IN THE BUNKER: DIRECTORS' AND OFFICERS' CONDUCT DURING A TIME OF COMPANY CRISIS

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ABSTRACT: When a company is insolvent, creditors look to any available "deep pocket," which can include a company's directors and officers. Indeed, as a company operates near insolvency or is insolvent, the creditors are entitled to the fiduciary obligations of directors and officers. While litigation against these individuals is all too common, most cases have a logical outcome: self-dealing, preferential treatment and fraud are punished but those who act in good faith, even if unsuccessful, will be vindicated. This paper examines the relevant issues under U.S. law.
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I. Introduction

In times of financial stress, all too often unhappy creditors confronted by an insolvent corporate entity seek to find other "deep pockets" from which to recover.

The purpose of this paper is to consider issues of the potential personal liability of those individuals directly involved with the corporate entity, i.e., the directors and officers of the troubled company. (In this paper the term "company" will generally be used as the principles here apply not only to corporations but to other business organizations, such as limited liability companies (LLCs)).

At the outset, a general observation is in order which was gleaned from a review of the extensive precedent on this topic. This observation should provide at least some comfort to directors and officers of such business entities and those who advise them. The courts are generally consistent on the bedrock issue: if a director or officer has discharged his or her duties in good faith and attentively the possibility of being found personally liable for business decisions and actions is minimal. On the other hand, where the director or officer has acted out of self-interest or committed fraud or the like, liability should follow.

While the outcome of such cases certainly is logical and self-evident, when faced with the highly stressful prospect of personal liability, such precepts bear repeating.

The second general and related observation, also based on a review of the relevant cases, is that the courts do not punish individuals for business decisions that have not worked out favorably as opposed to business decisions which are improper ab initio.
Having set the context, this paper will address the following topics:

I. Introduction
II. What Law Governs?
III. Insolvency (Defined)
IV. Fiduciaries
V. Directors
VI. Officers
VII. Standing
VIII. The Duty of Care
IX. The Business Judgment Rule
X. The Duty of Loyalty
XI. The Zone of Insolvency
XII. Deepening Insolvency
XIII. Exculpatory and Indemnification Provisions
XIV. In Pari Delicto
XV. Aiding and Abetting the Breach of Fiduciary Duties
XVI. Damages
XVII. Practical Considerations and Steps
XVIII. Conclusion

II. What Law Governs?

A threshold issue to address is the determination of what jurisdiction's law governs in an action brought against a company's officers and directors.

The resolution of this issue necessarily implicates the "internal affairs" doctrine:

The internal affairs doctrine provides that only the state of incorporation has the authority to regulate a corporation's internal affairs. *Edgar v. MITE Corp.*, 457 U.S. 624, 645, 102 S.Ct. 2629, 73 L. Ed. 2d 269 (1982). 'Few if, any, claims are more central to a corporation's internal affairs that those relating to alleged breaches of fiduciary duties by a corporation's directors and officers.' *In re Fedders North America, Inc.*, 405 B.R. 527, 539 (Bankr. D. Del. 2009) (citing *In re Topps Co. Shareholders Litigation*, 925 A.2d 951 (Del. Ch. 2007)). The claims addressing breaches of fiduciary duties and related claims involve the internal affairs of debtor, and the laws of the state of incorporation control.

operations and to restructure such debt, are business decisions governing internal affairs that necessarily affect shareholder value. Accordingly, the law of the state of incorporation applies to the deepening insolvency count."); In re Ben Franklin Retail Stores, Inc., 225 B.R. 646, 652 n.11 (Bankr. N.D. Ill. 1998) (liability of directors determined by the jurisdiction of the state of incorporation, here Delaware).

An exception to this rule is where, with respect to a particular issue before the court, some other state has a more significant relationship to the parties and the transaction, in that case it is possible for the law of that state to be applied. In re MS55, Inc., 420 B.R. 806, 820-21 (Bankr. D. Colo. 2009).

Overall, for analytical purposes the law of the state of incorporation should be applied to claims against officers and directors relating to their conduct of the company's business "otherwise officers and directors could have no certainty about their duties." Ben Franklin, 225 B.R. at 652 n.11.

For the purposes of this paper, what will be considered are issues exclusively of U.S. law. Further, since a great many U.S. corporations are incorporated in Delaware, that state's law is of particular relevance.

