SHADES OF GRAY: RECENT DEVELOPMENTS THAT IMPACT ADVISING DIRECTORS AND OFFICERS IN THE TWILIGHT ZONE OF INSOLVENCY

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- Fredco is clearly solvent. It has annual net income of $1 zillion and no debt of any kind, paying even its trade creditors in cash, in advance. Fredco's board decides to buy a new building in a desirable location for cash and for less than a market price to house its growing operations in that market. The board does this after a full report on the matter and after a fulsome debate. No board member has any sort of personal interest in the transaction.
- The Board of Cartmanco votes to pay its chairman, Eric Cartman, a $50 million bonus, upon the recommendation of Eric Cartman. The Board, which consists of Cartman and three of his life-long friends, vote to do so without any sort of inquiry into whether the bonus is appropriate. Cartmanco had a $200 million loss last year and is in default on most of its debt obligations, and creditors are threatening to file an involuntary bankruptcy petition.

Did the directors[1] of Fredco violate their fiduciary duty? What about the directors of Cartmanco? These scenarios may be black and white, but we live and work in, and get paid to advise about, a world of more subtle grays. Consider the following:

- A "bricks and mortar" company is barely solvent from a balance sheet perspective, i.e., it has minimal shareholder equity. It timely pays creditors and vendors, but relies on a constant flow of cash from sales and receivables to do so. The company's board considers and implements a strategy to realign its entire operations to engage in a far riskier—but if successful, more profitable—software/internet business.

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- The CEO of an insolvent—but surviving—company works diligently to stave off creditors, re-negotiate longer payment terms with vendors and obtain additional infusions of capital in the sincere desire to save the company and avoid having to terminate his 30 employees. After 18 months of this, a group of trade creditors brings a petition for involuntary bankruptcy and argues that its damages are greater than they would have been had the CEO not kept the company on life support.

Lawyers, particularly lawyers who do what we all do, are constantly on the lookout for new developments on the topic of directors' and officers' fiduciary duties in corporate crisis situations, and to be sure, there are a tremendous number of articles out there. We do not attempt to capture all of the history, facets, and ideas on this topic; instead we offer this brief summary of where we think the state of the law is now and where it seems to be going.

First, a brief recap of the bare essentials:

- Directors are charged with the *fiduciary duty* to manage the corporation's affairs on behalf of the shareholders.
- The specific duties, as spelled out by cases and commentators, are most often distilled to encompass the duties of care and loyalty.
- The *duty of care* requires that directors exercise the degree of care that a reasonably careful and prudent person would exercise under similar circumstances.
- The *duty of loyalty* requires that directors act in good faith and in the reasonable belief that the action taken is in the best interests of the corporation.
- The *standard* for whether a director fulfills his or her fiduciary duty is governed by the *business judgment rule*.
- Courts generally apply the business judgment rule's presumption in the absence of some active wrongdoing. Directors' first line of defense, and their lawyers' first job in this context, is to make sure that the right *process* is followed so that the likelihood that decisions will fall under the protection of the business judgment rule is maximized.
- Under the law of most jurisdictions, the directors of a *clearly solvent* corporation owe the fiduciary duty to shareholders, i.e., the equity-holders, with *no* such fiduciary duty owed to the corporation's creditors.
- When a corporation is *clearly insolvent*, however, the corporation's directors are held to owe a fiduciary duty to the creditor body.

- The law is much murkier when a corporation is neither *clearly solvent* nor *clearly insolvent*.
- People—i.e., shareholders and creditors—increasingly look to directors' pockets (or the pockets of their insurance carriers) for recovery when they lose money as a result of a corporation's failure.
- The existence and scope of director and officer liability insurance policies are critical to the analyses of a director's potential liability.

We will discuss very briefly each of these topics and highlight some of the more recent developments related to them and their implications to attorneys who practice in the field.

FIDUCIARY DUTIES OF DIRECTORS

A corporation is controlled, ultimately, by its board of directors. While shareholders may elect or remove directors (who, in turn, as a collective board, may install, remove, and control the operational management, i.e., executive officers), it is the directors who make the decisions that will affect shareholder value as well as other financial aspects of the corporation. As such, the directors are charged with a responsibility to manage the corporation's affairs on behalf of the shareholders, and courts typically characterize the board's responsibility as a fiduciary duty owed by the directors to the corporation and its shareholders.[2]

The specific duties, as spelled out by cases and commentators, are most often distilled to encompass two duties: the *duty of care* and the *duty of loyalty*. The Supreme Court of Delaware has described both duties as "equal and independent."[3]

The *duty of care* requires that directors exercise the degree of care that a reasonably careful and prudent person would exercise under similar circumstances.[4] Many states have codified this standard for director conduct after Model Business Corporation Act § 8:30(a), which reads:

> A director shall discharge his duties as a director, including his duties as a member of a committee:
>
> (1) in good faith.
>
> (2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances.
>
> (3) in a manner he reasonably believes to be in the best interests of the corporation.[5]

Cases have generally been of two types: nonfeasance cases, where a director has failed to supervise or monitor,[6] or misfeasance or bad decision cases.[7] However, due to the Delaware legislature's enactment of § 102(b)(7), discussion supra, commentators have implied that the duty of care is effectively unenforceable in that jurisdiction and noted that "care-based cases are in the minority of derivative and class action cases."[8]

The *duty of loyalty* requires that directors act in good faith and in the reasonable belief that the action taken is in the best interests of the corporation. Thus, any type of self-dealing conduct, such as misappropriation of corporate opportunities, taking excessive compensation, or utilizing corporate assets or information for personal gain, is prohibited. Cases have held that the duty of loyalty prohibits directors from using their position in the corporation to obtain personal benefits to the detriment of the corporation[9] and prohibits self-dealing or usurpation of corporate opportunity by directors.[10] In contrast to the duty of care, subjective good faith will not protect a director who has engaged in self-dealing or usurpation of corporate opportunity; rather, the transaction must be objectively fair.[11]

The *ordinary standard* for whether a director fulfills his or her fiduciary duty is governed by the *business judgment rule*. The business judgment rule is a judicially created "presumption that in making a business decision, the director of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company."[12]

Courts generally apply the business judgment rule's presumption in the absence of some active wrongdoing or malfeasance by directors seeking the protection of the business judgment rule.[13] For example, courts generally have held that the business judgment rule will not apply where there was a breach of the duty of loyalty.[14] Further, once a prima facie showing is made that a director has a self-interest in a particular corporate transaction, the burden shifts to the director to demonstrate that the transaction is fair and serves the best interests of the corporation and its shareholders.[15]

THE OUTER LIMITS OF THE BUSINESS JUDGMENT RULE

The most recent pronouncements regarding the outer limit of the business judgment rule may be *In re Walt Disney Company Derivative Litigation* ("*Disney II*").[16]

The Disney cases arose from the hiring and firing of Michael Ovitz as president of the Walt Disney Company. Essentially, the plaintiff-shareholders alleged that because Ovitz was a long-time personal friend of Michael Eisner, Chairman and CEO of Disney, Eisner negotiated an inordinately above-market employment contract for Ovitz with substantial severance payments in the event of a no-fault termination. After little more than a year of mediocre-to-poor job performance, Ovitz was terminated under the no-fault provision. The plaintiffs further alleged that the Disney board took no action to stop Eisner or examine his actions, but simply rubber-stamped the employment agreement and turned a blind eye when Eisner terminated Ovitz under the no-fault provision.

