{57} Id. at *34.

In the wake of Credit Lyonnais, practitioners and courts began to grapple with, not the actual holding of the decision, but the meaning of Chancellor Allen’s statement that the board owes its duty “to the entire corporate enterprise” when “operating in the vicinity of insolvency.” Some cases and commentators argued that Credit Lyonnais established authority for creditors to assert fiduciary claims against a board of directors where the company operated in the zone of insolvency. Indeed, some courts decided that it was black-letter law that “when a corporation is operating in the zone or vicinity of insolvency, its directors’ fiduciary duty extends not only to the corporation’s shareholders, but also to its creditors.” Bankruptcy courts latched onto this view as well, supporting creditor fiduciary duty claims where the debtor operated in the zone of insolvency prepetition. Courts proclaimed a director of a corporation within the zone of


59 See In re NCS Healthcare, Inc., S’holders Litig., 825 A.2d 240, 256 (Del. Ch.) (“But, as directors of a corporation in the ‘zone of insolvency,’ the NCS board members also owe fiduciary duties to the Company’s creditors.”), rev’d sub nom., Omni Care, Inc. v. NCS Healthcare, Inc., 822 A.2d 397 (Del. 2002); Royce de R. Barondes, Fiduciary Duties of Officers and Directors of Distressed Corporations, 7 Geo. Mason L. Rev. 45, 70 (1998).


insolvency “owes a fiduciary duty not only to [the debtor] and any shareholders, but also to its creditors.”62

Concern emerged, however, when reliance upon the zone of insolvency concept began to expand. While courts continued to propound duties upon directors of corporations in the zone of insolvency, then-Vice Chancellor Strine, now Chief Justice Strine, in 2004 questioned the entire theory. Vice Chancellor Strine stated, “Creative 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.”63 The Chancery Court further opined that grafting a board’s duties onto to creditors is a solution seeking a problem:

Creditors are often protected by strong covenants, liens on assets, and other negotiated contractual protections. The implied covenant of good faith and fair dealing also protects creditors. So does the law of fraudulent conveyance. With these protections, 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.64 Thus, creditors were already sufficiently protected through other legal doctrines.

Vice Chancellor Strine also pointed out that the “zone of insolvency” is a nebulous concept, open to practitioner exploitation and faulty judicial decision-making. First, determining whether a company is in the “zone of insolvency” is very problematic given that deciding when a company is insolvent – a supposed straight line in the sand – is already difficult enough.65 No doubt, Strine warned, plaintiff’s counsel would be able to plead sufficient allegations about the

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63 In re Prod. Resources Grp., LLC, 863 A.2d 772, 789 (Del. Ch. 2004).
64 Id. at 789-90.
65 Id. at 789 n.56.
company operating in the “zone” to survive a motion to dismiss but then see the claims weaken after discovery. Second, while the company is solvent, the board already owes shareholders fiduciary duties. Yet granting those duties to creditors where the company is solvent but within the “zone of insolvency” places the board at the whims of two groups of stakeholders with disparate interests. How is a court to decide whether the actions of the board breached their duties when the board’s duties are being pulled in different directions? Indeed, courts have recognized that shareholders may wish the board pursue more aggressive and risky actions in the hopes of obtaining a recovery while creditors may counsel a less risky approach to protect what little recovery they have left. Thus, Vice Chancellor Strine’s opinion began the persuasive attack on the zone of insolvency and its possible imposition of fiduciary duties to creditors before actual insolvency.

IV. Current Status of the Zone of Insolvency

A. Gheewahala

In the almost two decades since Credit Lyonnais, practitioners struggled with when and how the zone of insolvency affected existing fiduciary duties. In 2007, sixteen years after Credit Lyonnais, the Delaware Supreme Court clearly defined the point at which the fiduciary duties of directors and officers shift – at actual insolvency, and not somewhere in the middle of the zone of insolvency. In Gheewallah, the holder of certain radio-wave spectrum licenses, was a party, along with other such license holders, to an agreement whereby Clearwire Holdings, Inc.

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66 Id.
67 Id.
68 See Quadrant, 102 A.3d at 174-76.
(“Clearwire”) would purchase the package of licenses. Shortly after the agreement was entered into, the market for the spectrum licenses dissolved. Clearwire was unable to complete the purchase and ended up shuttering operations.

The plaintiff sued three directors on the board of Clearwire who were appointed to the board by Clearwire’s lender. The lawsuit was filed by the plaintiff directly, and on his own behalf, not derivatively. He alleged that the defendant directors breached their fiduciary duties to the plaintiff because the plaintiff was a creditor of Clearwire and Clearwire was either insolvent or operating in the zone of insolvency.70

The Delaware Chancery Court granted the directors’ motion to dismiss the complaint reasoning that the plaintiff, as a creditor, was not able to assert direct claims against the directors of an entity that is insolvent or is operating in the zone of insolvency.71 The Delaware Supreme Court affirmed and found that entering the zone of insolvency did not trigger the fiduciary duties that directors and officers owed to shareholders of a corporate entity to spread to its creditors. The shifting point was when the corporate entity reached actual insolvency, not before. In addition, the Court found that the rights conferred on creditors did not include direct claims against the directors or officers, only derivative claims.72

B. Recent Developments in Derivative Claims in The Zone of Insolvency

i. Trenwick

In Trenwick, the Delaware Court of Chancery further clarified the scope of derivative claims in the zone of insolvency: “If the board of an insolvent corporation, acting with due

70 Id. at 96.

71 Id. at 94.

72 Id. at 103.
diligence and good faith, pursues a business strategy that it believes will increase the corporation’s value, but that also involves the incurrence of additional debt, it does not become a guarantor of that strategy’s success. That 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.”73

