

DIRECTOR AND OFFICER LIABILITY IN THE CONTEXT OF BANKRUPTCY

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OUTLINE

I. Basics on the duties of officers and directors¹

A. Duty of Care

All directors owe a duty of care to the corporation and its shareholders. See Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (overruled on other grounds by Brehm v. Eisner, 746 A.2d 244 (Del. 2000)); Ga. Code Ann. S 14-2-830(a)(2). “A director’s duty to inform himself in preparation for a decision derives from the fiduciary capacity in which he serves the corporation and its stockholders. Lutz v. Boas, Del. Ch. 171 A.2d 381 (1961). See Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983) Since a director is vested with the responsibility for the management of the affairs of the corporation, he must execute that duty with the recognition that he acts on behalf of others [F]ulfillment of the fiduciary function requires more than the mere absence of bad faith or fraud. Representation of the financial interests of others imposes on a director an affirmative duty to protect those interests and to proceed with a critical eye in assessing information Thus, a director’s duty to exercise an informed business judgment is in the nature of a duty of care, as distinguished from a duty of loyalty. . . . [D]irector liability [for violation of the duty of care] is predicated upon concepts of gross negligence.” Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).

B. Duty of Loyalty

“[T]he duty of loyalty . . . requires that directors act in the best interest of the company and prohibits them from using their positions as directors to further their own self-interest.” Guth v. Loft, 5 A.2d 503, 510 (Del. 1939). “[T]he duty of loyalty mandates that the best interest of the corporation and its shareholders takes precedence over any interest possessed by a director, officer or controlling shareholder and not shared by the stockholders generally.” Cede & Co. v. Technicolor, 634 A.2d 345, 362 (Del. 1993). “Classic examples of director self-interest in a business transaction involve either a director appearing on both sides of a transaction or a director receiving a personal benefit from a transaction not received by the shareholders generally.” Id. (citing Nixon v. Blackwell, 626 A.2d 1366, 1375 (Del. 1993); Gilbert v. El Paso Co., 575 A.2d 1131,

¹ In the 2009 case of Gantler v. Stephens, 965 A.2d 695 (Del. 2009), the Delaware Supreme Court held that “officers of Delaware corporations, like directors, owe fiduciary duties of care and loyalty” and that “the fiduciary duties of officers are the same as those of directors.”

1146 (Del. 1990); Weinberger v. UOP, 457 A.2d at 710; Aronson, 473 A.2d at 812; Sterling v. Mayflower Hotel Corp., 93 A.2d 107, 110 (Del Ch. 1952)). “[T]he question of when director self-interest translates into board disloyalty is a fact-dominated question, the answer to which will necessarily vary from case to case.” Pogostin v. Rice, 480 A.2d 619, 624 (Del. 1984). The Eleventh Circuit has held that the failure to disclose the true financial condition of a company can be a basis for liability. See TSG Water Res., Inc. v. D'Alba & Donovan Certified Pub. Accountants, P.C., 260 F. App'x. 191, 198 (11th Cir. 2007).

C. Duty of Good Faith

The duty of care and the duty of loyalty have been described as the “fundamental” fiduciary duties. In re Gaylord Container Corp. Shareholders Litig., 753 A.2d 462, 476 n.41 (Del. Ch. 2000). However, there is also universal agreement that directors must discharge their duties in good faith. Some courts appear to consider the duty of good faith as merely a corollary to the duty of loyalty, while others consider the duty of good faith a separate and independent director duty. Compare Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993) and Emerald Partners v. Berlin, 787 A.2d 85, 90 (Del. 2001) with Gaylord Container Corp., 753 A.2d at 476 and Nagy v. Bistrieer, 770 A.2d 43, 49 n.2 (Del. Ch. 2000).

Good faith of directors is presumed. To overcome the presumption of good faith, a plaintiff must generally demonstrate that a director acted in bad faith. The Delaware courts have identified the following circumstances that would constitute a failure to act in good faith: (1) where a director is motivated by an actual intent to harm the corporation; (2) where a director intentionally acts with a purpose other than advancing the best interest of the corporation; (3) where a director acts with an intent to violate the law; and (4) where a director intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his or her duties. In re Walt Disney Co. Derivative Litig., 907 A.2d 693, 755-56 (Del. Ch. 2005), aff'd at 906 A.2d 27 (Del. 2006).

The duty of good faith acts “almost as a bridge between the concepts of due care and loyalty, transforming what might otherwise be deemed certain violations of the former into violations of the latter, even in the absence of an adverse pecuniary interest.” Reed and Neiderman, 29 DEL. J. CORP. L. at 123. Ordinary “duty of care” claims, which are often unsuccessful against directors because of an exculpatory charter provision contained in the corporate charter, may be excepted from such a provision if the claim alleges conduct that rises to the level of bad faith.

D. Duty of Disclosure

"[T]he duty of disclosure is not an independent duty, but derives from the duties of care and loyalty." Pfeffer v. Redstone, 965 A.2d 676, 684 (Del. 2009). "Corporate fiduciaries can breach their duty of disclosure under Delaware law . . . by making a materially false statement, by omitting a material fact, or by making a partial disclosure that is materially misleading. . . . Material facts are those for which there is a substantial likelihood that a reasonable person would consider [them] important in deciding how to vote." Id. (internal citations omitted).

The duty of disclosure entails a duty of candor to shareholders, which requires that directors make full and fair disclosure to the stockholders of pertinent information within the Board's control any time stockholder action is sought. Metro Commc'ns Corp. BVI v. Advanced MobileComm Tech. Inc., 854 A.2d 121, 156 (Del. Ch. 2004); Gantler v. Stephens, 965 A.2d 695, 710 (Del. 2009) ("It is well-settled law that directors of Delaware corporations have a fiduciary duty to disclose fully and fairly all material information within the board's control when it seeks shareholder action."). Additionally, where directors have a personal interest in a transaction, they are required to disclose the financial interest to the other directors. See HMG/Courtland Props., Inc. v. Gray, 749 A.2d 94, 119 (Del. Ch. 1999). Additionally, the duty of disclosure precludes directors from using their special knowledge for their own personal benefit and to the detriment of shareholders. Weinberger v. UOP, Inc., 457 A.2d 701, 711 (1983).