Concerning foreign corporations, it also should be expected that the law of the place of incorporation would similarly be applied, even if the venue of the action itself is in the U.S. See Batchelder v. Kawamoto, 147 F.3d 915, 920 (9th Cir. 1998) (internal affairs doctrine required the application of Japanese law to a derivative claim brought against the officers and directors of a Japanese corporation); Winn v. Schafer, 499 F.Supp.2d 390, 393 (S.D.N.Y. 2007) (as to breach of fiduciary claims, since the corporation was incorporated in the Cayman Islands that jurisdiction's law applied to the issue); but see Norlin Corp. v. Rooney, Pace, Inc., 744 F.2d 255,
263-64 (2d Cir. 1984) (the law of the place of incorporation (Panama) would not be applied to a fiduciary duty claim where the contacts with New York outweighed the interests of that foreign state).

III. Insolvency (Defined)

To place the pertinent issues in context, it will be useful to set a framework for a key factual threshold, i.e., the insolvency of the company:

Insolvency has a settled meaning under fraudulent transfer law, whether the relevant statute be § 548 of the Bankruptcy Code, the Uniform Fraudulent Transfer Act or the Uniform Fraudulent Conveyance Act. Its statutory definition is, in essence, an excess of liabilities over the value of assets. This is sometimes referred to as insolvency in the bankruptcy sense.

In re Healthco Int'l, Inc., 208 B.R. 288, 301-02 (Bankr. D. Mass. 1997) (applying Delaware law). Moreover, even if a case is pending before the bankruptcy court, it is permissible to consider state law principles concerning the finding of insolvency. Carrieri v. Jobs.com Inc.,
393 F.3d 508, 530-31 (5th Cir. 2004) (Texas state insolvency factors were relevant to the
determination of the insolvency issue in a bankruptcy action).

Thus, in considering the claims against directors and officers of a putatively insolvent
company, the court has a variety of bases on which to make the threshold determination as to
whether the company was solvent or insolvent, or, as will be discussed below, was near
insolvency or indeed would be rendered insolvent by the actions of those in charge of the
company.

As will also be discussed below, when a company has become insolvent, or is near
insolvent, there is a shift in the scope of the duties of the company's directors and officers. In
this context, it should be emphasized that the "insolvency" being considered is insolvency in fact
and not insolvency due to a filing such as in a bankruptcy court. See The Clarkson Co. Ltd. v.
Shaheen, 660 F.2d 506, 512 (2d Cir. 1981) (once a corporation was insolvent in fact the duties of
the officers and directors towards creditors arises); Geyer v. Ingersoll Publications Co., 621 A.2d
784, 787-88 (Del. Ch. 1992) ("[I]nsolvency means insolvency in fact rather than insolvency due
to a statutory filing in defining insolvency for purposes of determining when a fiduciary duty to
creditors arises...").

IV. Fiduciaries

In considering the issue of directors' and officers' potential liability, the status of those
persons as a fiduciary is critical. Initially, what must be considered is who in particular is a
fiduciary and to whom is the duty owed:

But to say that a man is a fiduciary only begins analysis; it gives
direction to further inquiry. To whom is he a fiduciary? What
obligations does he owe as fiduciary? In what respects has he
failed to discharge these obligations? And what are the
consequences of this deviation from duty?

As far as the level and extent of fiduciary duty, the Court of Appeals of New York expressed the parameters of a fiduciary's duty as follows:

Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held for something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions. Wendt v. Fischer, 243 N.Y. 439, 444, 154 N.E. 303 [(1926)]. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not be consciously lowered by any judgment of this court.


As to who is a fiduciary: "It is black letter law that a dominant or controlling stockholder or a sole shareholder has a fiduciary relationship to the corporation, which is also true of directors and officers of the corporation." Corcoran v. Frank B. Hall & Co., Inc., 149 A.D.2d 165, 174, 545 N.Y.S.2d 278 (N.Y. App. Div. 1989).