The Court went on to find that there is no cause of action for “deepening insolvency” in Delaware. “Delaware law does not recognize this catchy term as a cause of action because it does not express a coherent concept. Even when a firm is insolvent, the business judgment rule protects fiduciaries from undertaking risky strategies that ultimately fail or place the corporation further into debt or insolvency. The fact that the residual claimants of the firm at that time are creditors does not mean that the directors cannot choose to continue the firm’s operations in the hope that they can expand the inadequate pie such that the firm’s creditors get a greater recovery. By doing so, the directors do not become a guarantor of success. Put simply, under Delaware law, ‘deepening insolvency’ is no more of a cause of action when a firm is insolvent than a cause of action for ‘shallowing profitability’ would be when a firm is solvent. Existing equitable causes of action for breach of fiduciary duty, and existing legal causes of action for fraud, fraudulent conveyance, and breach of contract are the appropriate means by which to challenge the actions of boards of insolvent corporations.”74

73 Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P., et al., 906 A.2d 168, 205 (Del. Ch. 2006); see also id. at 195 n.75 (“Even when a corporation is solvent, the notion that the directors should pursue the best interests of the equityholders does not prevent them from making a myriad of judgments about how generous or stingy to be to other corporate constituencies in areas where there is no precise legal obligation to those constituencies. I do not understand this complexity to diminish when a firm is insolvent simply because the residual claimants are now creditors.”).

74 Id. at 174.
Trenwick further enforced that the directors of a Delaware corporation are clearly protected by the business judgment rule when a corporation is insolvent and that “deepening insolvency” is not a standalone cause of action. Trenwick also added to the theme first espoused in Gheewalla that directors should work to maximize the corporate enterprise if the corporation is solvent, in the zone of insolvency, or insolvent. Insolvency only changes the residual beneficiaries of the enterprise. Nor does it change a creditor’s lack of standing to pursue a direct claim in his own right for breach of contract or fiduciary duty. A creditor may bring only a derivative claim once there exists an actual insolvency.

ii. Quadrant

Most recently, the Delaware Court of Chancery issued an opinion in Quadrant Structured Products Company, Ltd. v. Vertin, which analyzed creditors’ standing to bring derivative claims against directors and officers of Delaware corporations.75 Expanding on the Delaware Supreme Court decision in Gheewalla regarding fiduciary duties owed to creditors, Vice Chancellor Laster’s opinion has two primary holdings. First, creditors must establish a corporation’s insolvency at the time they filed suit and need not demonstrate that the corporation remained insolvent through judgment. Second, even if the corporation becomes solvent during the litigation process, the creditors’ standing is not revoked.

As a creditor, Plaintiff Quadrant Structured Products Company, Ltd. (“Quadrant”) asserted derivative claims for breaches of fiduciary duty against the directors of Athilon Capital Corporation (the “Company”) and EBF & Associates (“EBF”), which held equity and certain junior debts of the Company.76 The Company returned to solvency while Quadrant’s suit was

76 Id. at *2.
still pending. Defendants moved for summary judgment, advocating for a continuous insolvency requirement, under which a creditor can only maintain a derivative claim during the time a corporation is insolvent. Defendants argued that summary judgment was appropriate because under Gheewalla, creditors can only sue directors for breach of fiduciary duties once the corporation is insolvent. Because Quadrant was no longer a creditor “of an insolvent corporation,” it lacked standing to pursue its claims.

The Court, however, held that Delaware law does not impose a continuous insolvency requirement for creditor standing. Rather, a creditor must only establish that the corporation was insolvent at the time suit was filed. The court was “driven by the rationale that once a firm is insolvent, the creditors replace the stockholders as the equitable owners of the firm’s assets and the initial beneficiaries of any interest in value.” Also, a corporation’s future is always uncertain and possibly volatile, so “a troubled firm could move back and forth across the insolvency line such that a continuing insolvency requirement would cause creditor standing to arise, disappear, and reappear again. If the corporation’s financial condition fluctuated sufficiently, misconduct would evade review.” Finally, if both stockholders and creditors have

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77 Id. at *4.
78 Id.
79 Id. at *5
80 Quadrant, 2015 WL 2062115, at *12 (“In my view, therefore, to maintain standing to sue derivatively, a creditor must establish that the corporation was insolvent at the time the creditor filed suit. The creditor need not demonstrate that the corporation continued to be insolvent until the date of judgment.”).
81 Id.
82 Id. at *10.
83 Id. at *12.
84 Id.
standing to sue a distressed corporate board, “the court supervising the derivative litigation has ample tools available to manage it.”

Defendants also argued that Quadrant must also show “that the corporation is irretrievably insolvent,” such that the insolvent corporation had no reasonable prospect of returning to solvency. The court rejected this argument and held “the irretrievable insolvency test only applies in receivership proceedings” and is not an element to consider when discussing creditor-derivative standing. Therefore, “[t]o bring a derivative action, the creditor-plaintiff must plead and later prove insolvency under the traditional balance sheet or cash flow tests.”

In rejecting these additional hurdles (continuous insolvency and irretrievably insolvent), the Court restated the significant principles iterated by the Gheewalla opinion:

1. The “zone of insolvency” has no implications for fiduciary duty claims. “The only transition point that affects fiduciary duty analysis is insolvency itself.”

2. Derivative actions are the only means for creditors to bring fiduciary duty claims against the debtor corporation. Creditors cannot bring direct claims for breach of fiduciary duty.

3. Directors of an insolvent corporation do not owe particular duties to creditors. Rather, directors owe fiduciary duties to the corporation itself, for the benefit of its residual claimants. When the corporation is insolvent, the category of residual claimants includes the corporation’s creditors.

4. Shareholders do not lose their right to bring derivative claims as the corporation becomes insolvent. Insolvency only expands the pool of potential plaintiffs to include both shareholders and creditors.