In an initial decision, *In re The Walt Disney Company Derivative Litigation* ("*Disney I*"),[17] the complaint survived a motion to dismiss because the court found that the allegations and all reasonable inferences that could be drawn from it, if true, portrayed the directors as consciously indifferent to a material issue facing Disney and established intentional misconduct or egregious process failures that implicated the foundational obligation of directors to act honestly and in good faith to advance corporate interests.[18]

In *Disney II*, the court, after trial and extensive fact-finding where it found many of the factual allegations in the complaint to be true, held that none of the Disney directors, including Eisner and Ovitz, had breached their fiduciary duties. While the court had harsh words for Eisner and the board, calling Eisner a Machiavellian imperialist who created his own Magic Kingdom and the board members Eisner's cast of yes-men, and stating that there were "many aspects of defendants' conduct that fell significantly short of the best practices of ideal corporate governance corporate," the court emphasized that "best practices" was not the applicable standard for determining whether a director breached his or her fiduciary duty.[19]

So even in today's post-*Enron* and *WorldCom* environment, the business judgment rule presumption still applies, provided there is "no evidence of fraud, bad faith or self-dealing in the sense of personal profit or betterment."[20] The director's conduct may be "Machiavellian," encourage sycophancy, and fall "significantly short of the best practices of ideal corporate governance," but the director may still find protection under the rule.[21]

While most cases do apply a broad application of the protection of the business judgment rule, a seminal case from Delaware imposes qualifications on the use of the rule and the directors who would seek shelter under it. In *Aronson*, the Delaware Supreme Court noted:

> There are certain common principles governing the application and operation of the [business judgment] rule.
>
> First, its protections can only be claimed by disinterested directors whose conduct otherwise meets the tests of business judgment. From the standpoint of interest, this means that directors can neither appear on both sides of a 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 all stockholders generally. [...]. Thus, if such director interest is present, and the transaction is not approved by a majority consisting of the disinterested directors, then the business judgment rule has no application whatever in determining demand futility.

> Second, to invoke the rule's protection directors have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them. Having become so informed, they must then act with requisite care in the discharge of their duties.[22]

Disney II addressed the qualifications imposed by *Aronson* and still found Eisner's conduct eligible for the protection of the business judgment rule. In a footnote, the court suggested that although Eisner was "an imperial CEO," it was not a case of "a patently self-dealing transaction."[23] With regard to a director's duty to inform himself or herself, the *Disney II* court found that "at least as the duty of care is typically defined in the context of a business judgment (such as a decision to select and hire a corporate president), of all the defendants, [Eisner] was certainly the most informed of all reasonably available material information, making him the least culpable in that regard."[24]

SHIFTING DUTIES AS THE CORPORATION IS NO LONGER CLEARLY SOLVENT

The *standard* by which a director's action is judged is just one issue of import, of course. Equally important is the question of *to whom* the duty is owed. Much has been written about how duties otherwise owed to shareholders alone begin to be owed to creditors as well once a corporation enters the zone of insolvency.

Clearly, the concept of when a corporation becomes insolvent—or more amorphously, enters the zone of insolvency—is critical to a determination as to whether creditors may be the beneficiaries of the fiduciary duty owed by directors. Courts have traditionally applied two different tests for insolvency.

- Under the "balance sheet" test for insolvency, as the name suggests, a corporation is insolvent when its liabilities exceed the value of its assets.[25]
- Under the "equity" test for insolvency, a corporation is considered insolvent when it is unable to pay its debts as they become due in the ordinary course of business.[26]

To complicate matters, courts have found that a presumption of insolvency may apply immediately before the filing of bankruptcy.[27] Additionally, courts have extended the concept of insolvency to scenarios where the directors approve a transaction that benefits shareholders but leaves the corporation insolvent, on the "brink of insolvency," or with "unreasonably small capital."[28] It is necessary to note that insolvency is in no way contingent on the corporation commencing a formal case in a bankruptcy court.[29]

CLEARLY SOLVENT CORPORATIONS

Under the law of most jurisdictions, the directors of a *clearly solvent* corporation owe the fiduciary duty to *shareholders*, i.e., the equity-holders, with no such fiduciary duty owed to the corporation's creditors.[30] The underlying principle is that the assets of a clearly solvent corporation will be presumably adequate to satisfy creditors.[31] As the Second Circuit noted in *United States v. Jolly,* "[b]orrower-lender relationships are typically at arm's length, and a firm's obligations to creditors are generally regarded solely as contractual."[32]

CLEARLY INSOLVENT CORPORATIONS

When a corporation is *clearly insolvent*, its directors are held to owe a fiduciary duty to the *creditor body.*[33] The underlying principle here is that a clearly insolvent corporation will presumably not have sufficient assets to satisfy its creditors in full. "Where the corporation is clearly insolvent…, corporate action taken for the intended benefit of shareholders may adversely affect or prejudice creditors, since creditor recoveries are now at risk."[34]

Courts are divided on the issue of whether the directors *continue to owe fiduciary duties to shareholders once the corporation becomes insolvent.* Some courts, including those in Delaware, hold that directors of insolvent or nearly insolvent corporations owe fiduciary duties to the entire corporate body, which includes both creditors and shareholders.[35] Other courts have held that the duty "shifts" when a corporation becomes insolvent, and these courts appear to take the view that directors no longer owe a fiduciary duty to the equity-holders but *only* to the creditors.[36]

CORPORATIONS IN THE "ZONE" OR "VICINITY OF INSOLVENCY"

A murkier situation exists when the corporation is neither clearly solvent nor clearly insolvent, but rather is approaching insolvency or is in the "zone" or "vicinity of insolvency." As the corporation's financial status moves along the spectrum, the constituency who may recover for a breach of the duty may be said to shift accordingly.

Credit Lyonnais Bank Nederland N.V. v. Pathe Communications Corp. is perhaps the most famous opinion addressing directors' fiduciary duty in the "vicinity of insolvency."[37] In this unpublished opinion, the Delaware Chancery Court stated that "[a]t 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 [i.e., shareholders], but owes its duty to the corporate enterprise."[38] The corporation's "board or its executive committee ha[ve] an obligation to the community of interest that sustained the corporation, to exercise judgment in an informed, good faith effort to maximize the corporation's long-term wealth creating capacity."[39]

The dispute in *Credit Lyonnais* arose from the leveraged buyout of MGM/UA Communication Company by Pathe Communications. In an effort to help MGM escape bankruptcy, Credit Lyonnais Bank, the principal lender in the transaction, provided financing to MGM pursuant to a corporate governance agreement.[40] The agreement provided that MGM's new board of directors would include three members to be appointed by Pathe. However, the corporate governance agreement also created an executive committee consisting of Alan Ladd (Chairman and CEO) and the chief operating officer and delegated to that committee all the powers delegable under Delaware law, except the powers to file for bankruptcy, issue securities, or appoint or remove the chairman and CEO, all of which would require the vote of four directors, i.e. the consent of Pathe.[41]

Pathe alleged that members of Ladd's management team breached their fiduciary duty to Pathe as the 98.5% shareholder in two ways. First, they entered into certain severance agreements with certain members of the Ladd team, which were triggered by Pathe's owner regaining control. Pathe asserted that these payments represented a tax upon the shareholders' exercise of their right to elect the board and thus constituted a breach of duty. Second, Pathe claimed that the executive committee—with whom the bank chose to share its contractual power to veto asset sales—delayed and impeded the sale of MGM's interest in a foreign movie distribution consortium, as well as other transactions.[42]

The court found no breach of duty by the directors. With respect to the severance agreements, the court found that they were a reasonable response to the risks of instability or insecurity to these employees, which might come if Pathe regained control.[43] Further, the court rejected the claim that Ladd was disloyal because he failed to facilitate transactions that would have resulted in Pathe regaining control. The court found that the evidence showed that Ladd's actions were prudent from the viewpoint of MGM. Because the company had recently been in bankruptcy, and even thereafter the directors labored in the shadow of that prospect, Ladd's team members "were appropriately mindful of the potential differing interests between the corporation and its 98% shareholder."[44] The court stated: "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."[45]

Some courts have interpreted *Credit Lyonnais* as handing creditors a sword with which to attach directors. Others have stated that *Credit Lyonnais* intended to clothe the directors with a shield.