E. The Business Judgment Rule Presumption

"Under Delaware law, the business judgment rule is the offspring of the fundamental principle, codified in 8 Del. C. § 141(a), that the business and affairs of a Delaware corporation are managed by or under its board of directors." Van Gorkom, 488 A.2d at 872 (citing Pogostin v. Rice, 480 A.2d 619, 624 (Del. 1984); Aronson v. Lewis, 473 A.2d 805, 811 (1984); Zapata Corp. v. Maldonado, 430 A.2d 779, 782 (1981)). "The business judgment rule is a presumption that the Court will not second guess decisions made by directors unless 'the directors are interested or lack independence relative to the decision, do not act in good faith, act in a manner that cannot be attributed to a rational business purpose or reach their decision by a grossly negligent process . . .'" Kahn v. Portnoy, 2008 Del. Ch. LEXIS 184, *20 (Dec. 11, 2008) (citing In re Lear Corp. S'holder. Litig., 967 A.2d 640 (Del. Ch. 2008); Brehm v. Eisner, 746 A.2d 244, 264 n.66 (Del. 2000)); Brock Built, LLC v. Blake, 300 Ga. App. 816, 822 (Ga.

Ct. App. 2009) (observing that business judgment rule is inapplicable where officers engage in fraud or bad faith).

“The business judgment rule ‘operates *both* as a procedural guide for litigants and a substantive rule of law.’ Cede & Co. v. Technicolor, Inc., 634 A.2d 345 (Del. 1993) (quoting Citron v. Fairchild Camera & Instrument Corp., 569 A.2d 53, 64 (Del. 1989); Unitrin, Inc. v. American Gen. Corp., 651 A.2d 1361 (Del. 1995). As a *procedural* guide the business judgment presumption is a *rule of evidence* that places the initial burden of proof on the plaintiff. . . . ‘If a shareholder plaintiff fails to meet this evidentiary burden, the business judgment rule attaches to protect corporate officers and directors and the decisions they make, and our courts will not second-guess these business judgments. . . . If the rule is rebutted, the burden shifts to the defendant directors, the proponents of the challenged transaction, to prove to the trier of fact the “entire fairness” of the transaction to the shareholder plaintiff.’” Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1162 (Del. 1995).

F. Entire Fairness – Burden Shifted to Directors

“Where . . . the presumption of the business judgment rule has been rebutted, the board of directors’ action is examined under the entire fairness standard. Unitrin, Inc. v. American Gen. Corp., 651 A.2d at 1371 n. 7 (collecting cases). [The Delaware Supreme] Court has described the dual aspect of entire fairness [in the context of a merger] as follows:

The concept of fairness has two basic aspects: fair dealing and fair price. The former embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and stockholders were obtained. The latter aspect of fairness relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company’s stock . . . However, the test for fairness is not a bifurcated one as between fair dealing and fair price. All aspects of the issue must be examined as a whole since the question is one of entire fairness.

Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983). Thus, the entire fairness standard requires the board of directors to establish ‘to the *court’s* satisfaction that the transaction was the product of both fair dealing *and* fair price.’” Cinerama, Inc. v. Technicolor, Inc., 663 A.2d

1156, 1162 (Del. 1995) (citing Cede v. Technicolor, Inc., 634 A.2d 345, 351-58 (Del. 1993)).

G. Enhanced Scrutiny

Primarily applies in sale of control transactions and challenges to defensive measures adopted by directors. “Enhanced scrutiny is Delaware’s intermediate standard of review.” Reis v. Hazelett Strip-Casting Corp., 2011 Del. Ch. LEXIS 11, *24 (Del. Ch. Jan. 21, 2011). “Framed generally, it requires that the defendant fiduciaries ‘bear the burden of persuasion to show that their motivations were proper and not selfish’ and that ‘their actions were reasonable in relation to their legitimate objective.’” Id. (citing Mercier v. Inter-Tel (Del.), Inc., 929 A.2d 786, 810 (Del. Ch. 2007). “The key features of . . . enhanced scrutiny . . . are: (1) a judicial determination regarding the adequacy of the decisionmaking process employed by the directors, including the information on which the directors based their decision; and (b) a judicial examination of the reasonableness of the directors’ action in light of the circumstances then existing.” Paramount Communications v. QVC Network, 637 A.2d 34, 45 (Del. 1994). However, where a board’s action “purposefully interferes with the exercise of shareholder voting rights” the Court may require directors to show a “compelling justification” for the action. See Kidsco Inc. v. Dinsmore, 674 A.2d 483, 495 (Del. Ch. 1995).

II. Common Fiduciary Duty Claims Against Directors and Officers Outside of Bankruptcy

A. Breach of the Duty of Care

Duty of care decisions tend to fall into one of two categories: 1) shareholder challenges to a particular board decision (e.g. approval of a merger); or 2) shareholder challenges to directors’ general oversight or monitoring of corporate activities.

1. Shareholder challenges to a particular board decision

Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985)

In Van Gorkom, the shareholders of Trans-Union Corporation sued the corporation’s directors after the directors hastily voted to approve a cash-out merger. The merger had been driven almost entirely by Trans-Union’s Chairman and CEO, who had unilaterally chosen a per-share purchase price for the merger on the basis of less than complete information. Id. Upon presentation of the

merger proposal by the CEO to the board of directors, the directors approved the transaction after a mere two hours of discussions. Id. The Court found that the directors were liable for breaching their duty of care because they: "(1) did not adequately inform themselves as to [the CEO's] role in forcing the 'sale' of the Company and in establishing the per share purchase price; (2) were uninformed as to the intrinsic value of the Company; and (3) given these circumstances, at a minimum, were grossly negligent in approving the 'sale' of the Company upon two hours' consideration, without prior notice, and without the exigency of a crisis or emergency." Id. at 873. The Van Gorkam decision established a "gross negligence" standard for directors in the duty of care context. See id. ("We think the concept of gross negligence is also the proper standard for determining whether a business judgment reached by a board of directors was an informed one.").

Brehm v. Eisner (In re Walt Disney Co. Derivative Lit.), 906 A.2d 27 (Del. 2006)

In Brehm v. Eisner, a group of Disney shareholders challenged the Disney board's decision to pay former President Michael Ovitz \$130 million in severance pursuant to an employment contract after Ovitz had worked for the Company for only 14 months. The plaintiff shareholders claimed that the severance payment was the product of a breach of the directors' duty of care. The Delaware Supreme Court affirmed the Chancery Court's finding that the directors were disinterested and that their decisions with respect to Ovitz were protected by the business judgment rule.

Corporate Waste. The plaintiffs in Brehm v. Eisner also claimed that, even if the business judgment rule could not be rebutted, the Disney directors were still liable for corporate waste. See Brehm, 906 A.2d at 73-74 ("[a] plaintiff who fails to rebut the business judgment rule presumptions is not entitled to any remedy unless the transaction constitutes waste."). To prove a claim for corporate waste, "plaintiffs must shoulder the burden of proving that the exchange was 'so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration.'" Id. "A claim of waste will arise only in the rare, 'unconscionable case where directors irrationally squander or give away corporate assets.' This onerous standard for waste is a corollary of the proposition that where business judgment presumptions are applicable, the board's decision will be upheld unless it cannot be 'attributed to any rational business purpose.'"