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85 Id. at *13.
86 Id. at *17.
87 Id. at *16.
88 Id. at *1.
89 Quadrant, 2015 WL 2062115, at *7 (citing Gheewalla, 930 A.2d at 101 (rejecting the “zone of insolvency” because of “the need for providing directors with definitive guidance.”).
90 Id.
91 Id.
92 Id.
Quadrant eliminated two potential hurdles creditors face when bringing derivative claims for breaches of fiduciary duty. It clarified that (i) a creditor need only show insolvency when initiating the suit to establish standing and (ii) a return to solvency will not revoke the requisite standing to maintain derivative claims for breaches of fiduciary duty. While this case seemingly expanded a creditor’s right to pursue derivative claims against insolvent companies, Quadrant reaffirmed long-standing restrictions that protect the directors and officers of distressed corporations. Specifically, (i) creditors still cannot bring direct claims for breaches of fiduciary duty, (ii) Delaware continues to reject the theories of “deepening insolvency” and “zone of insolvency,” and (iii) protections of the business judgment rule still afford directors of insolvent corporations considerable latitude to take actions to maximize a corporation’s value.

C. Current State of “Zone of Insolvency” Law

In the wake of Gheewalla, the general rule under Delaware law is that prior to actual insolvency, including while operating in the zone of insolvency, directors and officers of a corporate entity owe their fiduciary duties of loyalty, care, and good faith solely to the corporation itself and its shareholders, not to other constituencies such as creditors. Therefore, individual creditors of a corporate entity that are either solvent or operating in the zone of insolvency cannot bring direct claims for breach of fiduciary duties to recoup their individual losses against the directors and officer. Other courts have followed this approach by limiting the fiduciary duties that directors and officers owe to creditors when the corporate entity operates in the zone of insolvency.93 At this point in time, derivative rights in the zone of insolvency are still in question.

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However, once the entity actually becomes insolvent, those fiduciary duties shift and expand to include shareholders directly and creditors on a derivative basis on behalf of the corporate entity.\textsuperscript{94} There are two primary approaches to assessing insolvency – equitable insolvency\textsuperscript{95} and balance sheet insolvency.\textsuperscript{96} Delaware courts have ruled that insolvency may be demonstrated by either approach, but it is usually not an easy task to determine exactly when the line of insolvency has been crossed.\textsuperscript{97}

As mentioned above, creditors are unable to assert a direct action against directors and officers for breach of their fiduciary duties under Delaware law.\textsuperscript{98} Yet, creditors are not prohibited from pursuing derivative claims against directors and officers for breach of their fiduciary duties while the company is operating in the zone of insolvency. While this remains the standard under Delaware law, some courts applying other states’ laws have found that

\textsuperscript{94} \textit{Gheewalla}, 930 A.2d at 103 (When a company becomes insolvent, the directors and officers owe fiduciary duties to the insolvent corporation for the benefit of its creditors, while continuing to attempt to maximize the value of the company for the potential residual benefit of the shareholders); cf. \textit{Akande v. Transamerica Airlines, Inc. (In re Transamerica Airlines, Inc.)}, 2006 WL 587846, at *7 (Del. Ch. Feb. 28, 2006) (“When a company becomes insolvent, its directors owe fiduciary duties to the company’s creditors, as well as its stockholders.”(citing \textit{Prod. Res. Group, LLC v. NCT Group, Inc.}, 863 A.2d 772, 790-91 (Del. Ch.2004))).

\textsuperscript{95} A corporation is deemed insolvent when it is unable to pay its debts in the ordinary course of business.

\textsuperscript{96} A corporation is deemed insolvent when its liabilities exceed the reasonable market value of its assets.

\textsuperscript{97} \textit{Gheewalla} at 98 (stating that the Delaware Chancery Court noted that insolvency may be shown by meeting the definition of either equitable insolvency or balance sheet insolvency).

\textsuperscript{98} \textit{Gheewalla}, 930 A.2d at 103 (“To recognize a new right for creditors to bring direct fiduciary claims against . . . directors would create a conflict between those directors’ duty to maximize the value of the insolvent corporation for the benefit of all those having an interest in it, and the newly recognized direct fiduciary duty to individual creditors.”).
creditors of insolvent entities do have standing to bring direct claims for breach of fiduciary duties against directors and officers.  

Delaware courts have confirmed that there is no cause of action for “deepening insolvency” under Delaware law and that, even 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.” As long as the decision-making process is informed and conducted in good faith, the directors and officers are permitted to pursue strategies that they believe will maximize the value of the corporate entity and returns to shareholders. The Delaware Supreme Court in *Gheewalla* and other courts across the country have avoided attempting to define the parameters of the zone of insolvency. As a result, the directors and officers of a corporation operating in the zone of insolvency must balance the often conflicting interests of shareholders and creditors.

**D. Derivative Claims Against an LLC**

As referenced *infra*, the state of fiduciary duty law for a Delaware LLC is not entirely certain. However, recent jurisprudence has defined fiduciary duties with respect to insolvent

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102 See id. at 98 n.20 (“In light of its ultimate ruling, the Court of Chancery did not attempt to set forth a precise definition of what constitutes the ‘zone of insolvency.’ Our holding in this opinion also makes it unnecessary to precisely define a ‘zone of insolvency.’” (quoting *Credit Lyonnais Bank Nederland N.V.*, 1991 WL 277613, at *34); see also *Prod. Res. Group LLC v. NCT Group, Inc.*, 863 A.2d 772, 789 n.56 (stating that although many court opinions and articles address the zone of insolvency, a clear definition of the zone of insolvency still does not exist).
Delaware LLC’s. The Delaware Supreme Court’s opinion in *CML V, LLC v. Bax* is instructive to this analysis. In *CML*, the Court of Chancery found that a creditor of an insolvent LLC does not have standing to bring a derivative claim because of specific language in the LLC Act. As previously noted, under Delaware jurisprudence a creditor may still bring a derivative claim against an insolvent corporation.