The confusion stems from a single footnote in which Chancellor Allen provided an example of a solvent corporation facing an array of expected values from various business options.[46] In the example, the course of action considered optimal for the "community of interest that the corporation represents" would not have been the result "reached by a director who thinks he owes duties directly to shareholders only."[47] A result that was in fact in the best interests of the corporation's community of interests would be reached "by directors who are capable of conceiving of the corporation as a legal and economic entity."[48] Chancellor Allen explained: "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."[49]

A director of a corporation in the zone of insolvency, Chancellor Allen wrote, was not "merely [to be] the agent of the residue risk bearers" but rather to "the corporate enterprise" itself, and that the directors have an obligation "to the community of interest that sustained the corporation…"[50] Thus, some argue, *Credit Lyonnais* was intended to provide a *shield* to directors from potential liability to shareholders who may argue that the directors had a duty to undertake extreme risk as long as the company would not technically breach any legal obligations to its creditors.

Vice Chancellor Strine addressed this issue in *Production Resources*,[51] where he wrote:

> Somewhat oddly, a decision of this court that attempted to emphasize that directors have discretion to temper the risk that they take on behalf of the equity holders when the firm is in the "zone of insolvency" has been read by some as creating a new body of creditor's rights law. The *Credit Lyonnais* decision's holding and spirit clearly emphasized that directors would be protected by the business judgment rule if they, in good faith, pursued a less risky business strategy precisely because they feared that that a more risky strategy might render the firm unable to meet its legal obligations to creditors and other constituencies…
>
> 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. To the extent that a firm is in the zone of insolvency, some read *Credit Lyonnais* as authorizing creditors to challenge directors' business judgments as breaches of a fiduciary duty owed to them. Some cases in the courts of other jurisdictions have embraced this reading.
>
> This view of the common law of corporations is not unproblematic. Arguably, it involves using the law of fiduciary duty to fill gaps that do not exist.[52]

Vice Chancellor Strine then referred to the traditional contractual and statutory protections afforded to creditors as the reason why gaps as to protection for creditors do not exist:

> 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.[53]

Based on this reasoning, Vice Chancellor Strine concluded that there were in fact instances where directors of corporations in the vicinity of insolvency could take actions ostensibly in the interests of equity-holders that would increase creditors' risk: "Having complied with all legal obligations owed to the firm's creditors, the board would, in that scenario, ordinarily be free to take economic risk for the benefit of the firm's equity owners, so long as the directors comply with their fiduciary duties to the firm by selecting and pursuing with fidelity and prudence a plausible strategy to maximize the firm's value."[54]

In *Production Resources*, the court also made clear that the protection of the business judgment rule applies to a director's action during any of the phases of solvency/insolvency discussed above, i.e., whether the company is clearly solvent, clearly insolvent, or in the vicinity of insolvency. Specifically, Vice Chancellor Strine in *Production Resources* stated that as a corporation approaches insolvency, its board still may take risks on behalf of equity-holders as long as its decisions fall within the purview of the business judgment rule:

> I assume that, at all times, directors have an obligation to consider the legal duties of the firm and to avoid consciously placing the firm in a position when it will be unable to discharge those duties. Our statutory law reflects this aspect of director responsibility. *See*, *e.g.*, § 102(b)(7)(ii) (conduct that involves knowing violations of law cannot be exculpated). If this is accepted as a proposition, it seems to me even less plausible that directors' duties somehow change profoundly as the firm approaches insolvency. As the proportion of the firm's enterprise value that is comprised of debt increases, directors must obviously bear that in mind as a material consideration in determining what business decisions to make. I doubt, however, that there is a magic dividing line that should signal the end to some, most, or all risk-taking on behalf of stockholders or even on behalf of creditors, who are not homogenous and whose interests may not be served by a board that refuses to undertake any further business activities that involve risk. As a result, the business judgment rule remains important and provides directors with the ability to make a range of good faith, prudent judgments

> about the risks they should undertake on behalf of troubled firms. *See Angelo, Gordon & Co. v. Allied Riser Comm. Corp.,* 805 A.2d 221, 229 (Del. Ch. 2002) (denying a motion for preliminary injunction because plaintiffs made no showing of lack of good faith on the part of the directors of the insolvent corporation and stating that "even where the law recognizes that the duties of directors encompass the interests of creditors, there is room for application of the business judgment rule").[55]

Thus, *Production Resources* serves as a prime example of the Delaware view that directors of insolvent and nearly insolvent corporation owe their fiduciary duties to the entire corporate body, which includes both creditors and shareholders.

NEW WAYS TO EMPTY DEEP POCKETS

No self-respecting article on our chosen topic would be complete without a discussion of the tort claim of deepening insolvency, which has developed as an avenue to provide damages to injured creditors against solvent third parties whose control and decision-making added to a company's insolvency.

Deepening insolvency has been recently defined as the "'fraudulent prolongation of a corporation's life beyond insolvency,' resulting in damage to the corporation caused by increased debt."[56] It has also been described as a "theory of liability [that] holds that there are times when a defendant's conduct, either fraudulently or even negligently, prolongs the life of a corporation, thereby increasing the corporation's debt and exposure to creditors."[57]

The genesis of the theory has been credited to the court in *Bloor v. Dansker (In re Investors Funding Corp. of New York Securities Litigation).*[58] In that case, the defendant accounting firm certified financial statements that allegedly overstated income and assets and allegedly induced other parties to invest in the debtor prior to filing bankruptcy. The court rejected the defendant's contention that the corporation benefited simply by virtue of its continued existence facilitated by continued funding, stating: "A corporation is not a biological entity for which it can be presumed that any act which extends its existence is beneficial to it."[59]

The concept began as a theory of damages in *Investors Funding* and *Schacht,*[60] and thereafter was often raised in response to affirmative defenses that argued that increased debt, while potentially injurious to creditors, was beneficial to the borrower corporation.[61] More recently, some courts have accepted the theory that insolvent corporations may suffer distinct injuries when they continue to operate and incur more debt, and these courts have treated deepening insolvency as an independent cause of action.[62] Note also that some courts have either rejected the theory outright or raised questions about its viability.[63]

As an independent tort, the concept of deepening insolvency raises a myriad of important issues to all parties transacting with the insolvent or nearly insolvent corporation. Perhaps the most critical is that the concept allows, and arguably encourages, a treasure hunt for deep pockets. Notably, there is a long list of potential targets for claims that parties have contributed to keeping the company on "life support." Defendants to deepening insolvency claims have included directors and officers,[64] equity-holders,[65] lenders (particularly when the additional financing serving as the corporation's lifeline is tied to additional collateral and/or better terms for the lender),[66] and professional advisors to the company, such as accountants,[67] financial advisers,[68] and even attorneys.[69]

Before we leave this topic, we are compelled to put it in perspective. That is, deepening insolvency might best be thought of as the flavor of the day. It is just one more means to the end of getting plaintiffs a recovery when the corporation they would otherwise seek redress from is broke. A new theory may become in vogue tomorrow, and then many people will write articles and speak at seminars on that new theory. Our point is (without passing judgment on the efficacy of the particular theory) that directors are, in some instances, walking targets.

