Litigating Fiduciary Duty Claims

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Chapter 12

Litigating Breach of Fiduciary Duties in the Zone of Insolvency

By Aaron Krauss

Dave Director wakes up in the middle of the night in a cold sweat. Although he wishes it were just a dream, he knows it isn't. The Acme Widget Company, on whose board he sits, has entered the dreaded Zone of Insolvency. Perhaps not as bad as entering the Twilight Zone,[1] but with almost as many plot twists. And with all of the horror, at least for those on the Acme Widget Company's board. Because, thanks to Chancellor Allen,[2] now that the Acme Widget Company has entered into the zone of insolvency, everyone can sue Dave.

I. What Is All the Fuss About?

Do you remember all that stuff you read in Chapters 2 through 4 about how a board of directors owes its fiduciary duty to the stockholders? In *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, Chancellor Allen said

> At least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the

1. Apologies to Rod Sterling and everyone at CBS who worked on the *Twilight Zone*.
2. *See* Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., 1991 WL 277613 at *34 and n.55 (Del. Ch. Dec. 30, 1991).

> residue risk bearers [i.e. the stockholders], but owes its duty to the corporate enterprise.[3]

Many judges (and lawyers) interpreted Chancellor Allen's statement as meaning that, if a company[4] is operating "in the zone of insolvency," the company's board owes a duty to the company's creditors, in addition to its stockholders.[5] Owing a duty to creditors seemingly puts the company's directors in a "catch-22"[6] because

> especially when a corporation is in financial distress, the interests of the shareholders and the corporation itself may inherently collide with those of the creditors, making any respective duties owed by directors to each constituency potentially in conflict and making the scope of each respective duty elusive and difficult to ascertain.[7]

As Chancellor Allen put it

> The possibility of insolvency can do curious things to incentives, exposing creditors to risks of opportunistic behavior and creating complexities for directors. Consider, for example, a solvent corporation having a single asset, a judgment for $51 million against

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3. *See* Credit Lyonnais, 1991 WL 277613, at *34. *See also* Berg & Berg Enterprises, LLC v. Boyle, 178 Cal. App. 4th 1020, 1038 (2010) (labeling Credit Lyonnais as the "genesis" of "the modern common law notion that the individual directors of a financially distressed corporation operating in the zone of insolvency or even upon insolvency owe a duty of care to its creditors").

4. Generally speaking, the duties owed by a corporation's officers and directors and a limited partner's general partner and managers are the same. Limited partnerships can, however, eliminate fiduciary duties by using the right language in their partnership agreements. *See, e.g.*, Bandera Master Fund LP v. Boardwalk Pipeline Partners, LP, 2019 WL 4927053, at *7 (Del. Ch. Oct. 7, 2019). If a limited partnership choses to eliminate fiduciary duties, the limited partners are protected by whatever contractual obligations the limited partnership agreement imposes on the general partner(s) and the manager(s). *See, e.g.*, *Bandera Master Fund*, 2019 WL 4927053, at *8. Although the (deleted) fiduciary duties and the (imposed) contractual duties may be substantively similar (or even identical), a creditor is not a party to the limited partnership agreement and will therefore be unable to assert contractual claims. The creditor will, however, be able to assert claims for the breach of whatever contract created the credit relationship. *See, e.g.*, *Bandera Master Fund*, 2019 WL 4927053, at *21–22); Berg & Berg Enterprises, LLC v. Boyle, 178 Cal. App. 4th 1020, 1038 (2010).

5. Other courts got to a similar place by employing the "trust fund doctrine," which holds that when a company is in the "zone of insolvency," the directors must treat the company's assets as a "trust fund" to pay creditors, and must avoid diverting, dissipating, or unduly risking those assets. *See, e.g.*, *Berg & Berg*, 178 Cal. App. 4th, at 1032.

6. Apologies to Joseph Heller.

7. *See, e.g.*, *Berg & Berg*, 178 Cal. App. 4th, at 1037–38.

a solvent debtor. The judgment is on appeal and thus subject to modification or reversal. Assume that the only liabilities of the company are to bondholders in the amount of $12 million. Assume that the array of probable outcomes of the appeal is as follows

	Expected Value of Judgment on Appeal	Expected Value
25% chance of affirmance	$51mm	$12.75
70% chance of modification	$4mm	$2.8
5% chance of reversal	$0	$0