In *CML*, citing to section 18-1104, the Delaware Supreme Court found that the “General Assembly expressly acknowledged in the text of the LLC Act that common law equity principles supplement the Act’s express provisions.” The Supreme Court went on to explain that “what this means is that where the General Assembly has not defined a right, remedy, or obligation with respect to an LLC, courts should apply the common law. It follows that if the General Assembly has defined a right, remedy, or obligation with respect to an LLC, courts cannot interpret the common law to override the express provisions the General Assembly adopted.” The court found that equity could not extend derivative actions to creditors of insolvent LLCs because the LLC Act expressly limited such claims to members and assignees of LLCs.

V. Other Jurisdictions View on Fiduciary Duties, Zone of Insolvency, and Deepening Insolvency

A. Corporate Fiduciary Liability In the Zone of Insolvency to Creditors of in Other States

As noted, the law is evolving and no uniform approach exists with respect to fiduciary duties in the zone of insolvency, the exact duties owed to creditors upon insolvency depends upon the jurisdiction. Nearly all courts, however, find directors breached their duties when directors engaged in self-dealing conduct. Such self-dealing typically is evidenced when directors: (1) withdraw corporate assets from an insolvent corporation to pay debts owed to creditors...
directors;\textsuperscript{104} (2) use corporate funds to pay off debts personally guaranteed by the director;\textsuperscript{105} (3) divert corporate assets to benefit insiders and to avoid paying creditors;\textsuperscript{106} (4) appropriate proceeds from the sale of corporate assets, or transferring assets to a related entity controlled by the same directors;\textsuperscript{107} and (5) engage in prohibited preferential treatment of creditors.\textsuperscript{108}

In times of financial distress, the day-to-day activities of directors will change markedly. At times, directors will be called upon to implement tough measures such as to liquidate or file for bankruptcy to conserve cash and cut costs in the short term. But insolvency does not require directors’ to necessarily liquidate or implement procedures to benefit creditors. Rather, directors of an insolvent corporation owe creditors the same fiduciary duties that are those owed to shareholders of a solvent corporation—loyalty, care and good faith.

\textsuperscript{104} See Berg & Berg Enters., LLC v. Boyle, 178 Cal. App. 4th 1020, 1041 (2009) (noting that diverting corporate assets that might otherwise be used to pay creditor claims are “acts that involve self-dealing or the preferential treatment of creditors”).

\textsuperscript{105} See Ass’n of Mill & Elevator Mut. Ins. Co. v. Barzen Int’l, Inc., 553 N.W.2d 446, 451 (Minn. Ct. App. 1996) (stating that “as fiduciaries to the corporation’s creditors, the officers and directors of an insolvent corporation cannot approve a transfer or encumbrance of corporate assets * * *, the effect of which is to enable the director or officer to recover a greater percentage of his debt than general creditors of the corporation with otherwise similarly secured interests” (citation omitted)); Fagan v. La Gloria Oil and Gas Co., 494 S.W.2d 624, 628 (Tex. Ct. App. 1973) (directors liable for manipulating corporate affairs and kept the business going for the sole purpose of paying claims that they had against the corporation and claims they had personally guaranteed.)

\textsuperscript{106} Helm Financial Corp. v. MNVA Railroad, Inc., 212 F.3d 1076 1081–82 (8th Cir. 2000); Martin v. Freeman, 272 P.3d 1182, 1189 (Colo. App. 2012); O’Connell v. Pharmaco, Inc., 143 Ill.App.3d 1061, 1071 (1986) (“It is also unlawful for corporate directors to manipulate corporate property so as to pay their own claims against the company to the loss of creditors. When an officer breaches his fiduciary duty by wrongfully converting or misappropriating funds and thereby adversely affecting the relation between the corporation and its creditors, a creditor can maintain an action against the officer personally.”).

\textsuperscript{107} See N.Y. Credit Men’s Adjustment Bureau, Inc. v. Weiss, 110 N.E.2d 397, 400 (1953) (where directors sold assets for half the sum owed to creditors without notice to creditors, directors are liable unless they can refute claims of waste or improper depletion of assets).

Simply, when insolvent the sphere of the stakeholders expands to include creditors, who are the residual beneficiaries of any increase in the value of an insolvent corporation.\(^{109}\) For example, Texas law requires directors to deal fairly with corporate creditors, which includes preserving the value of the corporate assets to pay corporate debts without preferring one creditor over another or preferring themselves to the injury of other creditors.\(^{110}\)

Most states do not require directors of insolvent corporations to liquidate the corporation’s assets or initiate bankruptcy proceedings on the corporation’s behalf.\(^{111}\) The district court in New York in *RSL Commc’ns PLC v. Bildirici*\(^ {112}\) held “there is no absolute duty under American law to shut down and liquidate an insolvent corporation,” and “insolvency does not suddenly turn directors into mere collection agents.”\(^ {113}\) Therefore, directors’ inaction and refusal to liquidate the corporate assets or its subsidiaries was not a breach of their fiduciary duties. Likewise, the Minnesota bankruptcy court in *In re Sec. Asset Capital Corp.* held “[T]he duty remained owing to . . . the corporation, with unsecured creditors protected as included

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\(^{109}\) *Id.; see also Production Res. Group v. NCT Group, Inc.*, 836 A.2d 772 (Del. Ch. 2008) (holding that insolvency does not alter or eliminate the directors’ duty to maximize a corporation’s value). *Cf. In re Burton*, 416 B.R. 539 (Bankr. N.D.W. Va. 2009) (“when a corporation becomes insolvent, or in a failing condition, the officers and directors no longer represent the stockholders, but by fact of insolvency, become trustees for the creditors.”) (quoting *Arnold v. Knapp*, 84 S.E. 895, 899 (1915)).


\(^{111}\) *See, e.g., Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 195 n. 75); *Berg*, 178 Cal. App. 4th at 1041.