DIRECTORS & OFFICERS INSURANCE

Directors tend to be smart people. That is why they are asked to be directors. Consequently, knowing that they are potential targets of litigation, they are—now, more than ever—closely analyzing how they can protect themselves. This issue has highlighted the importance of adequate director and officer liability insurance policies ("D&O Policies").[70] When analyzing a director's potential liability for an alleged breach of his or her fiduciary duty, the existence and scope of D&O Policies are critical.[71]

D&O Policies generally contain one or more of three basic types of coverage.

1. *Side A*: This direct coverage covers individual directors and officers for losses when indemnification by the corporation is not available. The proceeds of Side A coverage are generally paid *directly to* or on the behalf of the directors and officers.
2. *Side B*: This coverage reimburses the corporation for the amounts *it* spends indemnifying (whether required or permissive) its directors and officers. Under Side B coverage, the corporation itself receives the proceeds of the policy as reimbursement for its indemnification payments and expenses to or on behalf of directors and officers.

3. *Side C:* This coverage, also known as "entity coverage," provides protection for the *corporation for any claims brought against it* directly.

Bankruptcy and insolvency implicate a number of issues with respect to D&O Policies, chief among them:

Is the D&O policy estate property? Bankruptcy courts have consistently held that D&O Policies, especially Side B and Side C coverage, are embraced within the statutory definition of property.[72]

Are the proceeds of the D&O policy estate property? As a general rule, if the insurance proceeds are payable to the debtor, the proceeds are usually considered estate property. Conversely, if the insurance proceeds are payable directly to individual claimants, the proceeds are usually considered not to be estate property.[73]

Particular issues often arise with respect to the defense costs incurred by directors and officers who have claims brought against them. Most D&O Policies do not contain a duty to defend the insured against any claim but provide for the advancement of defenses costs upon request and the obligation to reimburse them generally attaches as soon as attorney's fees are incurred.[74] Even where a D&O Policy does not explicitly provide that defenses costs are covered, courts have held that such costs are included within the scope of the term "loss."[75] However, insurers typically seek bankruptcy court approval for any defense cost advances, as the issue of whether proceeds of the policy are property of the estate is sufficiently unclear.

To the extent that D&O Policy proceeds are considered estate property, any payment of proceeds is stayed and the directors will not have access without relief from the automatic stay. There are a number of options directors can consider to alleviate or remove this issue:

- First, directors can enter into prepetition waivers of the automatic stay with the insurance carrier. However, these prepetition stay waivers have generally been held to be unenforceable.[76]
- A second option is to purchase a "Side A excess policy" which provides additional coverage above the limits of the primary "Side A" coverage. It kicks in when other insurance is not available to the directors and officers.[77]
- Additionally, independent directors or officers could purchase their own separate coverage, possibly with their board compensation increased to cover the costs.
- Finally, a corporation may eliminate entity coverage entirely. While this would effectively eliminate the automatic stay

> issues, it is not an ideal situation because it would leave the corporate entity without any insurance coverage.

One final note regarding D&O Policies: after a corporation files for bankruptcy, its insurance company may not terminate the prepetition insurance policy, as this has been uniformly held to be stayed by the automatic stay provision of Bankruptcy Code § 362(a)(3). However, the Bankruptcy Code does not prevent a prepetition insurance policy from expiring on its own terms postpetition.[78]

EXCULPATION—ANOTHER WAY FOR DIRECTORS TO PROTECT THEMSELVES

In response to the Delaware Supreme Court's decision in *Smith v. Van Gorkom*[79] and sensing a potential flight of corporations from Delaware,[80] the Delaware legislature enacted § 102(b)(7). Section 102(b)(7) of the Delaware General Corporation Law allows corporations to adopt charter provisions that exculpate their directors from liability for most breaches of fiduciary duty:

> (b) In addition to the matters required to be set forth in the certificate of incorporation by subsection (a) of this section, the certificate of incorporation may also contain any or all of the following matters:…
>
> (7) A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit. No such provision shall eliminate or limit the liability of a director for any act or omission occurring prior to the date when such provision becomes effective. All references in this paragraph to a director shall also be deemed to refer (x) to a member of the governing body of a corporation which is not authorized to issue capital stock, and (y) to such other person or persons, if any, who, pursuant to a provision of the certificate of incorporation in accordance with §141(a) of this title, exercise or perform any of the powers or duties otherwise conferred or imposed upon the board of directors by this title.[81]

The court in *Disney II* noted that one of the primary purposes of § 102(b)(7) is to "encourage directors to undertake risky, but potentially value-maximizing, business strategies, so long as they do so in good faith." A § 102(b)(7) provision in a certificate of incorporation will prohibit recovery of monetary damages from directors for shareholder claims exclusively based on a violation of the duty of due care.

In *Production Resources*, the court held that exculpation clauses indeed apply to prevent *creditors* as well as *shareholders* from bringing duty of care claims. Relying on the fact that any such claim held by a creditor is derivative in nature, the court stated, "[a]lthough § 102(b)(7) itself does not mention creditors specifically, its plain terms apply to all claims belonging to the corporation itself, regardless of whether those claims are asserted derivatively by stockholders or by creditors."[82]

As discussed above, many courts have said that when a corporation becomes insolvent or enters the zone of insolvency, the fiduciary duties of a corporation expand from its stockholders to its creditors. Vice Chancellor Strine in *Production Resources* states, however, that while that description is useful shorthand, the more precise formulation is that the directors' obligations are "to the firm itself."[83] Vice Chancellor Strine goes on to explain that the *transformation of a creditor into a residual owner does not change the nature of the harm in a typical claim for breach of fiduciary duty by corporate directors*.[84] While creditors may have standing to assert breach of fiduciary duties, no particular creditor would have the right to the recovery. Rather, all creditors would benefit when the firm was made whole and the firm's value was increased, enabling it to satisfy more creditor claims in the order of their legal claim on the firm's assets. Thus, claims brought by creditors when a company is insolvent *remain derivative,* with either shareholders or creditors suing to recover for a harm done to the corporation as an economic entity. Any recovery logically flows to the corporation and benefits the derivative plaintiffs indirectly to the extent of their claim on the firm's assets.[85]

Finally, it is not clear whether creditors would be prevented by an exculpation clause pursuant to § 102(b)(7) from bringing a deepening insolvency claim. Vice Chancellor Strine states in *Production Resources*:

> Only claims of the corporation asserted derivatively by creditors fall within the charter defense. The argument that clauses should not bind third parties lacks force because the clauses only restrict third parties to the extent that they seek to enforce rights on behalf of the corporation itself. Any claims that creditors possessed themselves against the firm or its directors—such as claims for breach of contract or for common law or statutory torts like misrepresentation and fraudulent conveyance—would not be barred by the exculpatory charter provision because those claims do not belong to the corporation or its stockholders.[86]

CONCLUSION

In conclusion, we offer some parting thoughts. Not unexpectedly, and consistent with history and human nature, plaintiffs are looking more and more for deep pockets and for creative ways to find them and empty them (e.g., the concept of deepening insolvency as an independent cause of action). Directors and officers, because of their D&O policies, if for no other reason, will continue to find themselves the targets of suits. This phenomenon, coupled with recent highly publicized cases of director malfeasance such as *Enron* and *WorldCom*, suggests that an era of heightened scrutiny of director conduct will remain for the immediate future.

As is often said, sunlight is the strongest cleanser, and this era of heightened scrutiny is already facilitating some reform. As mentioned above, Sarbanes-Oxley is an example of the crystallization of public reaction—and indignation—to a perceived problem of widespread abuse. However, Sarbanes-Oxley is an outside force brought to bear. We are seeing more and more boards proactively seeking advice on how to conduct themselves in a manner that will stand up to later challenge. Moreover, advising on internal reform may be the area in which attorneys who practice in the area of director and officer liability can provide the most value to their clients, e.g., educating corporate D&O clients about methods to minimize their potential liability. A concrete example of this involves the principle, discussed above, that directors may not find protection under the business judgment rule if they have not adequately informed themselves of the basis for and the consequences of their decisions. A lawyer may help her clients understand and establish the *procedures* and *processes* that should be used to make decisions that may later be judged by some standard imposed in their role as corporate fiduciaries.