In addition to those parties, it is also possible for other entities to become, by way of their conduct, fiduciaries of the company which in turn can lead to duties being owed to other parties, including the creditors of the company. For example, in In re Oakwood Homes Corp., 340 B.R. 510 (Bankr. D. Del. 2006), the trustee of a bankrupt company brought an action against the company's former bank, which bank had acted as the company's financial and restructuring advisor and was its lead lender. The trustee alleged that the bank had exercised de facto control over the debtor. The court found the allegations sufficiently alleged a fiduciary relationship. As
the court observed: "[F]iduciary liability is not dependent solely on the contract; rather the liability rests on the nature of the relationship." *Id.* at 518-19.

In general it is fair to say that those involved in the management (or control) of the company, whether as directors, officers or controlling shareholders, have fiduciary duties which require, as noted above, the highest level of proper conduct.

V. Directors

A venerable decision authored by a pre-eminent jurist, Learned Hand, addressed the general role of a director:

True, [the Director] was not very well-suited by experience for the job he had undertaken, but I cannot hold him on that account. After all, it is the same corporation that chose him which now seeks to charge him... Directors are not specialists, like lawyers or doctors. They must have good sense, perhaps they must acquaintance with affairs; but they need not -- indeed, perhaps they should not -- have any technical talent. They are the general advisers of the business, and if they faithfully give such ability as they have to their charge, it would be lawful to hold him liable. Must a director guarantee that his judgment is good? Can shareholders call him to account for deficiencies which their votes assured him did not disqualify him or his office? While he may not have been the Cromwell for that Civil War, [the director] did not engage to play any such role.


Key to the performance of a director, of course, are the duties the director owes to the company:

Under Delaware law, directors of solvent corporations owe fiduciary duties to shareholders, but not to creditors. The shareholders, after all, own the corporation and management of corporate assets is vested in the directors. The directors are therefore entrusted with the control and management of the property of others. As frequently happens when a person is so entrusted with the property of others, the law imposes fiduciary obligations on that person. Creditors, on the other hand, deal with
corporations by entering into contracts. Satisfaction of their claims against the corporate assets requires only compliance with their contracts. So long as the corporation is solvent, they require no additional protection; by definition, a solvent corporation, no matter how badly managed otherwise, is able to satisfy its contractual obligations.

_In re Ben Franklin Retail Stores, Inc._, 225 B.R. at 652-53 (footnote omitted).

The description above properly describes the duties of the directors of a solvent corporation, however, once the corporation is insolvent, the nature of the directors' duties change:

In insolvency, creditors, as residual claims to a definitionally-inadequate pool of assets, become exposed to substantial risk as the entity goes forward; poor decisions by management may erode the value of the remaining assets, leaving a corporation with even less capital to satisfy its debts in an ultimate dissolution. The elimination of the stockholders' interest in the firm and the increased risk to creditors is said to justify imposing fiduciary obligations towards the company's creditors on the directors.


What also should be kept in mind are the distinct fiduciary duties of the directors: "The directors of Delaware corporations have a triad of primary fiduciary ties: due care, loyalty, and good faith." _Emerald Partners v. Berlin_, 787 A.2d 85, 90 (Del. 2001). Each of these duties shall be addressed below.

**VI. Officers**

Concerning the potential personal liability of the officers of the company, in general terms it is fair to state that such duties are similar, if not identical, to those of the company's directors. _See Interstate Foods, Inc. v. Lehmann_, 2008 WL 4443850, No. 06 Civ. 13469 (JGK) *3 (S.D.N.Y. Sep. 30, 2008) (under New York law, officer of a corporation can be held individually liable if such officer personally participates or has actual knowledge of fraud or
misrepresentation); Technic Engineering, Ltd. v. Basic Envirotech, Inc., 53 F.Supp.2d 1007, 1011 (N.D. Ill. 1999) (under Illinois law, both directors and officers owe fiduciary duties to the corporation); In re Harry Levin, Inc., 175 B.R. 560, 569 (Bankr. E.D. Pa. 1994) (president of corporation, under Pennsylvania law, owed fiduciary duties to the corporation and, because of insolvency, its creditors); In re Xonics, Inc., 99 B.R. 870, 872 (Bankr. N.D. Ill. 1989) ("When a corporation is insolvent its officers and directors stand in a position of trust not only to the corporation and its shareholders, but also to its creditors."); Metro Communication Corp. BVI v. Advanced Mobilecomm Technologies Inc., 854 A.2d 121, 163-64 (Del. Ch. 2004) (where managers of company participated in bribery schemes, those allegations are sufficient to state a claim for a breach of a fiduciary duty by those managers); Lopez v. TDI Serv., Inc., 631 So.2d 679, 688 (La. App. 1994) (under Louisiana law officers, as well as directors, of corporations owe fiduciary duty not only to the corporate entity, but the company's creditors as well); B&S Rigging & Erection, Inc. v. Wydella, 353 N.W.2d 163, 166 (Minn. App. 1984) (under Minnesota law, when a corporation is insolvent or "on the verge of insolvency," its directors and officers became fiduciaries of the corporate assets for the benefit of creditors).