\(^{113}\) *Id.* (quoting *Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 195 n. 75 (Del. Ch. 2011)).
beneficiaries of the duty due to insolvency.”114 So “no particular form of liquidation, or indeed any liquidation at all, was required as a matter of law[.]”115

Nevertheless, courts will not find directors breached their fiduciary duties to an insolvent corporation’s creditors without evidence of a self-dealing act.116 In Helm Financial Corp., the Eight Circuit rejected a creditor’s attempt to hold directors personally liable for selling the corporation’s most valuable asset (its subsidiary’s stock) to the shareholders of the parent corporation.117 The court held “[t]he fiduciary duty of an insolvent corporation’s directors and officers to preserve and protect the assets of the corporation does not extend beyond the prohibition against self-dealing or preferential treatment.”118 The court reasoned “[a]s fiduciaries, [directors] cannot by reason of their special position treat themselves to a preference over other creditors.”119

In Bank of America v. Musselman, the Virginia federal district court followed the ruling in Helm Financial Corp. and similarly held “directors and officers owe a limited fiduciary duty to creditors during insolvency; this duty extends only to refraining from self-dealing acts.”120 That is, directors of an insolvent corporation “cannot be held personally liable for corporate debts absent the presence of self-dealing facts.”121

115 Id.
117 Helm Financial Corp., 212 F.3d at 1080-81.
118 Id.
119 Id. at 1081 (quoting Snyder Electric Co. v. Fleming, 305 N.W.2d 863, 869 (Minn.1981)).
120 Musselman, 222 F. Supp. 2d at 801.
121 Id.
The California Appellate Court’s decision in *Berg & Berg Enterprises, LLC v. Boyle* addressed the trust fund doctrine and the diversion of assets by directors that might be otherwise used to pay creditor claims. In *Berg & Berg Enterprises*, the company was operating within the zone of insolvency, if not actually insolvent. The Plaintiff, the company’s largest creditor, proposed the company reorganize through a Chapter 11 bankruptcy proceeding to derive value from the company’s net operating losses ($50,000,000). The company instead decided to utilize an assignment for the benefit of creditors under California law. Plaintiff claimed the company’s directors failed to make a reasonable investigation into its proposed Chapter 11 bankruptcy plan. So, the directors’ decision to employ an assignment for the benefit of creditors represented a breach of their fiduciary duties. The trial court disagreed with Plaintiff’s argument and sustained a demurrer because Plaintiff failed to allege a viable breach of fiduciary duty claim. The court of appeal affirmed the trial court’s sustaining of the demurrer.

The court held that “the scope of any extra-contractual duty owed by corporate directors to the insolvent corporation’s creditors is limited in California, consistently 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-

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122 *Berg,* 178 Cal. App. 4th at 1025.

123 The trust fund doctrine has been used by some states to impose liability on directors. Although not been accepted in all states, a variety of states employ it to impose liability on directors. See, e.g., *New York Credit Men’s Adjustment Bureau Inc. v. Weiss,* 110 N.E.2d 397 (1953) (“If the assets—the trust fund for the creditors—were actually improvidently wasted or depleted as a result of defendants’ unilateral action the plaintiff is entitled to recover the amount of the loss thus sustained.”); *Berg,* 178 Cal. App. 4th at 1041 (finding no breach of duties because claims did not involve self-dealing or prohibited preferential treatment of creditors); *Technic Engineering Limited v. Basic Envirotech Inc.*, 53 F. Supp. 2d 1007 (N.D. Ill. 1999) (“the moment a corporation becomes insolvent . . . the assets of the corporation must then be regarded as a trust fund for the payment of all its creditors and the directors occupy the position of trustees and fiduciaries.”).

124 *Berg,* 178 Cal. App. 4th at 1024 (emphasis added).
dealing or the preferential treatment of creditors.” 125 The court found Plaintiff failed to state a cognizable fiduciary duty breach claim because the basis of its claims “do not involve self-dealing or prohibited preferential treatment of creditors and further do not constitute the actual diversion, dissipation, or undue risking of [the company]’s assets that were otherwise available to pay creditors’ claims.” 126 Plaintiff only claimed the directors failed to investigate Plaintiff’s plan purportedly to maximize the benefit to the company’s creditors. 127

A Colorado court found a director liable for sitting idly while a self-dealing transaction took place even though he received no direct benefit from the transaction in Rosebud Corp. v. Boggio. There, a creditor under a promissory note executed by a corporation sued the corporate maker and its two directors for outstanding note payments. 128 Although the corporation was insolvent, one of its directors sold substantially all of the corporation’s assets and then converted the sale proceeds for his benefit. 129 The court held that an insolvent corporation’s directors are considered trustees for its creditors. 130 Thus, a director breached his duty by divesting a corporation of its property for his own benefit. 131 In addition to holding the self-dealing director personally liable, the other director was also liable to the plaintiff creditor for the unpaid debt. 132 The court reasoned the other director breached her duty to the plaintiff by sitting idly and allowing his fellow director to convert corporate assets to the creditor’s detriment. 133 In short, the

125 Id. at 1033.
126 Id. at 1043.
127 Id.
129 Id. at 370.
130 Id. at 373.
131 Id.
132 Id.
133 Id.
court held a director can be personally liable for inaction even if he appears to have received no benefit from a another director’s self-interested activities.134

The implication of these decisions is that although directors’ duties still run to the company, the directors’ fiduciary duties shift to include creditors in recognition of the fact that creditors are now the beneficiaries of an insolvent corporation’s value. But liability to creditors arises from certain prohibited acts, which when coupled with the business judgment rule, basically are narrowed to only those involving self-dealing.