Id. (citing Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1995)). In Brehm v. Eisner, the Delaware Supreme Court affirmed the ruling of the Chancery Court that the Disney Plaintiffs could not satisfy this high standard.

2. Failure of Oversight Claims

In re Caremark Int'l, Inc. Derivative Lit., 698 A.2d 959, 967 (Del. Ch. 1996)

Claims against directors for breaches of the duty of care may also take the form of "failure to monitor" claims. In Caremark, a plaintiff-shareholder brought suit against the board of directors of Caremark alleging that the directors had breached their fiduciary duty of care by failing to detect actions on the part of company employees that gave rise to substantial corporate liability. *Id.* The court ultimately approved the settlement, but observed in its opinion that, as a part of their duty of care, directors are required to make a good faith attempt to ensure that "information and reporting systems exist in the organization that are reasonably designed to provide senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance" and that "failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards." *Id.* at 969-70. Still, a claim for breach of the duty of care based on a "failure to monitor" theory "is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment." In re Caremark Int'l, Inc. Derivative Lit., 698 A.2d 959, 967 (Del. Ch. 1996); Guttman v. Jen-Hsun Huang, 823 A.2d 492, 505-06 (Del. Ch. 2003) (noting that "[a] Caremark claim is a difficult one to prove"); see also Rattner v. Bidzos, 2003 Del. Ch. LEXIS 103, *44 (Sept. 30, 2003); Gagliardi v. TriFoods Int'l Inc., 683 A.2d 1049 (Del. Ch. 1996).

Subsequent Delaware courts have found Caremark to stand for the proposition that "[i]n the typical [failure to monitor] case, 'in order to hold the directors liable, [a] plaintiff will have to demonstrate that they were *grossly negligent* in failing to supervise [their] subordinates.'" See Rattner v. Bidzos, 2003 Del. Ch. LEXIS 103, *44 (Sept. 30, 2003) (emphasis added). The Caremark decision has

also been interpreted by subsequent Delaware courts as “premis[ing] liability on a showing that the directors were conscious of the fact that they were not doing their jobs.” Guttman, 823 A.2d at 506. Some commentators have suggested that the standard of care described in Caremark may be even higher than gross negligence. See John L. Reed and Matt Neiderman, Good Faith and the Ability of Directors To Assert § 102(b)(7) of the Delaware General Corporation Law as a Defense to Claims Alleging Abdication, Lack of Oversight, and Similar Breaches of Fiduciary Duty, 29 DEL. J. CORP. L. 111, 131 (2004). In any event, shareholder claims against directors for breaches of the duty of care for failure to monitor corporate activities appear to require a showing of “knowing and deliberate indifference to a potential risk of harm” to the corporation and/or a systematic and sustained lack of oversight. See Caremark, 698 A.2d at 971; In re Walt Disney Corp. Derivative Lit., 825 A.2d 275 (Del. Ch. 2003).

B. Breach of Fiduciary Duty: Duty of Loyalty

1. Dual Directorships

Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983)

Plaintiff’s claims arose when The Signal Companies, Inc., which was 50.5% owner of UOP, Inc., acquired the remaining shares of UOP by merger transaction. The merger consideration included the payment of \$21 cash per share to the minority shareholders of UOP for their shares. A minority shareholder, on behalf of a class of all UOP shareholders who had not exchanged their shares for the merger consideration, attacked the validity of the merger and sought to set the merger aside, or in the alternative, an award of monetary damages. The Chancery Court found that the merger was entirely fair, but the Delaware Supreme Court reversed and held that merger did not meet the test of entire fairness. The primary reason supporting a lack of fairness was that a feasibility study prepared by two of UOP’s directors, who were also directors of Signal, indicated that Signal believed a price of \$24 per share would be a “good investment” for Signal. This information had not been disclosed to UOP’s other directors, and the two individuals with cross directorships failed to disclose their conflict of interest. The Court held: “The requirement of fairness is unflinching in its demand that where one stands on both sides of a transaction, he has the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts. . . . There is no dilution of

this obligation where one holds dual or multiple directorships, as in a parent-sub subsidiary context. . . Thus, individuals who act in a dual capacity as directors of two corporations, one of whom is parent and the other subsidiary, owe the same duty of good management to both corporations, and in the absence of an independent negotiating structure . . . , or the directors' total abstention from any participation in the matter, this duty is to be exercised in light of what is best for both companies." Weinberger, 457 A.2d. at 710-11.

2. Transactions For Personal Benefit

"A transaction is interested where directors appear on both sides of a transaction or expect to derive a financial benefit from it that does not 'devolve [] upon the corporation or all shareholders generally.' This personal benefit must be so significant that it is 'improbable that the director could perform her fiduciary duties . . . without being influenced by her overriding personal interest.'" Pfeffer v. Redstone, 965 A.2d 676 (Del. 2009).

Chaffin v. GNI Group, Inc., 1999 Del. Ch. LEXIS 182 (Del. Ch. Sep. 3, 1999)

Plaintiffs, former shareholders of GNI Group, Inc., sued the former directors of GNI for breach of their fiduciary duties of loyalty and care after the directors voted to approve a merger where one director, and the son of another, would continue in their management positions and (unlike the other shareholders) would have an equity interest in the post-merger entity as well as other benefits. Defendants moved to dismiss the complaint. The court denied the motion to dismiss, finding that the complaint stated a claim for breach of the duty of loyalty because the merger had not been approved by a majority of disinterested directors.

3. Usurpation of corporate opportunity

Yiannatsis v. Stephanis by Sterianou, 653 A.2d 275 (Del. 1995)

Pursuant to a shareholder agreement, Sunview Corporation had a right of first refusal to purchase a shareholder's stock upon the shareholder's death. When a shareholder died, the stock was offered to Sunview but the directors declined to purchase the stock on the basis that the corporation did not have sufficient funds.

After the corporation declined the opportunity, one of the directors then purchased the stock for the same price that had been offered to the corporation. A shareholder sued, arguing that the directors had usurped a corporate opportunity.

Citing Guth v. Loft, Inc., 5 A.2d 503 (Del. Ch. 1939), the Court observed that a corporate opportunity is usurped in the following circumstance:

If there is presented to a corporate officer or director a business opportunity which the corporation is financially able to undertake, is . . . in the line of the corporation's business and is of practical advantage to it, is one in which the corporation has an interest or a reasonable expectancy, and, by embracing the opportunity, the self-interest of the officer or director will be brought into conflict with that of his corporation . . .

The Chancery court found that the corporation was not insolvent and could have availed itself of the opportunity to purchase the stock. The Court further found that Sunview's opportunity to purchase the stock was never properly presented to Sunview and that the directors had acted without regard to the shareholder agreement or the fiduciary duties owed to the other shareholders. Accordingly, the Chancery Court found that the directors had breached their fiduciary duty by failing to properly present the opportunity to the corporation and by diverting the opportunity to themselves. The Delaware Supreme Court affirmed.