Research References:

Bankr. Serv. L Ed §§ 27:1051, 27:1128, 29:360, 34:389; Norton Bankr. L. & Prac. 2d §§ 27:2, 47:27, 77A:1 to 77A:7

West's Key Number Digest, Corporations 🔑 307 to 369, 537 to 569

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1. For the most part, the same rules that apply to directors also apply to officers. We use the terms interchangeably throughout the article. However, there are obvious distinctions, though most simply relate to the fact that directors' duties are more numerous. In any event, we are indeed focused on the duties of directors. Likewise, we use the term "corporation" and are indeed focused on corporations, though the discussion is largely applicable to other forms of entities.

2. The law of the state of incorporation of the corporation generally determines the extent and scope of the duties of officers and directors to shareholders. As many corporations are incorporated in the State of Delaware, much of this article will reference Delaware statutes.

3. Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 367, Fed. Sec. L. Rep. (CCH) P 97811 (Del. 1993), decision modified on reargument, 636 A.2d 956 (Del. 1994). To be sure, courts have identified other duties such as the duty of candor, duty of disclosure, and duty to protect confidential information, but these duties may be conceptualized as subsets of the two duties of care and loyalty.

4. See, e.g., Norlin Corp. v. Rooney, Pace Inc., 744 F.2d 255, 264, 5 Employee Benefits Cas. (BNA) 2706, Fed. Sec. L. Rep. (CCH) P 91564 (2d Cir. 1984); Francis v. United Jersey Bank, 87 N.J. 15, 432 A.2d 814, 824 (1981).

5. Another example of a statutory codification of one or more of a director's duties is, of course, Sarbanes-Oxley, which Congress enacted in response to high profile cases of D&O malfeasance. This article limits itself to common law fiduciary duty issues and does not include a discussion of the statutory duties imposed by Sarbanes-Oxley or other statutes.

6. See, e.g., In re Caremark Intern. Inc. Derivative Litigation, 698 A.2d 959 (Del. Ch. 1996).

7. See, e.g., Smith v. Van Gorkom, 488 A.2d 858, Fed. Sec. L. Rep. (CCH) P 91921, 46 A.L.R.4th 821 (Del. 1985).

8. Hillary A. Sale, Delaware's Good Faith, 89 Cornell L. Rev. 456, 462 (2004).

9. See, e.g., Federal Deposit Ins. Corp. v. Sea Pines Co., 692 F.2d 973, 976 (4th Cir. 1982).

10. See, e.g., Pepper v. Litton, 308 U.S. 295, 306-7, 60 S. Ct. 238, 84 L. Ed. 281 (1939); Guth v. Loft, Inc., 23 Del. Ch. 255, 5 A.2d 503, 510 (1939).

11. See, e.g., In re Xonics, Inc., 99 B.R. 870, 875-76 (Bankr. N.D. Ill. 1989).

12. In re Healthco Intern., Inc., 208 B.R. 288, 306, 30 Bankr. Ct. Dec. (CRR) 858, 37 Collier Bankr. Cas. 2d (MB) 1445 (Bankr. D. Mass. 1997) (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)). See also Matter of Reading Co., 711 F.2d 509, 517 (3d Cir. 1983) (under business judgment rule "a court will not disturb the judgments of a board of directors 'if they can be attributed to any rational business purpose'") (quoting Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971)).

13. See, e.g., Stern v. General Elec. Co., 924 F.2d 472, 476, 19 Fed. R. Serv. 3d 663 (2d Cir. 1991) ("the actions of corporate directors are subject to judicial review only upon a showing of fraud or bad faith") (citing Auerbach v. Bennett, 47 N.Y.2d 619, 419 N.Y.S.2d 920, 393 N.E.2d 994, 1000 (1979); Kalmanash v. Smith, 291 N.Y. 142, 51 N.E.2d 681, 687 (1943)). See also Sinclair Oil Corp., 280 A.2d at 722 ("fraud or gross overreaching"); Getty Oil Co. v. Skelly Oil Co., 267 A.2d 883, 887 (Del. 1970) ("gross and palpable overreaching"); Warshaw v. Calhoun, 43 Del. Ch. 148, 221 A.2d 487, 492-93 (1966) ("bad faith or a gross abuse of discretion"); Moskowitz v. Bantrell, 41 Del. Ch. 177, 190 A.2d 749, 750 (1963) ("fraud or gross abuse of discretion"); Penn Mart Realty Co. v. Becker, 298 A.2d 349, 351 (Del. Ch. 1972) ("directors may breach their fiduciary duty… by being grossly negligent"); Kors v. Carey, 39 Del. Ch. 47, 158 A.2d 136, 140 (1960) ("fraud, misconduct or abuse of discretion"); Allaun v. Consolidated Oil Co., 16 Del. Ch. 318, 147 A. 257, 261 (1929) ("reckless indifference to or a deliberate disregard of the stockholders").

14. See, e.g., Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 180, Fed. Sec. L. Rep. (CCH) P 92525, 66 A.L.R.4th 157 (Del. 1985).

15. See, e.g., Norlin Corp., 744 F.2d at 264.

16. In re Walt Disney Co. Derivative Litigation, 35 Employee Benefits Cas. (BNA) 1705, 2005 WL 2056651 at *30 (Del. Ch. 2005) (unpublished).

17. In re Walt Disney Co. Derivative Litigation, 825 A.2d 275, 30 Employee Benefits Cas. (BNA) 2288 (Del. Ch. 2003).

18. Notably, in a supplemental opinion, the court granted Ovitz' motion for summary judgment with respect to the complaint's first claim, which alleged that he violated his fiduciary duties in negotiating, arranging, and finalizing the terms of his employment agree-

ment; the court held that Ovitz did not owe any fiduciary duty to the company until he became an officer of the company, after he negotiated the employment agreement. In re Walt Disney Co., 2004 WL 2050138 at *3 (Del. Ch. 2004).

19. Disney II, 2005 WL 2056651 at *1, *30.

20. Disney II, 2005 WL 2056651 at *31.

21. Disney II, 2005 WL 2056651 at *1.

22. Aronson, 473 A.2d at 812. Further, the protection of the business judgment rule will be lost upon a showing of either improper director interest in a transaction or that the director has not adequately informed himself or herself. See Healthco, 208 B.R. at 306; Richard M. Cieri, Patrick F. Sullivan & Heather Lennox, The Fiduciary Duties of Directors of Financially Troubled Companies, 3 J. Bankr. L. & Prac. 405, 406 (1994). If the protection of the business judgment rule is lost, the burden then shifts to the directors to prove the fairness of the transaction. See Aronson, 473 A.2d at 549, n. 47 (citing Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983) stating that directors must establish that the proposed transaction was the product of fair dealing and priced under the "entire fairness" standard of review).

23. Disney II, 2005 WL 2056651, at *40, n.487.

24. Disney II, 2005 WL 2056651, at *39.

25. See, e.g., In re Koubourlis, 869 F.2d 1319, 1321, 19 Bankr. Ct. Dec. (CRR) 367, Bankr. L. Rep. (CCH) P 72720 (9th Cir. 1989); Clarkson Co. Ltd. v. Shaheen, 660 F.2d 506, 513 (2d Cir. 1981); N.Y. Debt. & Cred. Law § 271.