B. Jurisdictions Recognizing Creditor Suits Once Corporation Becomes Insolvent

Like Delaware, some jurisdictions extend the fiduciary duties of directors to creditors upon a corporation delving into insolvency. The New York district court in RSL Communications PLC v. Bildirici, held that “New York State’s corporate directors do not owe a duty of care to a corporation’s creditors when the corporation is arguably operating within the “zone of insolvency[].”135 The court recognized that the directors’ primary focus is the corporation and its shareholders so “adopting Plaintiff’s ‘zone of insolvency’ theory would provide redundant legal protections to creditors, while impeding corporations’ ability to recruit qualified directors, generate capital.”136

The Connecticut district court rejected a creditor’s fiduciary duty breach claim against the directors of corporation operating in the zone of insolvency while adopting the holdings in

134 Rosebud Corp., 561 P.2d at 373.
135 RSL Commc’ns PLC v. Bildirici, 649 F. Supp. 2d at 184, 203 (S.D.N.Y. 2009); see also, Hughes v. BCI Int’l Holdings, Inc., 452 F.Supp.2d 290, 308 (S.D.N.Y. 2006) (“Under New York law, corporate officers and directors owe a fiduciary duty to preserve corporate assets for the benefit of creditors once the company is actually insolvent.”) but not while the company is merely operating in the zone of insolvency; C3 Media & Marketing Grp. LLC. v. Firstgate Internet, Inc., 419 F. Supp. 2d 419, 431 (S.D.N.Y. 2005) (“the fact of insolvency causes a [fiduciary] duty to arise.”).
136 RSL Commc’ns, 649 F.Supp.2d at 206.
Gheewalla and Bildirici. The court reasoned that by ruling otherwise, “the Connecticut courts would ultimately expand fiduciary duties beyond the limits placed by Metcoff, Gheewalla, and Bildirici.” Courts in Illinois, New Hampshire, New Jersey, Tennessee, and Louisiana courts have similarly adopted Gheewalla’s holding and reasoning that directors owe fiduciary duties to the corporation’s creditors only once the corporation becomes insolvent.

Other jurisdictions require more than a corporation’s insolvency to grant creditors standing to bring breach of fiduciary duty claims against directors. California, like Delaware, does not recognize the “zone of insolvency.” That is, California court only find directors owe fiduciary duties to a corporation’s creditors when the corporation is insolvent. California, however, applies the “trust fund” doctrine, which provides an alternative standard to grant a creditor to derivative standing or, in other words, to sue on behalf of the corporation. The

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137 Master-Halso, Inc. v. Scillia, Dowling & Natarelli, LLC, 739 F.Supp.2d 100, 103 (D. Conn. 2010).
138 Metcoff v. Lebovics, 977 A.2d 285 (Conn. Super. Ct. 2007) (Connecticut superior court case rejecting direct creditor claims for breach of fiduciary duties while the company was in the zone of insolvency).
139 Master-Halso, Inc., 739 F.Supp.2d at 103.
140 GoHealth, LLC v. Simpson, 2013 WL 6183024 (N.D. Ill. 2013); Christians v. Grant Thornton, LLP, 733 N.W.2d 803, 809 (Minn. Ct. App. 2007) (stating that Minnesota law is not in conflict with Gheewalla’s holding and citing Delaware law as “more clearly developed” on the issue); Sanford v. Waugh & Co., Inc., 328 S.W.3d 836, 846 (Tenn. 2010) (“We agree with and adopt the Delaware Supreme Court’s reasoning and holding in Gheewalla.”); Newsome v. Gallacher, 722 F.3d 1257, 1267 (10th Cir. 2013); Judson Atkinson Candies, Inc. v. Latini-Hohberger Dhimantec, 529 F.3d 371 (7th Cir. 2008); In re Felt Mfg. Co., Inc., 371 B.R. 589, 611 (Bankr. D.N.H. 2007) (“Once a corporation is insolvent, its directors owe a fiduciary duty to the corporation's creditors and creditors have standing to maintain derivative claims for breaches of fiduciary duty.”); Francis v. United Jersey Bank, 432 A.2d 814, 824 (N.J. 1981) (New Jersey Supreme Court holding “While directors may owe a fiduciary duty to creditors also, that obligation generally has not been recognized in the absence of insolvency.”); In re Casini, 307 B.R. 800, 820 (Bankr. D.N.J. 2004).
141 Berg & Berg Enters., LLC v. Boyle, 178 Cal. App. 4th 1020, 1041 (2009) (“because the existence of a zone or vicinity of insolvency is even less objectively determinable than actual insolvency, we hold 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.”).
142 Id. (“there is no broad, paramount fiduciary duty of due care of loyalty that directors of an insolvent corporation owe the corporation’s creditors solely because of a state of insolvency.”).
California Court of Appeal in *Berg & Berg Enterprises, LLC v. Boyle* held that creditors can only sue derivatively if a corporation is both insolvent and its insiders are taking “actions that divert, dissipate, or unduly risk corporate assets.” In marked contrast to Delaware law, California bars an insolvent corporation’s creditors from suing directors for breach of fiduciary duties absent evidence of a director’s self-dealing or preferential treatment of creditors. Delaware law provides “the fact of insolvency places the creditors in the shoes normally occupied by the shareholders.”

Texas joins California and other jurisdictions, which require more than insolvency to permit creditor suits for breach of fiduciary duties. In *Aurelius Capital Master, Ltd. v. Acosta*, the court in Northern District Court of Texas analyzed when creditors can sue a corporation’s directors for breach of fiduciary duties. Without clear direction from the Texas Supreme Court, the court reviewed a 1973 Texas appellate court decision to conclude that creditors have never had standing to sue for a breach of fiduciary duty outside of the narrow exception under the trust fund doctrine. The *Aurelius* court brushed aside contrary decisions from federal bankruptcy courts sitting in Texas, noting those decisions either came where corporate debtor was already in dissolution or based on a mistaken assumption that Texas corporate law followed