Mid-South States provide for a similar cause of action. See, e.g., Parks v. Multimedia Technologies, Inc., 239 Ga. App. 282, 288-89, 520 S.E.2d 517, 524 (Ga. Ct. App. 1999) ("[I]f there is presented to a corporate officer or director a business opportunity which the corporation is financially able to undertake, is, from its nature, in the line of the corporation's business and is of practical advantage to it, is one in which the corporation has an interest or a reasonable expectancy, and, by embracing the opportunity, the self-interest of the officer or director will be brought into conflict with that of his corporation, the law will not permit him to seize the opportunity for himself.").

4. Entrenchment

“Under normal circumstances, directors’ actions are protected by the business judgment rule. In order to rebut the business judgment rule, ‘a successful claim of entrenchment requires plaintiffs to prove that the defendant directors engaged in actions which had the effect of protecting their tenure and that the action was motivated primarily or solely for the purpose of achieving that goal.’” In re Fuqua Indus., Inc., 2005 Del. Ch. LEXIS 60, *13 (May 6, 2005).

Cal. Pub. Emples. Ret. Sys. v. Coulter, 2002 Del. Ch. LEXIS 144 (Del. Ch. Dec. 18, 2002)

Shareholder stated a claim for entrenchment where the Complaint alleged that the board of directors of Lone Star Steakhouse & Saloon, Inc. approved generous golden parachute agreements for certain officers and directors, which would be triggered by any change in control, in response to a potential takeover threat. The Court found that directors are “presumptively ‘interested’ in such actions taken for entrenchment purposes,” causing the Court to excuse the demand requirement of Court of Chancery Rule 23.1, which requires plaintiffs to make demand on a board before asserting derivative claims (or otherwise plead facts supporting the conclusion that demand is excused).

5. Defensive measures

Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985)

A minority shareholder of Unocal who made a hostile tender offer for the company’s stock filed a complaint to challenge a board’s decision to effect a defensive self-tender offer by the corporation for its own shares. The Court found that when a board implements anti-takeover measures, there arises “the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders.” Unocal, 493 A.2d at 954. “If a defensive measure is to come within the ambit of the business judgment rule, it must be reasonable in relation to the threat posed.” Id. at 955. See also Revlon, Inc. v. Macandrews & Forbes Holdings, Inc., 506 A.2d 173, 181 (Del. 1985) (“This potential for conflict places upon the directors the burden of proving that they had reasonable grounds for believing there was a

danger to corporate policy and effectiveness, a burden satisfied by a showing of good faith and reasonable investigation. In addition, the directors must analyze the nature of the takeover and its effect on the corporation in order to ensure balance – that the responsive action taken is reasonable in relation to the threat posed.”) In Unocal, the Court found that “given the nature of the threat posed here the [director’s defensive] response is neither unlawful nor unreasonable.” Unocal, 493 A.2d at 947.

6. Sale of the Company

Revlon, Inc. v. Macandrews & Forbes Holdings, Inc., 506 A.2d 173, 181 (Del. 1985)

When the board has determined to sell the company, the “board’s primary duty becomes that of an auctioneer responsible for selling the company to the highest bidder.” Revlon, 506 A.2d at 184. Accordingly, where a board of directors approved defensive measures which had the effect of ending an active auction and foreclosing further bidding to the detriment of the shareholders, the directors’ action was not entitled to the deference of the business judgment rule.

C. Common Defenses to Claims against Directors and Officers

1. Demand

Chancery Court Rule 23.1 governs derivative suits in Delaware. Rule 23.1 requires that “the complaint . . . allege with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors or comparable authority and the reasons for the plaintiff’s failure to obtain the action or for not making the effort.” (emphasis supplied). This pleading standard is “factually intensive” and requires “director-by-director analysis.” Postorivo v. AG Paintball Holdings, Inc., 2008 LEXIS 29, *18-19 (Del. Ch. Feb. 29, 2008). “Conclusory, across-the-board allegations of a lack of independence will not prevail; allegations of this type are akin to the ‘shorthand shibboleth’ which this Court has long-rejected.” Khanna v. McMinn, 2006 LEXIS 86, *55 (Del. Ch. May 9, 2006). Where “the Complaint . . . restates the standard for demand futility, making generalized allegations regarding most if not all directors, without any particularized factual support,” the

complaint must be dismissed for failure to plead demand with sufficient particularity. Postorivo, 2008 LEXIS 29 at *23. Demand may be excused, however, whether the plaintiff pleads facts demonstrating that a majority of the board is so self-interested that demand would be futile. See Rales v. Blasband, 634 A.2d 927 (Del 1991).

The Mid-South States have similar demand requirements. For example, in Alabama, a shareholder must make pre-suit demand on the corporation prior to bringing a derivative claim. James v. James, 768 So.2d 356, 360 (Ala. 2000). In Alabama, the demand requirement can be excused by pleading facts showing that “there is such a degree of antagonism between the directors and the corporate interest that the directors would be incapable of performing their duty.” Elgin v. Alfa Corp., 598 So.2d 807, 814 (Ala. 1992). However, other Mid-South States do not allow demand to be excused. See, e.g., Speetjens v. Malaco Inc., 929 So. 2d 303, 309 (Miss. 2006) (“Mississippi’s written demand statute does not contain an exception for futility, and unless and until the Legislature decides to include one, it does not exist.”).

2. Safe Harbor

For interested-party transactions, Delaware law provides a safe harbor from liability where (1) the material facts of the director or officer’s interest is disclosed and a majority of the disinterested directors approves the transaction in good faith; or (2) the material facts of the director or officer’s interest is disclosed and a majority of the stockholders approves the transaction in good faith; or (3) the contract or transaction is fair to the corporation as of the time it is approved. 8 DGCL § 144.

Other states provide similar safe harbors. See, e.g., Ga. Code Ann. § 14-2-861(b); Fisher v. State Mut. Ins. Co., 290 F.3d 1256, 1260-61 (11th Cir. 2002).

3. Exculpatory Charter Provisions

Most states permit exculpatory charter provisions which shield corporate directors from liability for breaches of the duty of care (but not breaches of the duty of loyalty or good faith).

Example: 8 Del. Code § 102(b)(7):

§ 102. Contents of the certificate of incorporation.

. . . (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. . . .

C.f. Tenn. Code Ann. § 48-12-102(b): The [corporate] charter may set forth:

(3) A provision eliminating or limiting the personal liability of a director to the corporation or its shareholders 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:

- (A) For any breach of the director's duty of loyalty to the corporation or its shareholders;
- (B) For acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; or
- (C) For [liability for unlawful distributions].