The Bankruptcy Code incorporated the "balance sheet" test for determining insolvency. The Code's definition of "insolvent" is found in 11 U.S.C.A. § 101(a)(32), which provides:

> (A) with reference to an entity other than a partnership and a municipality, a financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation, exclusive of—
>
> (i) property transferred, concealed, or removed with intent to hinder, delay, or defraud such entity's creditors; and
>
> (ii) property that may be exempt from property of the estate under section 522 of this title.

11 U.S.C.A. § 101(a)(32).

26. See, e.g., Meighan v. Finn, 146 F.2d 594, 595 (C.C.A. 2d Cir. 1944), judgment aff'd, 325 U.S. 300, 65 S. Ct. 1147, 89 L. Ed. 1624 (1945); Shakey's Inc. v. Caple, 855 F. Supp. 1035, 1042-43 (E.D. Ark. 1994); In re Gordon Car and Truck Rental, Inc., 59 B.R. 956, 961 (Bankr. N.D. N.Y. 1985); Odyssey Partners, L.P. v. Fleming Companies, Inc., 735 A.2d 386, 417 (Del. Ch. 1999); Parkway/Lamar Partners, L.P. v. Tom Thumb Stores, Inc., 877 S.W.2d 848, 850 (Tex. App. Fort Worth 1994), writ denied, (Dec. 1, 1994).

27. See, e.g., In re Mortgage & Realty Trust, 195 B.R. 740, 751, 29 Bankr. Ct. Dec. (CRR) 8 (Bankr. C.D. Cal. 1996) (presumption of insolvency four days prior to bankruptcy filing); New York Credit Men's Adjustment Bureau v. Weiss, 305 N.Y. 1, 110 N.E.2d 397 (1953).

28. See, e.g., Healthco, 208 B.R. at 300-02.

29. In bankruptcy, some of the issues discussed in this article are less relevant as a practical matter to some extent because major decisions are subject to court approval after notice and a hearing, and consequently, lawsuits alleging breach of fiduciary duties while in bankruptcy are rare.

30. See, e.g., In re STN Enterprises, 779 F.2d 901, 904, Bankr. L. Rep. (CCH) P 70913 (2d Cir. 1985) (holding modified by, In re Dur Jac Ltd., 254 B.R. 279, 44 Collier Bankr. Cas. 2d (MB) 1774 (Bankr. M.D. Ala. 2000)); Paul H. Schwendener, Inc. v. Jupiter Elec. Co., Inc., 358

Ill. App. 3d 65, 293 Ill. Dec. 893, 829 N.E.2d 818 (1st Dist. 2005); Geyer v. Ingersoll Publications Co., 621 A.2d 784, 787 (Del. Ch. 1992); Francis, 432 A.2d 814.

31. See e.g., Norton Bankr. L. & Prac. 2d § 77A:1 ("Action taken by the directors in furtherance of shareholder interests primarily (or even only) should not deprive the creditors of their bargain in this scenario. Since only equity is at risk, the negative impact of a bad decision by the board of directors will be borne by the equity who alone stood to gain from the good decision.").

32. U.S. v. Jolly, 102 F.3d 46, 48 (2d Cir. 1996). It is assumed that creditors will be protected by the contractual terms for which they bargained and to which they agreed. "[T]he relationship between a corporation and the holders of its debt… is contractual in nature…. The terms of the contractual relationship agreed to and not broad concepts such as fairness define the corporation's obligations…" Katz v. Oak Industries Inc., 508 A.2d 873, 879 (Del. Ch. 1986). The rights of creditors are governed by the terms of the instruments giving rise to their claims and by the statutory law governing debtor-creditor relationships. See, e.g., Simons v. Cogan, 542 A.2d 785, 788 (Del. Ch. 1987), judgment aff'd, 549 A.2d 300 (Del. 1988).

For shareholders, however, there is no contractually-protected right to a return on investment. Equity-holders are inherently the risk-takers of the corporate enterprise. As shareholders benefit from any increase in the corporation's value, they expect the directors to act in a manner designed to maximize corporate growth. See, e.g., Ashman v. Miller, 101 F.2d 85, 91 (C.C.A. 6th Cir. 1939) ("Equity recognizes that stockholders are the proprietors of the corporate interest and are ultimately the only beneficiaries thereof.").

One court explains:

> It is presumed that creditors are capable of protecting themselves through the contractual agreements that govern their relationships with [solvent] firms. Furthermore, a specific body of law—the law of fraudulent conveyance—exists precisely to protect creditors. And, of course, important elements of federal bankruptcy law also protect creditors. Given that these legal tools exist to protect creditors, our corporate law (and that of most of our nation) expects that the directors of a solvent firm will cause the firm to undertake economic activities that maximize the value of the firm's cash flows primarily for the benefit of the residual risk-bearers, the owners of the firm's equity capital. So long as the directors honor the legal obligations they owe to the company's creditors in good faith, as fiduciaries they may pursue the course of action that they believe is best for the firm and its stockholders. Indeed, in general, creditors must look to the firm itself for payment, rather than its directors or stockholders, except in instances of fraud or when other grounds exist to disregard the corporate form.

Production Resources Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 787 (Del. Ch. 2004) (internal citations omitted).

33. See, e.g., In re McCook Metals, L.L.C., 319 B.R. 570, 594, 44 Bankr. Ct. Dec. (CRR) 44, 53 Collier Bankr. Cas. 2d (MB) 1281 (Bankr. N.D. Ill. 2005); In re Casini, 307 B.R. 800, 818 (Bankr. D. N.J. 2004); Paul H. Schwendener, Inc. v. Jupiter Elec. Co., Inc., 358 Ill. App. 3d 65, 293 Ill. Dec. 893, 829 N.E.2d 818 (1st Dist. 2005); Production Resources, 863 A.2d at 790-791; U.S. Bank Nat. Ass'n v. U.S. Timberlands Klamath Falls, L.L.C., 864 A.2d 930, 947 (Del. Ch. 2004), order vacated on other grounds, 875 A.2d 632 (Del. 2005); New York Credit Men's Adjustment Bureau, 110 N.E.2d 397.

34. Norton Bankr. L. & Prac. 2d § 77A:1.

35. See, e.g., Production Resources, 863 A.2d 772 (discussed more fully below).

36. See, e.g., California Pollution Control Financing Authority v. Agajanian, 990 F.2d 1256 (9th Cir. 1993), as amended on denial of reh'g, (June 25, 1993) (unpublished table decision) ("As a director, [the defendant's] fiduciary duty ran to the corporation and, after insolvency, its creditors"); Sea Pines, 692 F.2d at 976-77 ("when the corporation becomes insolvent, the fiduciary duty of the directors shifts from the stockholders to the creditors"); In re Hoffman

Associates, Inc., 194 B.R. 943, 964 (Bankr. D. S.C. 1995) ("when the Debtor became insolvent, the fiduciary duty owed by [the Debtor's director] shifted from the stockholders to all of the creditors").

As discussed more fully below, Production Resources, 863 A.2d 772, suggests that these cases miss the mark because there is never really a shift as to whom duties are owed—duties are always owed to the corporation; rather, the real inquiry involves determining who the residual owners of the corporation are. These competing schools of thought can also readily been seen in case law dealing with committee standing to sue in bankruptcy, a topic that is beyond the scope of this article.

37. Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., 17 Del. J. Corp. L. 1099, 1991 WL 277613 (Del. Ch. 1991).

38. Credit Lyonnais, 1991 WL 277613 at *34.

39. Credit Lyonnais, 1991 WL 277613 at *34.

40. Credit Lyonnais, 1991 WL 277613 at *34.

41. Credit Lyonnais, 1991 WL 277613 at *10-11.

42. Credit Lyonnais, 1991 WL 277613 at *33.

43. Credit Lyonnais, 1991 WL 277613 at *33.

44. Credit Lyonnais, 1991 WL 277613 at *34.

45. Credit Lyonnais, 1991 WL 277613 at *34.

46. The full text of Chancellor Allen's footnote is as follows:

> 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 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
25% chance of affirmance	($51mm)	$12.75
70% chance of modification	($4mm)	2.8
5% chance of reversal	($0)	0
--------Expected Value of Judgment on Appeal		$15.55

> 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 x 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.