In summary on this point, in addition to considering the fiduciary duties and obligations of the directors, the company's officers should certainly be included within the scope of this analysis.
VII. Standing

Although creditors in the case of an insolvent company are among those owed fiduciary duties by the company's directors and officers, it does not follow that the creditors have a right of direct action against the individual directors and officers.

This principle was articulated by the Supreme Court of Delaware in North American Catholic Education Programming Foundation, Inc. v. Gheewalla, 930 A.2d 92 (Del. 2007):

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 those having an interest in it, 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. Accordingly, we hold that the individual creditors of an insolvent corporation have no right to assert direct claims for breach of fiduciary duty against corporate directors. Creditors may nonetheless protect their interest by bringing derivative claims on behalf of the insolvent corporation or any other direct non-fiduciary claim...that may be available for individual creditors.

Id. at 103 (footnote omitted) (emphasis in original). See also Production Resources Group, L.L.C., 863 A.2d at 792-93 (once a corporation is insolvent, creditors have the ability to bring a derivative action in the name of the insolvent corporation against the individual directors).

Moreover, certainly for a company in bankruptcy, the bankruptcy trustee has standing to bring an action for damages sustained by the company as a result of the breach of fiduciary duties by its directors. In re Healthco Int'l, Inc., 208 B.R. at 300 ("The Trustee can bring any suit [the debtor corporation] could have brought, including suits against directors and controlling shareholders for a breach of fiduciary duty."). It is somewhat problematic whether a creditors' committee will always have standing to bring such actions. See, e.g., In re STN Enterp., 779
F.2d 901, 904 (2d Cir. 1985) (there may be a qualified right for creditors' committees to initiate such suits with the approval of the bankruptcy court, under circumstances where a trustee or a debtor in possession has unjustifiably failed to bring suit); but see In re BH S&B Holdings LLC, 420 B.R. 112, 152 (Bankr. S.D.N.Y. 2009) (unsecured creditors' committee had standing, under Delaware law, to bring breach of fiduciary duty claim).

VIII. The Duty of Care

In general terms, the duty of care requires the fiduciaries to inform themselves of material information, which is reasonably available to them prior to making a business decision. See, e.g., In re Healthco Int'l, 208 B.R. at 305. As has been further articulated:

The fiduciary duty of due care requires that the directors of a Delaware corporation use that amount of care which ordinarily careful and prudent men will use in similar circumstances, and consider all material information reasonably available in making business decisions, and that deficiencies in the directors' process are actionable only if the directors' actions are grossly negligent.

In re Walt Disney Co. Deriv. Litig., 907 A.2d 693, 749 (Del. Ch. 2005), aff'd, 906 A.2d 27 (Del. 2006) (internal quotation marks omitted). See also Metro Communication, 854 A.2d at 157 ("Because fiduciaries or business entities must take risks and make difficult decisions about what is material to disclose, they are exposed to liability for breach of fiduciary duty only if their breach of the duty of care is extreme."). A subset of the duty of care includes the duty to monitor a corporation's information and reporting system. In re Caremark Int'l Inc. Deriv. Litig., 698 A.2d 959, 970 (Del. Ch. 1996) (theoretically it would be possible to hold a director liable for losses caused by non-compliance with applicable legal systems in the event of a failure of a corporate information and reporting system.).
IX. The Business Judgment Rule

In defending a business decision, available to the directors of a company is the "business judgment rule":

It is well-settled under the Delaware business judgment rule that, in making a business decision, the directors of a corporation are presumed to act on an informed basis, in good faith, and in the honest belief that the action taken is in the best interest of the company.