4. Indemnification

Certificates of incorporation can also provide for the corporation to advance legal fees to directors and officers in the event that they are sued individually. These provisions are generally enforceable, even where the corporation files

suit against its former directors or officers. See Barrett v. Amer. Country Holdings, Inc., 951 A.2d 735 (Del. Ch. Ct. 2008) (calling plaintiff corporation's argument that it was not required advance fees to former officers and directors "outlandish").

III. Shifting/Heightened Duties in the "Zone of Insolvency"?

A. Directors' Fiduciary Duties to Creditors – Evolution of the Case Law

Following a 1991 decision by the Delaware Chancery Court in the case of Credit Lyonnais Bank, Nederland, N.V. v. MGM-Pathe Communications Co., 1991 Del. Ch. LEXIS 215 (Dec. 31, 1991) ("*Credit Lyonnais*"), some Courts began to hold that a directors' fiduciary duties to shareholders shift to the corporation's creditors when a corporation entered into the "zone of insolvency." See, e.g., Official Comm. Of Unsecured Creditors of Buckhead Am. Corp. v. Reliance Capital Corp. (In re Buckhead Am. Corp.), 178 B.R. 956, 968-69) (D. Del. 1994). Despite this trend, in recent years the Delaware Courts have made clear that creditors are not entitled to sue directors for a breach of fiduciary duty unless such a claim is brought derivatively on behalf of the corporation after the corporation has become insolvent.

1. Credit Lyonnais

The notion that a director's fiduciary duties might shift to a corporation's creditors when the corporation approaches insolvency was first introduced by the Delaware Chancery Court in the Court's 1991 decision in Credit Lyonnais. In Credit Lyonnais, the Delaware Court noted:

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.

Id. at 108. Then, in the "now-famous footnote fifty-five" of Credit Lyonnais, the Court went on to explain that there were some circumstances in which the directors' duties might not be owed exclusively to the shareholders:

The possibility of insolvency can do curious things to incentives, exposing creditors to a risk of opportunistic behavior and creating complexities for directors. . . . [I]n

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 108 n.55.

After Credit Lyonnais, some courts began to suggest that corporate directors might owe a fiduciary duty to creditors once the business entered into the “zone of insolvency.” See, e.g., Buckhead Am. Corp., 178 B.R. 956, 968-69 (D. Del. 1994) (denying motion to dismiss fiduciary duty claims by creditors where the court found that company was within the zone of insolvency); Weaver v. Kellogg, 216 B.R. 563, 582-84 (S.D. Tex. 1997) (denying motion to dismiss Chapter 11 trustee’s claim because directors might owe fiduciary duties to creditors if the corporation was in the “vicinity of insolvency” and the determination of those duties was a question of fact). The “zone of insolvency” also became a topic of debate among academics, many of whom argued that directors’ fiduciary duties should shift to creditors when a corporation enters into the zone of insolvency. See, e.g., Royce de R. Barondes, Fiduciary Duties of Officers and Directors of Distressed Corporations, 7 Geo. Mason L. Rev. 45, 66-71 (1998) (arguing that Credit Lyonnais should be read to create rights that are “affirmatively enforceable by creditors” against directors of companies in the vicinity of insolvency).

2. Production Resources

In 2004, the Delaware Chancery Court revisited the language in Credit Lyonnais in the case of Production Resources Group, LLC v. NCT Group, Inc., 863 A.2d 772 (Del. Ch. 2004). Production Resources involved a claim for breach of fiduciary duty brought by Production Resources Group (“PRG”), a creditor of defendant NCT Group, Inc. (“NCT”), against NCT’s directors and officers. Production Resources, 863 A.2d at 775. Because NCT was insolvent, PRG claimed that it was entitled to press its claims for breach of fiduciary duty as direct claims against NCT’s directors and officers. Id.

In considering whether PRG could maintain a direct action for breach of fiduciary duty, the Court observed that creditors “[t]ypically . . . may

not allege fiduciary duty claims against corporate directors.” Id. at 787. The Court explained:

It is presumed that creditors are capable of protecting themselves through the contractual agreements that govern their relationships with 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.

Id. The Court then turned to a discussion of the Credit Lyonnais decision and, in particular, footnote 55:

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 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 fiduciary duty claims, but to expose directors to a new set of fiduciary duty claims, this time by creditors. . . .

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. 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. 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.

Id. at 788. In footnote 57 of the opinion, the Production Resources Court further explained why the interpretation of Credit Lyonnais adopted by some Courts was incorrect:

. . . .[W]hen a firm is insolvent, creditors do not become residual claimants with interests entirely identical to stockholders, they simply become the class of constituents with the key claim to the firm's remaining assets. . . . Because creditors have no interest beyond the debts owed to them, they have no incentive (and much to risk) by encouraging business strategies that would risk the payment of the bulk of their claims but provide some hope that the firm's value will increase to the level at which there could be a return for the equity. It is for this reason that Chancellor Allen's Credit Lyonnais decision emphasized the duties of the directors to the firm and their duty to responsibly maximize its value, a duty that might require pursuing a strategy that neither the stockholders nor the creditors would prefer. When a firm is insolvent or near insolvency, the interests of the stockholders and creditors can be starkly divergent, with the stockholders preferring highly risky strategies that creditors would eschew. . . . Despite this divergence, I doubt the wisdom of a judicial endeavor to second-guess good-faith director conduct in the so-called zone [of insolvency]. Although it is easy to posit extreme hypotheticals involving directors putting cash in slot machines, the real world is more likely to generate situations when directors face a difficult choice between pursuit of a plausible, but risky, business strategy that might increase the firm's value to the level that equity holders will receive value, and another course guaranteeing no return for equity but preservation of value for creditors. Absent self dealing or other evidence of

bad faith, by what measure is a court fairly to critique the choice made through an award of damages? My reluctance to go down that road is also influenced by the reality that creditors are not monolithic and that different classes of creditors might have risk preferences that are greatly disparate, with some having interests more like stockholders.

Id. at 790 n.57.

The Production Resources Court also identified numerous practical problems with allowing creditors to assert breach of fiduciary duty claims based on actions taken by a board of directors when a corporation was in the zone of insolvency. First, the Court observed that “[i]f creditors have standing to bring derivative claims in the ‘zone of insolvency,’ they will share that standing with stockholders, leading to the possibility of derivative suits by two sets of plaintiffs with starkly different conceptions of what is best for the firm.” Id. at n.56. Second, the Court also expressed concern about the difficulty in defining the “zone of insolvency,” since “it is not always easy to determine whether a company even meets the test for solvency.” Id. (citing Keystone Fuel Oil v. Del-Way Petroleum Co., 1977 Del. Ch. LEXIS 181 (Del. Ch. Jun. 16, 1977)). The Court found that “[g]oing further and recognizing standing for creditors to bring fiduciary duty claims when a company is in the zone of insolvency would logically require [a] court to allow creditors standing if the complaint pleads facts that, if true, suggests that company is within some imprecise and hard-to-define vicinity of insolvency. This means that creditors will be able to get discovery in situations when it is ultimately determined that the relevant company was not only solvent, but never even within the so-called zone of insolvency.” See id. Accordingly, the Court disapproved of the right of creditors to assert claims for breach of fiduciary duty based on director decisions made while the company was in the “zone of insolvency.”