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

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

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

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

50. See also In re Adelphia Communications Corp., 323 B.R. 345, 386 (Bankr. S.D. N.Y. 2005); In re Flutie New York Corp., 310 B.R. 31, 57 (Bankr. S.D. N.Y. 2004) ("[A] director of a corporation that is in the zone or vicinity of insolvency… owes a fiduciary duty not only to [the company] and any shareholders, but also its creditors"); U.S. Timberlands Klamath Falls, 864 A.2d at 947-948 ("[D]irectors' or managers' fiduciary duties may extend to the interest of the company's creditors when the company is in the 'zone of insolvency'").

51. Production Resources, 863 A.2d 772.

52. Production Resources, 863 A.2d at 787-90 (internal citations omitted).

53. Production Resources, 863 A.2d at 787-90.

54. Production Resources, 863 A.2d at 787-90.

55. Production Resources, 863 A.2d at 788, n.52.

56. In re Global Service Group, LLC, 316 B.R. 451, 456, 43 Bankr. Ct. Dec. (CRR) 253, 53 Collier Bankr. Cas. 2d (MB) 57 (Bankr. S.D. N.Y. 2004) (quoting Schacht v. Brown, 711 F.2d 1343, 1350, Fed. Sec. L. Rep. (CCH) P 99160 (7th Cir. 1983)).

57. Jo Ann J. Brighton, Deepening Insolvency, 23-APR Am. Bankr. Inst. J. 34 (Apr. 2004). See also James H.M. Sprayregen, Jonathan P. Friedland, JoAnn J. Brighton, and Salvatore Bianca, Recharacterization of Debt to Equity: An Overview, Update, and Practical Guide to an Evolving Doctrine, Annual Survey of Bankruptcy Law (2004).

58. In re Investors Funding Corp. of New York Securities Litigation, 523 F. Supp. 533, Fed. Sec. L. Rep. (CCH) P 97696 (S.D. N.Y. 1980).

59. Investors Funding Corp., 523 F.Supp. at 540-41.

60. See Schacht, 711 F.2d at 1350.

61. See, e.g., Hannover Corp. of America v. Beckner, 211 B.R. 849, 854 (M.D. La. 1997); Allard v. Arthur Andersen & Co. (USA), 924 F. Supp. 488, 494, Fed. Sec. L. Rep. (CCH) P 99094, R.I.C.O. Bus. Disp. Guide (CCH) P 9029 (S.D. N.Y. 1996); In re Latin Inv. Corp., 168 B.R. 1, 6 (Bankr. D. D.C. 1993).

62. See, e.g., Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc., 267 F.3d 340, 349-52, 38 Bankr. Ct. Dec. (CRR) 147 (3d Cir. 2001) (applying Pennsylvania law); In re Exide Technologies, Inc., 299 B.R. 732, 750-52 (Bankr. D. Del. 2003).

63. See, e.g., Florida Dept. of Ins. v. Chase Bank of Texas Nat. Ass'n, 274 F.3d 924, 935-36 (5th Cir. 2001) (questioning whether Texas recognizes the cause of action); Askanase v. Fatjo, 1996 WL 33373364 at *28 (S.D. Tex. 1996) (rejecting bankruptcy trustee's "deepening insolvency" argument because "[t]he shareholders… could not be damaged by additional losses incurred after the point of insolvency because they had already lost their equity interest in the company"); Coroles v. Sabey, 2003 UT App 339, 79 P.3d 974, 983 (Utah Ct. App. 2003) (rejecting deepening insolvency as a theory of damages because, "[a]lthough

deepening insolvency might harm a corporation's shareholders, it does not, without more, harm the corporation itself"). See also Feltman v. Prudential Bache Securities, 122 B.R. 466, 473-74 (S.D. Fla. 1990) (accepting that deepening insolvency constitutes a recognized cause of action but finding that insolvent corporations were not harmed by artificial extensions of corporate lives where complaint alleged that corporations were shams and served as conduits for stolen money).

64. See, e.g., Global Service Group, 316 B.R. 451; In re RSL COM PRIMECALL, Inc., 2003 WL 22989669 at *5 (Bankr. S.D. N.Y. 2003).

65. See, e.g., Lafferty, 267 F.3d 340.

66. See, e.g., Exide, 299 B.R. 732; Global Service. Group, 316 B.R. 451.

67. See, e.g., Allard, 924 F. Supp. 488.

68. See, e.g., In re Flagship Healthcare, Inc., 269 B.R. 721, 38 Bankr. Ct. Dec. (CRR) 174 (Bankr. S.D. Fla. 2001).

69. See, e.g., In re RDM Sports Group, Inc., 277 B.R. 415 (Bankr. N.D. Ga. 2002); Hannover Corp. of America v. Beckner, 211 B.R. 849 (M.D. La. 1997).

70. Under certain states' statutes, including 8 Del. C. § 145(g), a corporation has the power to purchase and maintain insurance against any liability asserted against any of its agents, which includes its officers and directors.

71. Typical D&O Policy coverage exclusions include: insured vs. insured, rescission based on placement misrepresentations, deliberately fraudulent acts or omission, liability for gains or advantages to which the insured person is not legally entitled, prior notice/coverage period. However, a discussion of each exclusion is beyond the scope of this article.

In a bankruptcy proceeding, one of the exclusions that is frequently discussed is the insured vs. insured exclusion. A bankruptcy trustee, representative of the bankruptcy estate, or creditors' committee may be confronted with the argument that this exclusion applies as they bring an action on behalf of the debtor's estate.

72. See generally A.H. Robins Co., Inc. v. Piccinin, 788 F.2d 994, 1001, 14 Bankr. Ct. Dec. (CRR) 752, 15 Collier Bankr. Cas. 2d (MB) 235, Bankr. L. Rep. (CCH) P 71094 (4th Cir. 1986) (rejected by, Algemene Bank Nederland, N.V. v. Hallwood Industries, Inc., 133 B.R. 176 (W.D. Pa. 1991)) (stating that "[u]nder the weight of authority, insurance contracts have been said to be embraced in this statutory definition of 'property'"). The rationale is that the corporation pays for and "owns" the policy.

However, D&O Polices are generally "single limit" policies which contain one policy limit for all three types of coverage. Every dollar paid under one side of the coverage reduces the dollars available under the other sides. Thus, the total available policy proceeds, if limited, must be shared between the directors and officers and the corporate entity, and determining the respective rights to coverage becomes a critical, and controversial, issue.

73. This issue has arisen in four distinct scenarios, with the following rules established:

> 1.When the D&O Policy provides only direct coverage to the directors and officers, i.e., "Side A," the proceeds are not estate property. See, e.g., Louisiana World Exposition v. Federal Ins. Co., 864 F.2d 1147, 1152 (5th Cir. 1989) (holding held that debtor had no right to policy proceeds where the policy provided only liability coverage for directors and officers and did not provide corporate reimbursement coverage); In re Allied Digital Technologies, Corp., 306 B.R. 505, 512, 42 Bankr. Ct. Dec. (CRR) 204 (Bankr. D. Del. 2004); In re Medex Regional Laboratories, LLC, 314 B.R. 716, 720-21, 43 Bankr. Ct. Dec. (CRR) 178, 52 Collier Bankr. Cas. 2d (MB) 1591 (Bankr. E.D. Tenn. 2004).
>
> 2. When the D&O Policy provides only direct coverage to the debtor, i.e., "Side C", the proceeds are estate property. Allied Digital, 306 B.R. at 512; Medex, 314 B.R. at 720.
>
> 3. When there is potential coverage for both the directors and officers and the debtor, the D&O Policy's proceeds are generally considered to be estate property if deple-

tion of the proceeds would have an adverse effect on the estate. Allied Digital, 306 B.R. at 512-13. In other words, to the extent the policy actually protects the estate's other assets from diminution, the proceeds are considered estate property.