_Minnesota Invco of RSA #7, Inc. v. Midwest Wireless Holdings LLC_, 903 A.2d 786, 797 (Del. Ch. 2006) (footnote omitted.). Moreover:

[Its protections can only be claimed by disinterested directors whose conduct otherwise meets the test of business judgment. From the standpoint of interest, this means that directors can neither appear on both sides of the transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or stockholders generally.


Stated differently, the business judgment rule is process oriented as opposed to results determinative as business failure is an ever-present risk. The business judgment rule exists precisely to ensure that directors and managers act in good faith to undertake "risky strategies that seem to promise future profit." _Trenwick American Litig. Trust v. Ernst & Young, L.L.P._, 906 A.2d 168, 194 (Del. Ch. 2006), aff'd, 931 A.2d 438 (Del. 2007).

It is also appropriate to note that the assertion of the business judgment rule is an affirmative defense and thus cannot be used as a basis to dismiss an action at the outset of the litigation. _In re The Brown Schools_, 368 B.R. at 401.
X. The Duty of Loyalty

A corollary to the duty of care is the duty of loyalty which essentially also encompasses the duty to act in good faith:

There are two ways to breach the duty of loyalty: (1) self-dealing and (2) failure of oversight.

But even when board action does not involve self-dealing and the business judgment rule standard in review is applicable, a plaintiff can prevail by showing that the directors breach their duty of loyalty. In the case of the duty of loyalty, the plaintiff does so by showing that board action was not undertaken in a good faith effort to further the stockholders' interest, but for some personal reason, such as entrenchment. If the plaintiff proves the subject bad faith of that kind, it can have the challenged action set aside in equity as a breach of the duty of loyalty and potentially recover monetary damages or relief for the injury the corporation.

As a subsidiary element of the duty of loyalty, a successful claim for the breach of the duty of good faith requires plaintiff to demonstrate one of three actions: '(1) where the fiduciary intentionally with a purpose other than that of advancing the best interest of the corporation; (2) where the fiduciary acts with the intent to violate an applicable positive law; or (3) where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.'


As noted above, there are two main grounds on which a claim for the breach of the duty of loyalty lies: first, where the defendant was on both sides of the transaction (In re The Brown Schools, 386 B.R. 37, 47 (Bankr. D. Del. 2008)); and second, based on a failure of the directors to act in the face of a known duty to act "thereby demonstrating the conscious disregard for their responsibilities..." (Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006)).
XI. The Zone of Insolvency

The concept of a shift in the directors' obligations from the shareholders of the company to the creditors has given rise to the concept of the "zone of insolvency." There is no recognized definition of the term or concept.

Among other cases, this concept may be traced to Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., 1991 WL 277613, Civ. A. No. 12150 *34 (Del. Ch. 1991), in which the court stated "At least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely an agent of the residue risk bearers, but owes its duty to the corporate enterprise." Credit Lyonnais further recognized the conundrum of directors who believe their duties are owed only to the shareholders as opposed to directors who are thinking of the company as a separate legal and economic entity. Referring to the latter, the court stated: "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." Id. at n. 55. Consistent with Credit Lyonnais, other courts have held that being on the "verge" of insolvency has triggered the expansion of fiduciary duties to the creditors. B&S Rigging, 353 N.W.2d at 166.

The uncertainty as to the precise definition of what constitutes the "zone of insolvency" is likely to continue. See Gheewalla, 930 A.2d at 98 n. 20 (noting there is no precise definition of the term). However, it is fair to conclude that despite a lack of clear definitional precision, the concept will nonetheless be used by the courts to consider the scope of the fiduciary duties of those involved in the management of the company: "Historically, the 'zone of insolvency' is a created concept created to account for a shifting and expanding of a board of directors' fiduciary

XII. **Deepening Insolvency**

As noted above, the concept of the "zone of insolvency" is not in any way a cause of action but instead is simply the triggering mechanism for the inclusion of creditors among those who are owed fiduciary duties by the directors and officers of a company.

In contrast is the concept of "deepening insolvency," which has been asserted to be a separate cause of action against the individuals involved in the management of a company. That being said, as will be discussed here, this separate cause of action has been criticized by a number of courts, and indeed rejected in several prominent jurisdictions.