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143 Id. (emphasis added).
144 Id.
147 *Fagan v. La Gloria Oil & Gas Co.*, 494 S.W.2d 624, 628 (Tex. Civ. App. 1973) (“There is a well recognized exception to that basic rule that [creditors may not sue for breach of fiduciary duties] . . . frequently called the trust fund doctrine.”).
148 See, e.g., *Mims v. Fail (In re Vartec Telecom, Inc.)*, 2007 Bankr. LEXIS 3240, *6 (Bankr. N.D. Tex. Sept. 18, 2007) (“a cause of action based on a company’s directors’ and officers’ fiduciary duty to creditors when the company is in the ‘vicinity’ or ‘zone’ of insolvency is recognized.”).
the law of Delaware.149 Ultimately, the court concluded that “creditors can only bring [derivative] suits when the corporation is insolvent and no longer operating.”150

While Missouri and North Carolina do not adhere to the trust fund doctrine, like California and Texas, they require more than insolvency for creditor suits.151 In Drummond Co. v. St. Louis, the Missouri Court of Appeal held a corporation must be “clearly going out of business or incapable of doing business, and that it is conclusively established that it is insolvent.”152 North Carolina’s approach differs slightly, it does not recognize the zone of insolvency, but a fiduciary duty to creditors is created when there is “a winding up or dissolution of the corporation.”153 Where the directors “run an insolvent corporation only to recover amounts owed to them, to the detriment of the corporation’s other creditors, courts will equate that to a winding up or dissolution and find that directors and officers owed a fiduciary duty to the creditors.”154

C. Jurisdictions Recognizing Creditor Suits When Corporation is in the Zone of Insolvency

Not all jurisdictions follow Delaware concerning creditor suits against directors. In Florida, Arizona, and Vermont, directors owe fiduciary duties to creditors when a corporation is perceived to be in the zone of insolvency. Federal courts in Florida hold that “fiduciary duties of

150 Id.; see also Conway v. Bonner, 100 F.2d 786, 787 (5th Cir. 1939); Floyd v. Hefner, 2006 WL 2844245, at *10 (S.D. Tex. Sept. 29, 2005).
151 Drummond Co. v. St. Louis Coke & Foundry Supply Co., 181 S.W.3d 99, 104 (Mo. Ct. App. 2005) (“Missouri has rejected the concept that corporate directs are fiduciaries for creditors, even in the event of insolvency…absent statutory authority or an intentional or fraudulent act.”).
152 Id.
153 In re Maxx Race Cards, Inc., 266 B.R. 74, 78 (Bankr. W.D.N.C. 1998); In re Bostic Const., Inc., 435 B.R. 46, 62 (Bankr. M.D.N.C. June 25, 2010) (“Although the general rule is that directors of North Carolina corporations do not owe a fiduciary duty to the creditors of the corporation, an exception exists when there are circumstances amounting to a winding up or dissolution of the corporation.”).
154 In re Maxx Race Cards, 266 B.R. at 78.
officers and directors are extended to the creditors of a corporation when the corporation becomes insolvent or is in the ‘vicinity of insolvency.’”\textsuperscript{155} In a recent Court of Appeals of Arizona decision, the court held that the duties of directors or officers of a corporation are implied by law.\textsuperscript{156} And “these fiduciary obligations can apply even to creditors when a corporation enters the zone of insolvency, without regard to the terms of the underlying contract.”\textsuperscript{157} In \textit{Gladstone v. Stuart Cinemas Inc.}, the Supreme Court of Vermont held “corporate directors do owe a fiduciary duty to creditors, particularly when the corporation becomes insolvent.”\textsuperscript{158} Further, that court held this duty could even apply to corporations that are not technically insolvent; when a “corporation operates in the vicinity or the zone of insolvency” a duty to creditors exists.\textsuperscript{159}

The decisions in the cases involving director liability when the company operates in the zone of insolvency provides little guidance and leaves critical issues unresolved. There is no precise definition for when a solvent corporation enters the zone of insolvency. So out of fear their corporation is operating within the zone of insolvency, directors consider creditors’ interest when examining proposed transactions. As such, directors are placed in a dangerous position of defending their actions against potential claims by creditors for breach of fiduciary duty claims in jurisdictions that recognize the zone of insolvency.

Such decisions serve as a reminder that many jurisdictions lack a relatively clear rule on creditor suits for breach of directors’ fiduciary duties unlike Delaware. Certain states permit suits


\textsuperscript{157} \textit{Id.} (citing \textit{Dawson v. Withercombe}, 163 P.3d 1034, 1057 (Ariz. Ct. App. 2007)).


\textsuperscript{159} \textit{Id.}
when a corporation operates in the zone of insolvency. While others have eroded a creditor’s ability to sue corporate directors until the corporation is insolvent. And where a state has adopted the trust fund doctrine (e.g., Texas and California) relying on Delaware law may be insufficient since those states likely impose additional requirements for creditors to pursue a breach of fiduciary duty claim.

**D. Other Jurisdictions’ View on Deepening Insolvency**

Some courts permit claims against directors under the theory of “deepening insolvency.” Deepening insolvency has been defined as “an injury to the Debtors’ corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life.” As stated above, Delaware does not recognize the tort of deepening insolvency. Below is a summary of how leading cases have decided this issue.

Generally, courts that permit a cause of action for deepening insolvency require plaintiffs to establish: (1) fraud; (2) which causes the expansion of corporate debt, and (3) which prolongs the life of the corporation. The Third Circuit Court of Appeals in *Lafferty* held that creditors’ committee had standing to pursue claims for deepening insolvency against the debtor’s lawyers, accountants and underwriters for conspiring with the debtor to fraudulently issue debtor securities as part of a Ponzi scheme. However, in *In re CitX Corp.*, the court limited the

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161 *Trenwick America Litigation Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168 (Del. Ch. 2006).