The Production Resources Court then turned to the question of whether a creditor could pursue a direct claim alleging breach of fiduciary duty against directors *after* the corporation became insolvent. Id. at 791. Ultimately, the Court found that “[t]he 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.” Id. at 792. Rather, the later fact of insolvency “simply changes the class of those eligible to press the claim derivatively, by expanding it to include creditors.” Id.

3. **Gheewalla**

In the May 2007 case of N. American Catholic Educ. Programming Foundation, Inc. v. Gheewalla, 930 A.2d 92 (Del. 2007), the Delaware Supreme Court weighed in on the “zone of insolvency” issue and largely adopted the analysis of the Production Resources Court. In Gheewalla, the Delaware Supreme Court stated:

In this case, the need for providing directors with definitive guidance compels us to hold that no direct claim for breach of fiduciary duties may be asserted by the creditors of a solvent corporation that is operating in the zone of insolvency. When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners.

Id. at 101. The Court continued, however, and also held that direct claims for breach of fiduciary duty may not be asserted by creditors even when a corporation has crossed the threshold into insolvency:

When a corporation is *insolvent*, however, its creditors take the place of the shareholders as the residual beneficiaries of any increase in value. Consequently, the creditors of an *insolvent* corporation have standing to maintain derivative claims against directors on behalf of the corporation for breaches of fiduciary duties. The corporation’s insolvency makes the creditors the principal constituency injured by any fiduciary breaches that diminish the firm’s value. Therefore, equitable considerations give creditors standing to pursue derivative claims against the directors of an insolvent corporation. Individual creditors of an insolvent corporation have the same incentive to pursue valid derivative claims on its behalf that shareholders have when the corporation is solvent.

. . . . To date, the Court of Chancery has never recognized that a creditor has the right to assert a *direct* claim for breach of fiduciary duty against the directors of an *insolvent* corporation. However, prior to this opinion, that possibility remained an open question because of the “arguendo assumption” in this case and the *dicta* in Production

Resources and Big Lots Stores. . . . 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 fiduciary duty claims against those directors would create a conflict between those directors' duty to maximize the value of the insolvent corporation for the benefit of all those having an interest in it, and the newly recognized direct fiduciary duty to 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 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 nonfiduciary claim. . .**

Id. at 102-03 (emphasis added).

Accordingly, under Delaware law, a corporate director's fiduciary duties do not change once a corporation enters into the "zone of insolvency." Gheewalla, 930 A.2d at 101. Rather, once a corporation enters into the zone of insolvency, directors are permitted to take into account the interests of other stakeholders, including creditors, when making decisions. See Production Resources, 863 A.2d at 788. Furthermore, the zone of insolvency does not confer standing upon creditors to challenge the business decisions of directors as a breach of fiduciary duty. Gheewalla, 930 A.2d at 101. Rather, once a company becomes insolvent, the creditors have standing to maintain a derivative claim against the directors on behalf of the corporation for breaches of fiduciary duties owed to the corporation. Id. at 102-03. This is because at the point of insolvency, the creditors stand in the shoes of the shareholders as the residual interest holders of the corporation. See Schoon v. Smith, 2008 Del. LEXIS 67, at *31 n.46 (Del. Feb. 12, 2008) ("Gheewalla confers standing upon creditors to bring a derivative action where the corporation is insolvent, but only because the shareholders of an insolvent corporation no longer have an economic interest in the corporate entity--only its creditors have that interest. Only for that reason and in that context does

Gheewalla permit creditors to stand in the shoes of the shareholders.”).

B. Heightened Fiduciary Duties in the Zone of Insolvency?

Bridgeport Holdings

At least one recent decision out of the Delaware Bankruptcy Court suggests that directors of a corporation that has entered into the “zone of insolvency” need to exercise special diligence if they want to ensure that their actions will be afforded the protections of the business judgment rule. In Bridgeport Holdings Inc. Liquidating Trust v. Boyer (In re Bridgeport Holdings Inc.), 388 B.R. 548 (Bankr. D. Del. 2008), a liquidating trust asserted several claims against the debtor corporation’s former directors and officers, alleging that the directors breached their fiduciary duties of loyalty and care by rushing to sell the company’s assets, failing to consider potential strategic alternatives, and abdicating their decision-making authority to one of the corporation’s officers, all of which resulted in a “fire sale” of the company’s assets on the eve of bankruptcy. Id. at 554 – 559. The directors and officers filed a motion to dismiss the trust’s claims, arguing, among other things, that (1) the duty of loyalty claims should be dismissed because there was no allegation that the directors were not disinterested or acted out of self-interest; and (2) the duty of care claims should be dismissed because the corporation’s certificate of incorporation contained an exculpatory charter provision. Id. at 563 – 70. The Court denied the motion on both counts.

First, with respect to the duty of loyalty claims, the Court found that allegations of self-dealing were not necessary to sustain a duty of loyalty claim. Rather, the Court found that duty of loyalty claims could be sustained where directors failed to act in good faith. Specifically, the Court found that “[a] fiduciary acts in bad faith when, among other things, he takes or fails to take any action that demonstrates a ‘faithlessness or lack of true devotion to the interests of the corporation and its shareholders.’” Id. at 564 (citing Ryan v. Gifford, 918 A.2d 341, 357 (Del. Ch. 2007)). Because the plaintiff had pled facts supporting the claim that the directors “failed to act in good faith by abdicating crucial decision-making authority” to the Chief Operating Officer (who was an Alix Partners consultant) and then “fail[ed] adequately to monitor his execution of a ‘sell strategy,’ resulting in an abbreviated an uninformed sale process,” the Court denied the directors’ motion to dismiss the Plaintiff’s duty of loyalty claims.

Second, with respect to the trust’s duty of care claims, the Court found that neither the exculpatory charter provision nor the business judgment

rule compelled dismissal of the duty of care claims. In particular, the Court held that where a “duty-of-loyalty claim remains . . . the due-care claim is not defeated by [an exculpatory charter provision under] Section 102(b)(7).” Importantly, therefore, the Court found that an exculpatory charter provision will not necessarily shelter directors from liability for a breach of the duty of care where the facts indicate that the directors may have also breached their duty of loyalty by failing to act in good faith or otherwise.