Thus, the best evaluation is that the current value of the equity is $3.55 million ($15.55 million expected value of judgment on appeal – $12 million liability to bondholders). Now assume an offer to settle at $12.5 million (also consider one at $17.5 million). By what standard do the directors of the company evaluate the fairness of these offers? The creditors of this solvent company would be in favor of accepting either a $12.5 million offer or a $17.5 million offer. In either event they will avoid the 75% risk of insolvency and default. The stockholders, however, will plainly be opposed to acceptance of a $12.5 million settlement (under which they get practically nothing). More importantly, they very well may be opposed to acceptance of the $17.5 million offer under which the residual value of the corporation would increase from $3.5 to $5.5 million. This is so because the litigation alternative, with its 25% probability of a $39 million outcome to them ($51 million – $12 million = $39 million) has an expected value to the residual risk bearer of $9.75 million ($39 million × 25% chance of affirmance), substantially greater than the $5.5 million available to them in the settlement. While in fact the stockholders' preference would reflect their appetite for risk, it is possible (and with diversified shareholders likely) that shareholders would prefer rejection of both settlement offers.

But if we consider the community of interests that the corporation represents it seems apparent that one should in this hypothetical accept the best settlement offer available providing it is greater than $15.55 million, and one below that amount should be rejected. But that result will not be reached by a director who thinks he owes duties directly to shareholders only. It will be reached by directors who are capable of conceiving of the corporation as a legal and economic entity. 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 corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act.[8]

So, does Dave Director have a way out of this catch-22? Actually, he might, because some judges, especially the Delaware Supreme Court in *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*,[9] have reinterpreted (some might even say "walked back" or overruled) Chancellor Allen's holding.

Gheewalla involved a dispute over licenses to the wireless spectrum. The plaintiffs sued the directors of Clearwire (a company that had promised to pay them to acquire their licenses), claiming that Clearwire's directors had impermissibly favored Clearwire's stockholders over Clearwire's creditors such as the plaintiffs.[10] The plaintiff in *Gheewalla* was not a stockholder of Clearwire.[11] Instead, it was a putative creditor.[12] Additionally, the plaintiff alleged "direct, not derivative, fiduciary duty claims against the Defendants, who served as directors of Clearwire while it was either insolvent or in the 'zone of insolvency.'"[13] Specifically, the plaintiffs alleged that when Clearwire entered the zone of insolvency, its directors should have liquidated Clearwire's assets to benefit Clearwire's creditors, and that its directors breached their fiduciary duty to Clearwire's creditors by allowing Clearwire to remain in business (which caused Clearwire to "burn through" assets that would otherwise have been available to pay creditors).[14] After considering Chancellor Allen's comments, the Delaware Supreme Court "h[e]ld that the creditors of a Delaware corporation that is either insolvent or in the zone of insolvency have no right, as a matter of law, to assert direct

8. *See Credit Lyonnais*, 1991 WL 277613, at *34 n.55.

9. N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92 (Del. 2007).

10. *See id*. at 93–94. The plaintiffs claimed that, when prices of the wireless spectrum dropped following the WorldCom bankruptcy (which "dumped" huge "amounts" of the wireless spectrum on the market), Clearwire's directors—who all worked for Goldman Sachs, which was Clearwire's sole "backer"—worked with Goldman Sachs to dry up liquidity for Clearwire so that Clearwire could not (and would not have to) pay plaintiffs for their portion of the spectrum as it has promised. *Id*. at 94–96.

11. *Id*. at 93.

12. *Id*. at 93–94.

13. *Id*. at 94.

14. *Id*. at 95.

claims for breach of fiduciary duty against the corporation's directors."[15] The Delaware Supreme Court reached this conclusion[16] because

> It is well established that the directors owe their fiduciary obligations to the corporation and its shareholders. While shareholders rely on directors acting as fiduciaries to protect their interests, creditors are afforded protection through contractual agreements, fraud and fraudulent conveyance law, implied covenants of good faith and fair dealing, bankruptcy law, general commercial law and other sources of creditor rights. Delaware courts have traditionally been reluctant to expand existing fiduciary duties. Accordingly, "the general rule is that directors do not owe creditors duties beyond the relevant contractual terms."[17]

15. *Id.* at 94. *See also In Re* Tribune Co. Fraudulent Conveyance Litig., 2018 WL 6329139, at *7 (S.D.N.Y. Nov. 20, 2018).