The concept of an action for "deepening insolvency" was recognized in *Official Committee of Unsecured Creditors v. R. F. Lafferty & Co., Inc.*, 267 F.3d 340 (3d Cir. 2001). In *Lafferty*, the court stated:

> Even when a corporation is insolvent, its corporate property may have value. The fraudulent and concealed incurrence of debt can damage that value in several ways. For example, to the extent that bankruptcy is not already a certainty, the incurrence of debt can force an insolvent corporation into bankruptcy, thus inflicting legal and administrative costs to the corporation... In addition, prolonging an insolvent corporation's life through bad debts may simply cause the dissipation of corporate assets.

> These harms can be averted, and the value within an insolvent corporation salvaged, if the corporation is dissolved in a timely manner, rather than kept afloat with spurious debt.

*Id.* at 349-50. *See also In re Flagship Healthcare, Inc.*, 269 B.R. 721, 728 (Bankr. S.D. Fla. 2001) (allegations that financial advisor caused, through its wrongful conduct, the corporation to increase its debt, alleged a claim of "deepening insolvency").
That being said, given the evident judicial hostility to an independent tort of "deepening insolvency," the continued viability of this cause of action is doubtful. For example, the Delaware Chancery Court has expressly rejected the cause of action:

Delaware law imposes no absolute obligation of the board of the company that is unable to pay its bills to cease operations and to liquidate. Even when the company is insolvent, the board may pursue, in good faith, strategies to maximize the value of the firm. As a thoughtful federal decision recognizes, Chapter 11 of the Bankruptcy Code expresses a societal recognition that an insolvent corporation's creditors (and society as a whole) may benefit if the corporation continues to conduct operations in the hope of turning things around.

....

The rejection of an independent cause of action for deepening insolvency does not absolve directors of insolvent corporations of responsibility. Rather, it remits plaintiffs to the contents of their traditional toolkit, which contains, among other things, causes of action for breach of fiduciary duty and for fraud.

Trenwick, 906 A.2d at 204-05 (footnote omitted). The "thoughtful federal decision" referred to in Trenwick is In re Global Serv. Group LLC, 316 B.R. 451 (Bankr. S.D.N.Y. 2004). In Global, the court, after an extensive analysis of the evolution of the tort, concluded that such an action did not exist under New York law, which was to be applied in the case as the debtor was a New York LLC. In essence, the court observed that the fiduciaries of an insolvent business could well and properly conclude that the company should continue to operate in order to enhance or maximize the company's enterprise value. The court further observed: "Thus, in contrast to the laws of some foreign jurisdictions, including the United Kingdom, there is no absolute duty under American law to shut down or liquidate an insolvent corporation. The fiduciaries may, consistent with the business judgment rule, continue to operate the corporation's business." Id. at 460 (footnote and citations omitted).

**XIII. Exculpatory and Indemnification Provisions**

It is possible, by way of statute, for the directors and officers of a company to be exculpated or indemnified from any liability for a breach of the duty of care.

For example, 8 Del. C. § 102(b)(7) authorizes Delaware corporations, by the insertion of a provision in the certificate of incorporation, to exculpate their directors from monetary damage liability for a breach of the duty of care. The statute has exceptions to its reach, however, including acts or omissions which were not in good faith. "Thus, a corporation can exculpate its directors for monetary liability for a breach of the duty of care, but not for conduct that is not in good faith." *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d at 65.

Further, through Delaware's indemnification statute, 8 Del. C. § 145, a corporation is allowed to indemnify any director, officer, employee or agent of the corporation against expenses arising from an action brought against that individual, as long as the person acted in good faith and that person reasonably believed the action was in the best interest of the corporation: "[U]nder Delaware statutory law a director or officer of the corporation can be indemnified for liability (and litigation expenses) incurred by reason of a violation of the duty of care, but not for a violation of the duty to act in good faith." *Id.* at 65-66. The reach of such exculpatory provisions will bind creditors who are in a position to claim against the company for
the breach of fiduciary duties. In re BH S&B Holdings LLC, 420 B.R. at 145 n. 13 (applying Delaware law).

It also should be noted that duty of loyalty breaches are not indemnifiable nor exculpated under the Delaware statutory law. In re The Brown Schools, 386 B.R. at 47.

Similar to the business judgment rule, an exculpation clause is an affirmative defense and thus cannot be used as the basis to dismiss an action at the pleadings stage. In re The Brown Schools, 368 B.R. at 401.