The Court also refused to dismiss plaintiff’s claims on the basis of the business judgment rule. Citing *McMullin v. Beran*, 765 A.2d 910, 918 (Del. 2000), the Court found that “[t]he business judgment rule is rebutted if the plaintiff shows that the directors failed to exercise due care in informing themselves before making their decision.” *Id.* at 571. Because the trust had adequately pled fact to support the conclusion that the directors had failed to adequately inform themselves about the transaction and about other potential alternatives before rushing to the sale process, the Court refused to dismiss the duty of care claims on the basis of the business judgment rule. The Court found further that “[t]he imposition of time constraints on a board’s decision-making process may compromise the integrity of its deliberative process.” *Id.*

The *Bridgeport Holdings* case suggests that directors of companies within the “zone of insolvency” must take special care to ensure that their decisions are reasonable, deliberate and informed. In addition, the case also demonstrates that a failure to act or a delegation of duties that rises to the level of an abdication of decision making authority may vitiate the protection of the business judgment rule.

i. Recent Developments on Director Duties in the “Zone of Insolvency”

Sanford v. Waugh & Co., 328 S.W.3d 836 (Tenn. 2010)

In *Waugh*, a creditor sued the directors and officers of an insolvent Tennessee corporation for breach of fiduciary duty in connection with the company’s failure to comply with the terms of a stock sale agreement that required the company to make monthly installment payments to the creditor. The Tennessee Supreme Court directly addressed the question of “whether an individual creditor of an insolvent corporation may assert a direct claim for breach of fiduciary duty against the corporation’s officers and directors.” Adopting the reasoning of the Delaware Supreme Court’s *Gheewalla* decision, the Tennessee Supreme Court held that “individual creditors of an insolvent corporation have no right to assert direct claims

for breach of fiduciary duty against corporate officers and/or directors.” Waugh, 328 S.W.2d at 847. The Court found that the creditor’s rights were adequately protected by his contractual and security agreements with the debtor, the implied covenant of good faith and fair dealing, federal bankruptcy law, Tennessee’s version of the Uniform Fraudulent Transfers Act, and the trust fund doctrine. Id.

IV. Claims Against Directors & Officers of a Corporation in Bankruptcy

A. Types of claims that may arise

- 1. Breach of Fiduciary Duty**
- 2. Aiding and Abetting Breach of Fiduciary Duty**
- 3. Avoidance – e.g., 11 U.S.C. §§ 544(b), 547, 548, etc.**
- 4. Equitable subordination**
- 5. Securities claims – e.g., § 10(b), Rule 10b-5**
- 6. Unjust enrichment**

Official Committee of Unsecured Creditors of Hechinger Investment Co. v. Fleet Retail Finance Group (In re Hechinger Investment Co.), 274 B.R. 71 (D. Del. 2002)

A state law unjust enrichment claim cannot be used to circumvent the protections afforded by Section 546 of the Bankruptcy Code.

- 7. “Deepening Insolvency”**

“Deepening insolvency” is a cause of action based on the fraudulent prolongation of a corporation’s life beyond insolvency, resulting in injury to the corporation caused by increased debt. See Schacht v. Brown, 711 F.2d 1343, 1350 (7th Cir.), cert. denied, 464 U.S. 1002 (1983). Courts have disagreed on whether “deepening insolvency” is a viable theory.

Limor v. Buerger, et al. (In re Del-Met Corp.), 322 B.R. 781 (Bankr. M.D. Tenn. 2005)

Debtor was an automotive parts supplier. Plaintiff Chapter 7 Trustee sued the debtor’s three largest customers (the “Controlling

Customers”) as well as certain outside professionals of the debtor. Among other claims, the Trustee asserted claims for breach of fiduciary duty in connection with “deepening insolvency” of the debtor, on the grounds that the defendants had effectively taken over control of the company and operated for the benefit of the Controlling Customers without regard to the impact on the Debtor or its creditors. While the Trustee initially argued that her “deepening insolvency” claim was simply a claim for breach of fiduciary duty and not an independent tort, the Trustee later urged the Court to adopt the tort of “deepening insolvency” under Tennessee Law.

The Defendants moved to dismiss the “deepening insolvency” claim. In the absence of any Tennessee authority on the issue, the Court looked to the law of other states, including Delaware, New York, and Pennsylvania. The Court found that there was growing acceptance of the “deepening insolvency” theory and that “[g]rowing of the deepening insolvency theory confirms its soundness.” Ultimately, the Court determined that “if presented with compelling facts, the Tennessee Supreme Court would recognize deepening insolvency as an actionable breach of a duty to a corporation.” Accordingly, the Court denied the Defendants’ motion to dismiss the Trustee’s deepening insolvency claim.

Trenwick America Litig. Trust v. Ernst & Young LLP, 906 A.2d 168 (Del. Ch. 2006)

The Trenwick Group, Inc. and affiliates (“Trenwick”) filed for chapter 11 bankruptcy, and a plan was confirmed that created a Litigation Trust to hold the remaining assets of the Debtors. The Litigation Trust asserted claims against Trenwick’s former directors, alleging that Trenwick’s board had engaged in an imprudent business strategy resulting in the company’s bankruptcy. Among the claims asserted by the Trust was a claim under the theory of “deepening insolvency.” The Trust alleged that Trenwick’s former directors had “color[ed] [the Debtors] an even deeper shade of red” by increasing Trenwick’s debt in connection with an acquisition that had occurred shortly before bankruptcy.

The Delaware Chancery Court refused to recognize a cause of action for “deepening insolvency,” explaining that the term “does not express a coherent concept.” The Court found that Delaware law does not impose an “absolute obligation on the board of a company that is unable to pay its bills to cease operations and to

liquidate". Rather, the directors' duties continue to be to pursue in good faith strategies to maximize the value of the company.

Official Comm. of Uns. Cred. of Propex Inc. v. PNB Paribas (In re Propex Inc.), 415 B.R. 321 (Bankr. E.D. Tenn. 2009)

Citing Trenwick and other recent cases, the Bankruptcy Court for the Eastern District of Tennessee found that "a growing number of courts regard deepening insolvency with skepticism." The Court found that "Tennessee courts appear to be careful about pronouncing the arrival of new legal doctrine, where the policy it represents is still actively debated and would have policy consequences. . . . The current state of affairs with regard to deepening insolvency, as the court sees it, is that the theory is still obscure and difficult to distinguish from existing torts, that it duplicates existing legal remedies, and that much scholarly and judicial opinion has recently turned against it." The Court therefore concluded that "Tennessee courts would probably not spring forward to embrace" a new cause of action for deepening insolvency. Accordingly, the court dismissed the deepening insolvency claim.