16. "Trust fund" courts have reached similar conclusions using different reasoning. *See, e.g.*, *Berg & Berg*, 178 Cal. App. 4th, at 1041 ("While no California cases 'expressly limit the fiduciary duty under the trust fund doctrine to the prohibition of self-dealing or the preferential treatment of creditors, the scope of the trust fund doctrine in California is reasonably limited to cases where directors or officers have diverted, dissipated, or unduly risked the insolvent corporation's assets.' In other words, the doctrine is not applied to create a duty owed by directors to creditors solely due to a state of corporate insolvency. Application of the doctrine requires, in addition, that directors have engaged in conduct that diverted, dissipated, or unduly risked corporate assets that might otherwise have been used to satisfy creditors' claims. Accordingly, based on this established doctrine, we conclude that under the current state of California law, there is no broad, paramount fiduciary duty of due care or loyalty that directors of an insolvent corporation owe the corporation's creditors solely because of a state of insolvency, whether derived from Credit Lyonnais or otherwise. And we decline to create any such duty, which would conflict with and dilute the statutory and common law duties that directors already owe to shareholders and the corporation. We also perceive practical problems with creating such a duty, among them a director's ability to objectively and concretely determine when a state of insolvency actually exists such that his or her duties to creditors have been triggered. We accordingly hold that the scope of any extra-contractual duty owed by corporate directors to the insolvent corporation's creditors is limited in California, 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-dealing or the preferential treatment of creditors. Further, because all the California cases applying the trust-fund doctrine appear to have dealt with actually insolvent entities, and 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.") (citations and footnotes omitted). *See also In re* AWTR Liquidation, Inc., 548 B.R. 300, 324–25 (Bankr. C.D. Cal. 2016).

17. *Gheewalla*, 930 A.2d at 99 (citations omitted).

In fact, the Delaware Supreme Court went further, and noted that "an otherwise solvent corporation operating in the zone of insolvency is one in most need of effective and proactive leadership—as well as the ability to negotiate in good faith with its creditors—goals which would likely be significantly undermined by the prospect of individual liability arising from the pursuit of direct claims by creditors."[18]

> In this case, the need for providing directors with definitive guidance compels us to hold that no direct claim for breach of fiduciary duties may be asserted by the creditors of a solvent corporation that is operating in the zone of insolvency. 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.[19]

As much as Dave Director will no doubt be pleased with this "definitive guidance" from the Delaware Supreme Court, that guidance did not come without a price. Indeed, the Delaware Supreme Court gave that guidance because it knew that directors of a corporation operating in the zone of insolvency faced the herculean task of trying to save the company.[20] The Delaware Supreme Court explicitly acknowledged that creating a new fiduciary duty owed to creditors would make that task next to impossible—even for Hercules.

> Recognizing that directors of an insolvent corporation owe direct fiduciary duties to creditors, would create uncertainty for directors who have a fiduciary duty to exercise their business judgment in the best interest of the insolvent corporation. To recognize a new right for creditors to bring direct fiduciary claims against those 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,

18. *Id.* at 100–01 (citations omitted).

19. *Id.* at 103 (citations omitted). *See also* Bandera Master Fund, 2019 WL 4927053, at *15 n.9.

20. As a bankruptcy court put it: "As a practical matter, the alternative to such essentially unchanging duties would be for directors' and officers' duties to change substantially once the corporation crossed some invisible line that is later determined to constitute insolvency. Such a rule would be unfair to directors and officers, and it would harm all constituent groups by creating conflicting incentives and unclear directions for risk management." *See AWTR*, 548 B.R. at 306.

> and the newly recognized direct fiduciary duty to individual creditors. Directors of insolvent corporations must retain the freedom to engage in vigorous, good faith negotiations with individual creditors for the benefit of the corporation.[21]

So what is the status of the law following this "spat" between the Delaware Court of Chancery and the Delaware Supreme Court?[22] As one judge summarized,

> Before *Gheewalla* and its forerunners, the following principles were frequently asserted as true:
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> - The fiduciary duties owed by directors extended to creditors when the corporation entered the vicinity of insolvency.
> - Creditors could enforce the fiduciary duties that directors owed them through a direct action for breach of fiduciary duty.
> - Under the trust fund doctrine, the directors' fiduciary duties to creditors included an obligation to manage the corporation conservatively as a trust fund for the creditors' benefit.
> - Because directors owed fiduciary duties both to creditors and stockholders, directors faced an inherent conflict of interest and would bear the burden of demonstrating that their decisions were entirely fair.
> - Directors could be held liable for continuing to operate an insolvent entity and incurring greater losses for creditors under a theory known as "deepening insolvency."
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> * * *
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> After *Gheewalla* and the decisions by Chief Justice Strine, at least as I read them, none of these assertions remain true. In their place is a different regime in which the following principles are true:
>
> - There is no legally recognized "zone of insolvency" with implications for fiduciary duty claims. The only transition point that affects fiduciary duty analysis is insolvency itself.
> - Regardless of whether a corporation is solvent or insolvent, creditors cannot bring direct claims for breach of fiduciary duty. After a corporation becomes insolvent, creditors gain

21. *Gheewalla*, 930 A.2d at 101 (citations omitted).