4. When the D&O Policy provides the debtor with coverage in connection with the debtor's indemnification of directors and officers, but such indemnification is hypothetical or speculative, the proceeds are not estate property. Allied Digital, 306 B.R. at 512-13.

See generally, James H.M Sprayregen, Jonathan P. Friedland, Marjon Ghasem:, Director and Officer Insurance, presented at the Thirty-First Annual Southeastern Bankruptcy Law Institute, Atlanta, Georgia (April 14-16, 2005), citing N.R. Eitel, Now You Have It, Now You Don't: Directors and Officers Insurance After A Corporate Bankruptcy, 46 LOY. L. REV. 585,588 (2000). The fourth scenario was addressed by the bankruptcy court for the Eastern District of Tennessee in In re Medex. Medex, 314 B.R. 716. In Medex, the creditors' committee filed an adversary proceeding against the debtor's principals alleging breach of fiduciary duties. In turn, the debtor's principals asserted a right to indemnification by the debtor. The adversary proceeding initiated by the committee constituted a "claim" under the D&O Policy, and the insurance carrier agreed to pay the reasonable and necessary defense costs subject to a court order declaring that the proceeds were not property of the estate or granting stay relief with respect to the use of such proceeds. Medex, 314 B.R. at 722. The court stated that, to the extent proceeds under a D&O Policy are paid directly to nondebtors, such proceeds are clearly not considered property of the estate. Conversely, to the extent that such proceeds are paid directly to the debtor, the proceeds clearly are estate property. Medex, 314 B.R. at 720-21. The D&O Policy in the case provided direct coverage for officers and directors and for the corporate debtor; however, the "Side C" coverage—where proceeds were payable directly to the corporation—had lapsed, and while the indemnification coverage ("Side B") was still potentially available, the debtor had not actually made any payments to the officers and directors or committed to make any indemnification payments. The court concluded that the indemnification coverage was "hypothetical and/or speculative" and that the only proceeds at issue were those payable to the officers and directors. As these proceeds were not property of the estate, the stay did not apply. Medex, 314 B.R. at 720-21.

74. See, e.g., McCuen v. American Cas. Co. of Reading, Pennsylvania, 946 F.2d 1401, 1406-07 (8th Cir. 1991); Okada v. MGIC Indem. Corp., 823 F.2d 276, 282 (9th Cir. 1986); In re WorldCom, Inc. Securities Litigation, 354 F. Supp. 2d 455, 464-65 (S.D. N.Y. 2005). One court has stated that "to hold otherwise would not provide insureds with protection from financial harm that insurance policies are presumed to give." Nu-Way Environmental, Inc. v. Planet Ins. Co., 1997 WL 462010 at *3 (S.D. N.Y. 1997). It is important to note whether the D&O Policy provides that the payment of defense costs erodes payment limits.

75. See, e.g., Okada, 823 F.2d at 282; Wedtech Corp. v. Federal Ins. Co., 740 F. Supp. 214, 221 (S.D. N.Y. 1990). An additional factor in favor of finding a duty to pay defense costs is that such provisions are "construed liberally and any doubts about coverage are resolved in the insured's favor." WorldCom, 354 F.Supp.2d at 464 (internal citations omitted).

76. But see In re Atrium High Point Ltd. Partnership, 189 B.R. 599, 28 Bankr. Ct. Dec. (CRR) 254 (Bankr. M.D. N.C. 1995) (standing for the proposition that prepetition waivers should be enforced when negotiated between sophisticated parties). See generally, James H.M Sprayregen, Jonathan P. Friedland, Marjon Ghasem:, Director and Officer Insurance, presented at the Thirty-First Annual Southeastern Bankruptcy Law Institute, Atlanta, Georgia (April 14-16, 2005).

77. For example, if the "Side A" coverage has been stayed by virtue of the corporation's bankruptcy proceedings, the "Side A excess coverage" may "drop down" to provide coverage for the directors and officers. Because the corporation would not be the insured, the proceeds would remain available and not subject to the automatic stay or considered property of the bankruptcy estate.

78. See, e.g., Aetna Cas. & Sur. Co. v. Gamel, 45 B.R. 345 (N.D. N.Y. 1984); In re American Medical Imaging Corp., 133 B.R. 45, 14 Employee Benefits Cas. (BNA) 1763 (Bankr. E.D. Pa. 1991).

79. In Smith v. Van Gorkom, the Delaware Supreme Court held that directors of the Trans Union Corporation were liable for breaching their fiduciary duties in the course of approving a cash-out merger. Van Gorkom, 488 A.2d at 864. While the court noted that "there were no allegations of fraud, bad faith, or self-dealing," it concluded that directors' loyalty and good faith alone were insufficient. Van Gorkom, 488 A.2d at 873. Directors also had a duty to "inform[] themselves as to all information that was reasonably available to them" before making important corporate decisions. Van Gorkom, 488 A.2d at 877.

Following the decision, insurance companies increased their premiums and even threatened to stop underwriting D&O insurance. William T. Allen, Jack B. Jacobs, & Leo E. Strine, Jr., Function Over Form: A Reassessment of Standards of Review in Delaware Corporation Law, 56 Bus. L. Rev. 1287, 1300 n. 49 (Aug. 2001).

80. David Rosenberg, Making Sense of Good Faith in Delaware Corporate Fiduciary Law: A Contractarian Approach, 29 Del. J. Corp. L. 491, 497 (2004) ("Delaware did not become the center of American corporate law by ignoring the needs and worries of corporate directors.").

81. Del. Code Ann. tit. 8, §102 (b)(7).

82. Production Resources, 863 A.2d at 793.

83. Production Resources, 863 A.2d at 791. While directors continue to have the task of attempting to maximize the economic value of the firm, the fact of insolvency "affect[s] the constituency on whose behalf the directors are pursuing that end" and "places the creditors in the shoes normally occupied by the shareholders-that of residual risk-bearers." Production Resources, 863 A.2d at 791. Where the remaining equity is under water, whatever remains of the company's assets will be used to pay creditors, usually either by seniority of debt or on a pro rata basis among debtors of equal priority. Production Resources, 863 A.2d at 791.

84. Production Resources, 863 A.2d at 792.

85. Production Resources, 863 A.2d at 792. For a very recent case on this topic, see Big Lots Stores, Inc. v. Bain Capital Fund VII, LLC, 2006 WL 846121 at *1 (Del. Ch. 2006) (granting directors' motions to dismiss because most of the claims of plaintiff, the sole substantial creditor, were "derivative in nature, not direct, and thus belong to the bankruptcy estate"). The court explained:

> [T]he underlying infirmity of the complaint is that the unavoidable effect of granting relief would be to unfairly advantage the plaintiff, an unsecured creditor, over any number of other unsecured creditors having claims in the bankruptcy. Simply put, this case stands for the well-established proposition that derivative claims cannot be used by a single creditor to upset the structured bankruptcy process. That principle equally applies when a plaintiff has erroneously characterized various derivative claims as direct, in the hope of escaping the broad jurisdiction of the bankruptcy court and the proceedings therein.

Production Resources, 863 A.2d at 792.

86. Production Resources, 863 A.2d at 795.