163 *Lafferty*, 267 F.3d at 352 (“In sum, we believe that the soundness of the theory, its growing acceptance among courts, and the remedial theme in Pennsylvania law would persuade the Pennsylvania Supreme Court to recognize “deepening insolvency” as giving rise to a cognizable injury in the proper circumstances.”).
applicability of deepening insolvency to situations where the defendants engaged in fraud.\textsuperscript{164} The court in \textit{CitX} stated its disagreement with courts recognizing a deepening insolvency claim based solely on negligence, and held that only evidence of fraudulent conduct could support such a claim.\textsuperscript{165} The court noted it had previously treated deepening insolvency as a claim based upon the “fraudulent expansion of corporate debt and prolongation of corporate life,” so fraud is an essential element of any deepening insolvency claim.\textsuperscript{166} The court also refused to recognize deepening insolvency as a theory of damages for negligence.\textsuperscript{167}

In \textit{In re Global Serv. Group}, a Chapter 7 bankruptcy trustee for a limited liability company commenced an adversary proceeding against the debtor’s insiders and senior secured lenders alleging they caused the debtor to operate while insolvent and to incur debt it could not repay.\textsuperscript{168} The trustee argued the “expansion of debt was the proximate cause of the damage to [the debtor] and its creditors.”\textsuperscript{169} The court concluded that treating deepening insolvency as a theory of damages or as an independent cause of action may be unnecessary:

\textsuperscript{164} \textit{Seitz v. Detweiler, Hershey & Assocs., P.C. (In re CitX Corp.)}, 448 F.3d 672, 681 (3d Cir. 2006) (“\textit{W}e note that \textit{Lafferty} holds only that fraudulent conduct will suffice to support a deepening-insolvency claim under Pennsylvania law. \ldots \text{To that end, we hold that a claim of negligence cannot sustain a deepening-insolvency cause of action.’}).

\textsuperscript{165} \textit{Id.} at 680-81.

\textsuperscript{166} \textit{Id.} at 681 (quoting \textit{Lafferty}, 267 F.3d at 347). \textit{See also Dixon v. Am. Cmty. Bank & Trust (In re Gluth Bros. Constr., Inc.),} 424 B.R. 379, 390 (Bankr. N.D. Ill. 2009) (if Illinois were to recognize the theory of deepening insolvency, it would only do so in the context of a claim of fraud”).

\textsuperscript{167} \textit{Id.} (“\textit{Seitz’s} malpractice claim fails because he cannot establish harm or causation. He could not establish harm because deepening insolvency is not a valid theory of damages for negligence.”).


\textsuperscript{169} \textit{Id.} at 456.
Prolonging an insolvent corporation’s life, without more, will not result in liability under either approach. Instead, one seeking to recover for “deepening insolvency” must show that the defendant prolonged the company’s life in breach of a separate duty, or committed an actionable tort that contributed to the continued operation of a corporation and its increased debt.\textsuperscript{170}

*Global Service* is an important case in the development of the theory of deepening insolvency. It clarifies that the mere continuation of an insolvent company is not in and of itself problematic.\textsuperscript{171} Rather, the prolongation must be accompanied by fraudulent or wrongful conduct that results in harm to the corporation or its creditors.\textsuperscript{172} In *Global Service*, because the trustee alleged no wrongdoing, defendants were not liable for deepening insolvency.\textsuperscript{173}

However, some courts have found that negligence is sufficient and that defendant need not have engaged in actual fraudulent behavior. The decision in *Smith v. Arthur Andersen LLP* recognized deepening insolvency as a cause of action when the allegations included that the defendants misrepresented the firm’s financial condition to its outside directors and investors.\textsuperscript{174} The court agreed with the Third Circuit in *Lafferty* that “prolonging an insolvent corporation’s life through bad debt may” dissipate corporate assets and harm the value of corporate

\textsuperscript{170} *Id.* at 459.

\textsuperscript{171} *Id.* at 461 (“the First Cause of Action wrongly assumes that prolonging the life of an insolvent corporation that continues to incur debt, without more, states a claim for relief.”).

\textsuperscript{172} *Id.* at 465 (“If the Complaint included this allegation [that Goldman continued to operate Debtor to siphon Debtor’s funds for own benefit], these claims might be legally sufficient. The prolongation of Global’s operations would smack of self-dealing, constitute a breach of fiduciary duty, and open up recovery under the theory of ‘deepening insolvency.’ But the Complaint does not include this allegation.”).

\textsuperscript{173} *Id.*

\textsuperscript{174} *Smith v. Arthur Andersen LLP*, 421 F.3d 989, 1004 (9th Cir. 2005).
property.\textsuperscript{175} But the holding in \textit{Smith} suggests that deepening insolvency does not require intentional conduct, rather that misrepresentation may be sufficient for such a claim.

Other jurisdictions have rejected deepening insolvency as an independent cause of action. The Fifth Circuit Court of Appeals in \textit{Wooley v. Faulkner (In re SI Restructuring, Inc.)} rejected the theory of deepening insolvency both as an independent cause of action and as a theory of damages.\textsuperscript{176} The Seventh Circuit Court of Appeals in \textit{Fehriback v. Ernst \& Young LLP} similarly rejected a deepening insolvency claim against debtor’s auditors because it was not based on an existing legal duty.\textsuperscript{177} The Bankruptcy Court sitting in the District of Columbia held there is no separate cause of action for the tort of deepening insolvency based on directors allowing the corporation to fall deeper into debt for the benefit of its lender, directors, and officers, which was couched as a breach of the fiduciary duties owed to the corporation.\textsuperscript{178}

\textsuperscript{175} Id. (quoting \textit{Lafferty}, 267 F.3d at 350); see also \textit{Lafferty}, 267 F.3d at 348 (stating that “deepening insolvency” refers to “an injury to the Debtors' corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life”).

\textsuperscript{176} \textit{In re SI Restructuring, Inc.}, 532 F.3d 355, 363 (5th Cir. 2008); see also \textit{Torch Liquidating Trust v. Stockstill}, 561 F.3d 377 (5th Cir. 2009) (applying Delaware law, held that Delaware does not recognize cause of action on behalf of corporation for deepening insolvency).

\textsuperscript{177} \textit{Fehribach v. Ernst \& Young LLP}, 493 F.3d 905 (7th Cir. 2007).