22. It should be noted that, even post-*Gheewalla*, some courts continue to hold that "when a corporation is insolvent, corporate directors and officers owe a fiduciary duty to the creditors of the corporation." *See, e.g.*, Eddystone Rail Co. v. Bridger Logistics, LLC, 2020 WL 1233557, at *3 (E.D. Pa. Mar. 12, 2020).

standing to assert claims derivatively for breach of fiduciary duty.

- The directors of an insolvent firm do not owe any particular duties to creditors. They continue to owe fiduciary duties to the corporation for the benefit of all of its residual claimants, a category which now includes creditors. They do not have a duty to shut down the insolvent firm and marshal its assets for distribution to creditors, although they may make a business judgment that this is indeed the best route to maximize the firm's value.
- Directors can, as a matter of business judgment, favor certain non-insider creditors over others of similar priority without breaching their fiduciary duties.
- Delaware does not recognize the theory of "deepening insolvency." Directors cannot be held liable for continuing to operate an insolvent entity in the good faith belief that they may achieve profitability, even if their decisions ultimately lead to greater losses for creditors.
- When directors of an insolvent corporation make decisions that increase or decrease the value of the firm as a whole and affect providers of capital differently only due to their relative priority in the capital stack, directors do not face a conflict of interest simply because they own common stock or owe duties to large common stockholders. Just as in a solvent corporation, common stock ownership standing alone does not give rise to a conflict of interest. The business judgment rule protects decisions that affect participants in the capital structure in accordance with the priority of their claims.[23]

Needless to say, Dave Director will almost assuredly spend may (billable) hours with Lisa Lawyer trying to understand this guidance. His questions are likely to fall into the following categories: What is the zone of insolvency (and how do I know when I get there)? Does the director of an insolvent company owe any duties directly to the company's creditors? If a director doesn't owe a direct fiduciary duty to an insolvent company's creditors (as *Gheewalla* and *Quadrant Structured Products* suggest) what—if any—duties does a director owe to the creditors of an insolvent company? And what defenses are available when creditors start filing lawsuits?

23. *See, e.g.*, Quadrant Structured Products Co. v. Vertin, 115 A.3d 535, 544–49 (Del. Ch. 2015) (citations omitted).

II. What Is the Zone of Insolvency?

Actually, no one knows.[24] It turns out that the zone of insolvency is like the penumbra of a constitutional right.[25] You "know it when you see it."[26] Fortunately, this indefiniteness has led some—but not all—judges to hold that there is no legal significance to a company's entering the zone of insolvency.[27] Instead, according to these judges, all that matters is whether the company is, or is not, insolvent. Because most judges agree with Dave Director (and directors everywhere) that a "bright line rule" is necessary.[28]

So what does it mean to be insolvent? Generally, there are two tests for insolvency: the balance sheet test and the ability to pay debts test.[29] The balance sheet test focuses on whether the company's total assets exceed its total liabilities. The ability to pay debts test focuses on whether the company has sufficient cash to pay its creditors as its debts come due, regardless of whether its total assets (which may be illiquid or difficult to value) exceed its total liabilities.[30]

It should be noted that the solvency test is applied at the time suit is filed.[31] There is no need for a company to be "irretrievably insolvent."[32] On the contrary, judges have recognized that it is possible for a company to go "back and forth" over the "line of insolvency" many times during the course of a lawsuit.[33] It would be counterproductive (some would say unworkable, or at best an invitation to gamesmanship) for a

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24. "There is no generally accepted meaning for the term 'zone of insolvency.'" *See In re* Jimenez, 608 B.R. 322, 328 n.1 (Bankr. M.D. Ga. 2019). *See also Gheewalla*, 930 A.2d 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.'") (citations omitted).

25. *See, e.g.*, Griswold v. Connecticut, 381 U.S. 479, 482 (1965) (Douglas, J.).

26. *See, e.g.*, Jacobellis v. Ohio, 378 U.S. 184, 197 (1964) (Stewart, J.).

27. *See, e.g.*, *Quadrant*, 115 A.3d at 546; *Berg & Berg*, 178 Cal. App. 4th at 1041.

28. *See, e.g.*, *Quadrant*, 115 A.3d at 553.

29. *See, e.g.*, *Gheewalla*, 930 A.2d at 98; *Quadrant*, 115 A.3d at 561. Some courts have rejected an "unreasonably small capital" test as being inconsistent with the Delaware Supreme Court's rejection of the "zone of insolvency" theory, reasoning that "unreasonably small capital" is subjective and appears to be another way of stating that the company is operating in the "zone of insolvency." *See, e.g.*, *In re* Tribune Company Fraudulent Conveyance Litigation, 2018 WL 6329139, at *8 (S.D.N.Y. Nov. 20, 2018).

30. This is the classic "cash flow problem" that sinks many companies with illiquid or unsaleable assets. It is also the most common reason for a Chapter 11 restructuring, and proof that "cash is king."