XIV. In Pari Delicto

At times those against whom such actions have been brought have asserted the defense of in pari delicto.

This doctrine precludes the claim by a corporation against its officers and directors if the wrongful conduct that was committed by those persons can be imputed to the corporation itself. In re The Brown Schools, 386 B.R. at 55. However, it also has been established that the in pari delicto doctrine is not applicable to corporate insiders, which would include a director of the company. Id. Similarly, the wrongful conduct of individual corporate officers and directors will not be imputed to the corporation if such action was not for its benefit. In other words, where the conduct alleged did not benefit the corporation and instead benefited the individual defendants, the affirmative defense of in pari delicto is not established. In re Total Containment, Inc., 335 B.R. 589, 621 (Bankr. E.D. Pa. 2005).

XV. Aiding and Abetting the Breach of Fiduciary Duties

In the context of claims against directors and officers in their personal capacities, it is also relevant to briefly touch on the issue of the cause of action for aiding and abetting a breach of fiduciary duties.
This claim has four elements: (1) the existence of a fiduciary relationship, (2) a breach of the fiduciary's duty, (3) a knowing participation in the breach by a defendant who is not a fiduciary, and (4) damages are proximately caused by the breach. *In re Exide Technologies, Inc.*, 299 B.R. 732, 749 (Bankr. D. Del. 2003). *See also In re Total Containment, Inc.*, 335 B.R. at 611 (possible for non-fiduciary defendants to be liable to the trustee, if those defendants rendered substantial assistance to the fiduciary defendants who had breached their duties).

It also should be noted that exculpatory provisions, such as the Delaware exculpatory statute discussed above, provide no protection to third parties who aid and abet directors in the violation of their obligations of *either* the duty or care or the duty of loyalty. *In re Healthco Int'l*, 208 B.R. at 308-09.

**XVI. Damages**

As to the computation of damages in the actions being discussed here:

The measure of damages governing the Trustee's claims for breach of fiduciary duties and aiding and abetting that breach is the amount of decrease in the fair market value of [the debtor corporation] that resulted from the defendants' actions. Based upon this measure of damage, the Trustee must prove: (a) the value of [the debtor corporation] at the time of the tortious conduct, (b) its decreased value resulting from the tortious conduct, and (c) that the tortious conduct was a significant contributing cause of the decrease.

*Id.* at 310.

**XVII. Practical Considerations and Steps**

As discussed at the beginning of this paper, the first and foremost practical consideration is the general course of the outcome of actions brought against directors.
Not to put too fine a point on it but the cases turn out as one would expect: where there is fraud and self-dealing, the individuals have been found liable; on the other hand, where the involved individuals have discharged their duties in a proper fashion, liability has not been found. See, e.g., Lopez, 631 So.2d at 688 (where there was a large payment to a single creditor who was also an officer, director and shareholder of the company but other creditors were paid nothing at all, there was a breach of the duty of good faith to the corporation and thus allowed for personal liability for the debts of the corporation); B&S Rigging, 353 N.W.2d at 168-69 (where directors authorized a payment to a corporate insider to the detriment of other creditors, personal liability of the directors was found); In re Xonics, 99 B.R. at 876 (where directors acted properly and with independence, there was no breach of fiduciary duties); Minnesota Invco, 903 A.2d at 797-98 (where directors acted with a good faith belief as to business decisions and with independence, there is no personal liability).

As far as practical steps that can be taken by directors as well as officers if the company nears the "zone of insolvency," the first step is not to consider immediately resigning. Although it may be counter-intuitive, it is better to have a place at the table during the discussions and decisions about the direction of the company.

As is well known, there exists directors' and officers' (D&O) liability insurance. If at all possible, as the company experiences difficulties, policy limits should be raised to the maximum extent possible.

Finally, if an action is brought against individuals independent counsel should be retained for the individual defendants. Bell Atlantic Corp. v. Bolger, 2 F.3d 1304, 1317-18 (3d Cir. 1993) (where actions have been brought against directors, the better practice is to obtain separate counsel for individual and corporate defendants).
XVIII. Conclusion

When companies enter the "zone of insolvency" or become insolvent, it stands to reason that it is a time of great stress. It is at those times, however, that the company's directors and officers, as difficult and challenging as it may be, must continue to discharge their duties in proper fashion with a view to independent and good faith conduct and decisions.