31. *See, e.g.*, *Quadrant*, 115 A.3d at 548.

32. *Id.*

33. *Id.* at 553.

plaintiff to gain and lose standing many times during the course of a lawsuit.[34] This is especially true because whether a company is insolvent is often subject to dispute, and is usually determined in hindsight.[35]

III. Does the Director of an Insolvent Company Owe a Duty Directly to the Company's Creditors?

Although Dave Director can take some comfort from the fact that courts usually find that nothing changes when a company enters the zone of insolvency,[36] actual insolvency is another story. This is because courts have held that "the creditors of an insolvent corporation have standing to maintain derivative claims against directors on behalf of the corporation for breaches of fiduciary duties."[37]

> Specifically, the most relevant duty of directors and officers remains the same regardless of insolvency: the duty to exercise their business judgment in an informed, good faith effort to preserve and grow the corporation's value. That duty must be exercised for the benefit of the whole corporate enterprise, encompassing all of its constituent groups, without undue preference to any. What principally changes upon insolvency is who can sue. For acts or omissions occurring outside of insolvency, the creditors cannot sue because they have no cognizable harm. But when the corporation is insolvent or is rendered insolvent by any standard measure—balance sheet, cash flow, or inadequate capitalization—then creditors join stockholders in being able to sue derivatively for breaches of fiduciary duties

34. *Id.* at 553.

35. *Id.* at 552.

36. Dave Director is likely to pepper Lisa Lawyer with questions about whether the particular judge picked to hear the case against him is likely to be one of the minority who still thinks that duties change when a company enters the zone of insolvency. Unless the judge has already written an opinion on the issue (which is a long shot if the case is not pending in Delaware), Lisa Lawyer is likely to be left attempting to reassure Dave with platitudes about what usually happens. She is also likely to remind Dave of the advantages of both incorporating in Delaware and inserting Delaware choice of forum clauses into articles of incorporation, bylaws, and contracts.

37. *See Gheewalla*, 930 A.2d at 101.

> to the corporation that divert, dissipate, or unduly risk corporate assets.[38]

Why should creditors of an insolvent company be allowed to bring derivative claims in addition to the insolvent company's stockholders? Because

> The corporation's insolvency "makes the creditors the principal constituency injured by any fiduciary breaches that diminish the firm's value." Therefore, equitable considerations give creditors standing to pursue derivative claims against the directors of an insolvent corporation. Individual creditors of an insolvent corporation have the same incentive to pursue valid derivative claims on its behalf that shareholders have when the corporation is solvent."[39]

So, if creditors can bring derivative claims, what is the nature of a Dave Director's duty to the Acme Widget Company's creditors? Like so many other things, people disagree. One Judge explained that a creditor's claim against a director could be either

> (i) an easily invoked theory that a creditor can assert directly as the firm approaches insolvency, (ii) a powerful cause of action that defendant directors will struggle to defeat because of an inherent conflict between their duties to creditors and their duties to stockholders, and (iii) a vehicle for obtaining a judicial remedy that would involve a forced liquidation of a firm that otherwise might continue to operate and return to solvency
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> [or] (i) something creditors only can file derivatively once the corporation actually has become insolvent, (ii) subject by default to the business judgment rule and not facilitated by any inherent conflict between duties to creditors and duties to stockholders, and (iii) only a vehicle for restoring to the firm self-dealing payments and other disloyal wealth transfers.[40]

Again, unless the particular judge assigned to the case has written on these issues, Lisa Lawyer will be left explaining to Dave Director that there are two schools of thought, one of which is much more favorable to him.

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38. *See AWTR*, 548 B.R. at 305–06.
39. *See Gheewalla*, 930 A.2d at 101 (citations omitted).
40. *See, e.g.*, *Quadrant*, 115 A.3d at 544. Vice Chancellor Laster ultimately held the latter view.

Regardless of whether the judge views a creditor's claim as powerful or routine, a creditor (like a stockholder) must usually bring a derivative, rather than a direct, claim.[41] Creditors, rather than stockholders, are allowed to bring derivative claims after a company becomes insolvent because they, and not the stockholders, are the "residual claim holders" post insolvency.[42] They, and not the stockholders, will benefit from any increase in the company's value, and are therefore entitled to sue to make sure that the directors live up to their obligation to attempt to increase the company's value.[43]

The ability of creditors to bring derivative claims against Dave Director for breaching his fiduciary duty does more than "just" increase the number of potential plaintiffs who might want to sue Dave. It also increases the likelihood of someone filing suit because the two pools of potential plaintiffs (i.e., stockholders and creditors) prefer radically different strategies.

> Stockholders and creditors are likely to have different approaches to risk, especially upon insolvency. Creditors, "holding fixed claims, generally prefer corporate decisions that minimize the risk of failure," whereas stockholders "generally prefer risky strategies because they profit from the success of [those] decisions but share the losses with creditors if the decisions fail."[44]

Indeed, "the closer to the line of insolvency, the more likely it is that stockholders will have nothing to lose and everything to gain by taking excessively large risks, and conversely the more likely that creditors will have the opposite incentive to take minimal if any risks."[45] As a result, to the extent Dave Director pursues a riskier strategy (to appease the stockholders and to try and pay everyone off), the creditors are likely to be aggrieved. To the extent Dave Director pursues a more conservative strategy (to appease the creditors and make sure they get at least something), the stockholders are likely to be aggrieved. As a result, at the end of the day, someone is going to be aggrieved. And that someone is going to go looking for a lawyer.

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41. *See, e.g.*, *Quadrant*, 115 A.3d at 546. It should be noted, however, that some courts have allowed creditors to bring direct, rather than derivative, claims. *See, e.g.*, Eddystone Rail Co. v. Bridger Logistics, LLC, 2020 WL 1233557, at *4 (E.D. Pa. Mar. 12, 2020).

42. *See, e.g.,* Quadrant, 115 A.3d at 551.

43. *Id*.

44. *See* AWTR, 548 B.R. at 327 (citations omitted).

45. *Id*. at 329–30.

IV. If Dave Director Doesn't Owe Creditors a Direct Fiduciary Duty, What Duties Does He Owe the Acme Widget Company's Creditors?

As set forth in Chapters 1 through 4, Dave Director owes the Acme Widget Company a duty of care and a duty of loyalty.[46] When the Acme Widget Company becomes insolvent, the company's creditors can sue (usually derivatively) to enforce those duties.[47] The duty of care requires Dave Director to act with skill and diligence. A creditor of an insolvent company is likely to claim either that Dave Director mismanaged the company by permitting (or, heaven forbid, causing) the company to engage in pursuits that were not likely to be profitable, or that Dave Director permitted (or, heaven forbid, orchestrated) fraudulent transfers.[48] The easiest way for Dave Director to breach the duty of care is through nonfeasance. It is amazing how many directors abdicate their responsibilities, especially when things are not going well. Simply put, the ostrich defense doesn't work.[49] Not even for an ostrich.

A breach of the duty of loyalty is equally easy for Dave Director to avoid if he follows Lisa Lawyer's good advice. Although Dave Director is entitled to take a salary (or stock),[50] he can't self-deal, and he certainly can't loot the company. Courts have recognized that creditors can bring claims against anyone who (allegedly) looted the company.[51] Creditors can even do so after a bankruptcy trustee is appointed, assuming the bankruptcy trustee declines to pursue the claim, because the claim against the "corporate looter" originally belonged to the

46. *See, e.g.*, *Quadrant*, 115 A.3d at 549.

47. *See, e.g.*, *AWTR*, 548 B.R. at 322.

48. A fraudulent transfer occurs when a debtor transfers an asset without receiving fair value in return for that asset at a time when the debtor is (or when the transfer makes the debtor) insolvent. *See, e.g.*, 12 Pa. Const. Stat. Ann. §§ 5104(a) and 5105. A transfer is also fraudulent if it is made with the intent to hinder, delay, or defraud a creditor. *See, e.g.*, 12 Pa. Const. Stat. Ann. § 5104(a).

49. *See, e.g.*, *AWTR*, 548 B.R. at 314 ("a director cannot close his eyes to what is going on about him in the conduct of the business of the corporation and have it said that he is exercising business judgment") (citations omitted).

50. *See, e.g.*, *Quadrant*, 115 A.3d at 547.

51. *See, e.g.*, *In re* Wilton Armetale, ___ F.3d ___, 2020 WL 4460000, at *1 (3d Cir. Aug. 4, 2020).

company's creditors, and it reverts to the creditors if it is explicitly or implicitly abandoned by the bankruptcy trustee.[52]

Although Dave Director will almost certainly focus on the creditors to whom the Acme Widget Company owes the most money (under the completely understandable belief that the Acme Widget Company will need to appease—or at least deal with—its major creditors if it is to survive), there are two classes of creditors who deserve particular attention when operating in the zone of insolvency: employees and the government.

Many states have enacted statutes that give employees the right to sue officers and directors in their personal capacity for unpaid wages.[53] These wage payment and collection laws arise out of legislature's (correct) belief that, if the people who are making the decision to pay or not pay employees' wages know that they will be personally liable for any unpaid wages, they will (somehow) arrange the company's affairs so that employees are paid. And, lest Dave Director think that employees might be too busy or too poor to hire lawyers to sue him, Lisa Lawyer will be quick to point out that not only do most wage payment and collection laws include fee-shifting provisions,[54] many are enforceable by state agencies,[55] and some include criminal provisions.[56] In addition to requiring that wages be paid, these statutes require that wages to be paid in a timely manner (usually no more than 15 days after the end of a pay period),[57] and often include hefty fines and penalties for late payment.[58] Wage payment and collection laws also require that wages be paid by cash or check (as opposed to credits, scrip, or "in kind").[59]

As for the government, "under the Internal Revenue Code, any individual responsible for the collection of, accounting for, and payment of trust-fund taxes who willfully fails to perform these obligations may be held personally liable for a penalty equal to the amount of the trust-fund taxes owed."[60] The government imposes this penalty because

52. *See, e.g.*, *Wilton Armetale*, 2020 WL 4460000, at *7.

53. *See, e.g.*, Pennsylvania's wage collection law, 43 P.S. §§ 260.1, *et seq*.

54. *See, e.g.*, 43 P.S. § 260.9a(f). Interestingly, Pennsylvania's wage payment and collection law explicitly provides that only the plaintiff (and not the defendant) can collect fees. *See* 43 P.S. § 260.9a(f).

55. *See, e.g., id*. § 260.9a(e).

56. *Id.* §§ 260.11a(b); 260.11a(c).

57. *Id.* § 260.3(a).

58. *Id.* § 260.10.

59. *Id.* § 260.6.

60. *See* Crisci v. United States, 407 Fed. App'x 573, 574 (3d Cir. 2010). *See also* United States v. Gregg, 2013 WL 6498249, at *5 (W.D. Pa. Dec. 11, 2013); 26 U.S.C. § 6672.

"withheld monies can be a tempting source of ready cash to a failing corporation beleaguered by its creditors."[61] As tempting as it may be, Lisa Lawyer will surely advise Dave Director that this is one temptation that should be resisted.

V. What Defenses Can Dave Director Employ?

Dave Director's most potent defense against creditors' claims is the business judgment rule. Numerous courts have held that directors can use the business judgment rule to defeat creditors' claims.[62] Under the business judgment rule, a director will not be held liable for the good faith exercise of reasonable business judgment—even if that business judgment turns out to be wrong—if the director is not engaged in self-dealing. A director can, for example, take the "long view" and approve actions that may cost the company money (or depress profits) in the short term, in the hopes that those actions will lead to long-term gains.[63] So, for example, if a creditor accuses Dave Director of breaching his fiduciary duty (and wasting corporate assets that could have been used to pay creditors) by approving expenses such as bonuses, above-market wages, advertising costs, or charitable contributions, Dave Director can defend by arguing that he approved those expenses because he believed they would lead to increased profits (and an increased ability to pay creditors) in the future. Ideally, if the reasonableness of Dave Director's belief is questioned, he will be able to point to the reports he received from experts showing that the expenditures were expected to lead to future profits, and to the board minutes stating that he relied on those experts when voting in favor of the expenditures.[64] Even courts holding that directors owe duties to creditors acknowledge that a director does not have to give creditors' interests priority, and the director's duty is "not a duty to liquidate and pay creditors when the corporation is near insolvency, provided that in the directors' informed, good faith judgement there is an alternative."[65]

61. *See Gregg*, 2013 WL 6498249, at *7 (citations omitted).
62. *See, e.g.*, *Quadrant*, 115 A.3d at 547.
63. *See, e.g.*, *Bandera Master Fund*, 2019 WL 4927053, at *14.
64. Certainly, if Lisa Lawyer had a hand in drafting the board minutes, those minutes would reflect such reliance. The lack of such a statement would enhance a creditor's claim.
65. *See Berg & Berg*, 178 Cal. App. 4th at 1032.

In addition to defending based on the business judgment rule, Dave Director can defend by arguing that his actions did not cause any damage to creditors.[66] Specifically, Dave Director can argue that nothing he did (or could have done) damaged the creditors. Instead, they were damaged by investing an a business that failed through no fault of Dave Director's. Although an argument—based on 20/20 hindsight, of course—that Dave Director should have done something different often has some appeal, 20 years of government statistics show that approximately half of all businesses fail in the first five years.[67] It would strain credulity to suggest that all of these businesses were mismanaged.

Relatedly, Dave Director may have to face claims of "deepening insolvency"—that is, that his actions (or inactions) turned a small loss into a large loss. While "deepening insolvency" may make sense under the "things can always get worse" theory, at least some states have rejected it (under the "if you are already dead you can't be further damaged" theory).[68]

Finally, Dave Director can defend against at least some claims by arguing that he was acting in his "individual," as opposed to "corporate," capacity when he took the action giving rise to the claim.[69] For example, Dave Director may have become a member of the Acme Widget Company's board because he was (or represented) a significant investor in (or creditor to) the company. Leaving aside the question of whether Dave Director owned (or controlled) enough stock to elect himself to the board, it is common for a startup company to offer a board seat to the investors who purchase a "round" or a "class" of stock (i.e., the owners of the "class B" or "B round" get to elect a director regardless of who the owners of the "class A" or "A round" stock wish to see on the board). As a company approaches insolvency, it is common for the company to ask existing investors (or debt holders) to put additional money into the company.[70] A company usually does so

66. Depending on the case, this defense can be a lack of causation, a lack of damages, or both.

67. *See, e.g.*, https://www.bls.gov/bdm/us_age_naics_00_table7.txt.

68. *See, e.g.*, Tow v. Bulmahn, 2016 WL 1722246, at *5 (E.D. La. Apr. 29, 2016); *Quadrant*, 115 A.3d at 547.

69. *See, e.g., Bandera Master Fund*, 2019 WL 4927053, at *10.

70. This "new money" can come in as either debt or equity. If it comes in as debt, it is likely to include collateral (assuming there is any that is unencumbered), priority, and "conversation rights" (i.e. the right to either convert the debt to equity at some future point, or to acquire equity as a "kicker"—often as a result of a warrant—in the future). If it comes in as equity, it is likely to "cram down" the existing equity holders (i.e., dilute their ownership

for two reasons. First, the "old money" already knows the status of the company and its likely prospects. As a result, "old money" does not need to perform nearly as much due diligence as "new money," and can therefore move faster, and at a lower cost and with less disruption to the company.[71] Second, "new money's" first question is inevitably going to be "why isn't old money coming to the table." If the company does not have a very good answer to this question, "new money" will assume that "old money" is not coming to the table because it believes doing so would be "throwing good money after bad." If Dave Director is "old money," he is entitled to make his own decision about whether he (or his principal) should put more money in. Specifically, he can decide not to invest more money even if he knows that the practical impact of his decision will be to "scare off" other potential investors. In making that decision, he is acting in his individual capacity (and exercising his individual rights) rather than acting in his capacity as a director of the Acme Widget Company.[72] Similarly, to the extent Dave Director accepts compensation from the Acme Widget Company, he is doing so in his individual capacity, and (absent any additional allegations of wrongdoing) not in breach of his fiduciary duty.[73]

VI. So What Is Dave Director to Do?

At the end of the day, Dave Director's duty to the Acme Widget Company is the same as it has always been. He has to keep himself informed, avoid conflicts and self-dealing, and make the best decisions he can to try and maximize the value of the Acme Widget Company as a whole. In doing so, he can take the interests—and desires—of both stockholders and creditors into account. Indeed, he can take many constituencies

percentage drastically). Existing equity holders often have anti-dilution rights. Anti-dilution rights allow existing equity holders to buy "their proportionate share" of any new equity on the same terms as the new equity holders. If they do so, they will continue to own the same proportion of the company as they owned before the "new money" came in.

71. The costs of gathering the information demanded during due diligence are not to be understated. Neither are the opportunity costs of having management take time and energy to respond to due diligence requests, especially when management has its hands full trying to save the company. Indeed, every hour management has to spend trying to raise money is an hour management cannot spend trying to solve whatever problems necessitated the fundraising in the first place.

72. *See, e.g.*, *Bandera Master Fund*, 2019 WL 4927053, at *10.

73. *See, e.g.*, Tow v. Bulmahn, 2016 WL 1722246, at *25 (E.D. La. Apr. 29, 2016).

into account, including employees, customers, and the environment.[74] But at the end of the day, he has to do what is best for the company as a whole, even if doing so will anger one or more constituencies. After all, he has Lisa Lawyer on retainer, and she can defend him against whatever claims may be brought against him. At least until the D&O policy runs out.[75]

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74. "B corporations" notwithstanding, a director who wishes to take things like environmental impact into account is well advised to do so under the rubric of increasing the value of the company over the long run. The business judgment rule can be invoked to justify a decision to take environmental considerations into account—even though they may cost the corporation more money in the short run—because doing so reduces the long term risk of (losing) an environmental or "public nuisance" lawsuit, or because the positive press associated with benefiting the environment will (again in the long run) increase sales sufficiently to make the decision a net positive for the company.

75. Many directors and officers liability insurance policies have "eroding limits" (i.e., any money spent defending claims reduces the amount available to pay claims). Directors and officers liability insurance policies also usually include "insured versus insured" exclusions. Depending on the wording of the exclusion and the wording of the claim, these exclusions can come into play. Finally, if a company goes out of business (through bankruptcy or otherwise), it would be well advised to purchase tail coverage if it is available.