Heard v. Perkins, 441 B.R. 701 (N.D. Ala. 2010)

In Heard, the trustee of a Chapter 11 debtor alleged that the debtor's chief executive officer and 99.9% shareholder breached his fiduciary duties by continuing to pursue a failed business strategy. Though Georgia law controlled the case, the Northern District of Alabama recognized that no Georgia law was directly on point. Accordingly, the Court looked to In re Far & Wide Corp., 378 Fed.Appx. 890 (11th Cir. 2010) (applying Florida and Delaware law). In re Far & Wide Corp. concluded that the debtors could not maintain claims against their former directors premised on the allegations that the former directors managed the debtors for the benefit of a majority shareholder, rather than preserving value for the debtors' creditors – the Eleventh Circuit characterized this as an impermissible "deepening insolvency" claim. Heard, 441 B.R. at 710. Based on In re Far & Wide Corp., the Heard court held that pursuing a "failed business strategy" was a recasting of a "deepening insolvency" claim and could not be maintained under Georgia law.

Official Comm. of Unsec. Cred. v. Baldwin (In re Lemington Home for the Aged), 2011 U.S. App. LEXIS 19312 (3d Cir. Sept. 21, 2011)

The Lemington Home for the Aged (“Lemington”) provided elder care services in Pennsylvania. Lemington had a history of significant management problems, including a lack of business and accounting records and a lack of meaningful oversight by management and the board. Prior to filing bankruptcy, Lemington’s board discussed a plan to transfer Lemington’s principal charitable asset, a fund held by an outside foundation, to an affiliated entity. Some of Lemington’s board members were also on the board of the transferee.

After Lemington filed a Chapter 11 case, the Bankruptcy Court authorized Lemington’s unsecured creditors’ committee to pursue claims against the board’s officers and directors. In addition to suing for breach of fiduciary duty, the creditors’ committee also asserted a claim for deepening insolvency. The Third Circuit found that, while a cause of action for deepening insolvency “has not been formally recognized by Pennsylvania state courts”, the Third Circuit “has found that ‘the Pennsylvania Supreme Court would determine that ‘deepening insolvency’ may give rise to a cognizable injury.” The Third Circuit found that, under Pennsylvania law, deepening insolvency is “defined as an injury to [a debtor’s] corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life.” The Court further found that “for such a claim to succeed, it is necessary to demonstrate that the directors’ actions caused the deepening of insolvency . . . [, that] fraud is necessary to support [the claim], and that ‘a claim of negligence cannot sustain a deepening insolvency cause of action.” In Lemington, the Third Circuit found that there was a genuine issue of material fact as to whether the directors and officers fraudulently contributed to deepening the insolvency of Lemington, and therefore declined to grant the directors’ and officers’ motion for summary judgment.

B. Standing Issues: Who is entitled to assert/pursue claims against directors of a corporation in bankruptcy?

1. Statutory Claims under the Bankruptcy Code

Avoidance claims derived from Code provisions which provide that the “trustee may” avoid and recover may only be brought by the

trustee. (E.g., claims under 11 U.S.C. §544(b); preference actions under § 547, and fraudulent transfers under § 548)

Exception: A creditor or creditors' committee may obtain permission from the bankruptcy court to pursue a claim derivatively on behalf of the bankruptcy estate if: (1) a demand was made on the trustee (or debtor-in-possession) to act; (2) the trustee (or debtor-in-possession) declined; (3) a colorable claim exists that would benefit the estate; and (4) the trustee's (or debtor-in-possession's) inaction was an abuse of discretion. Hyundai Translead, Inc. v. Jackson Truck & Trailer Repair, Inc. (In re Trailer Source, Inc.), 555 F.3d 231, 244-45 (6th Cir. 2009) (citing Canadian Pacific Forest Products, Ltd. v. J.D. Irving, Ltd. (In re The Gibson Group, Inc.), 66 F.3d 1436 (6th Cir. 1995)).

2. Absent a grant of derivative standing, the Trustee / Debtor-in-Possession has the sole right to control claims that are property of the bankruptcy estate.

Recent examples:

Deep Marine Holdings, Inc. v. FLI Deep Marine LLC (In re Deep Marine Holdings, Inc.), 2011 Bankr. LEXIS 2330 (Bankr. S.D. Tex. Jun. 13, 2011)

Minority shareholders of Deep Marine Holdings ("DMH") sued DMH's officers, directors, and controlling shareholders in Delaware state court for breaches of fiduciary duty, unjust enrichment, aiding and abetting breaches of fiduciary duty, fraud, and wrongful equity dilution (the "Delaware Actions"). DMH and affiliates (the "Debtors") subsequently filed bankruptcy. The Debtors, operating as Debtors-in-possession, then initiated an adversary proceeding against the minority shareholders seeking an injunction enjoining them from pursuing the Delaware Actions or taking any action to obtain possession or exercise control over property of the estate. On summary judgment, the Court found that the several of the minority shareholders' causes of action were derivative in nature because they alleged harm to the Debtor corporations rather than uniquely to the minority shareholders. Because these claims were derivative, they belonged to the bankruptcy estate. Accordingly, the Court granted the Debtors' motion for summary judgment in part and enjoined the minority shareholders from pursuing the derivative claims.

In re Mercedes Homes, 431 B.R. 869 (Bankr. S.D. Fla. Sep. 18, 2009)

Creditor's objection to non-debtor releases contained in a Chapter 11 plan was overruled because creditor had not articulated any viable basis to support their contention that they possessed a direct cause of action against the company's directors and officers. The Court stated:

"Actions for breach of fiduciary duty against officers, directors, and shareholders that can be brought either by a shareholder derivatively or by the corporation directly have long been held to become property of the bankruptcy estate once the corporation files a bankruptcy petition." In re Hearthside Baking Co., 402 B.R. 233, 250 (Bankr. N.D. Ill. 2009); Koch Refining v. Farmers Union Cent. Exch., Inc., 831 F.2d 1339, 1343 (7th Cir. 1987); Mitchell Excavators, Inc. v. Mitchell, 734 F.2d 129, 131 (2d Cir. 1984); Bayliss v. Rood, 424 F.2d 142, 146 (4th Cir. 1970). "The section 541 estate has been found to include any actions that a debtor corporation may have to recover damages for fiduciary misconduct, mismanagement or neglect of duty . . . " Koch Refining, 831 F.2d at 1343-1344. . . . As a matter of law, the Objecting [creditors] are unable to sue the Directors and Officers on account of any derivative actions because the ability to pursue a derivative action belongs to the Debtors' estates.

In re Mercedes, 431 B.R. at 876-77.

3. The Demand Requirement in Bankruptcy

(a) Trustee not required to make demand

Burch v. Huston (In re USDigital, Inc.), 443 B.R. 22 (Bankr. D. Del. 2011)

"Typically, in a derivative suit shareholders are required to first make a demand on the board of directors for corrective action or demonstrate that demand would be futile. However, in the context of a chapter 7 proceeding, the trustee is the sole representative of the estate with the authority to sue and be sued. The Trustee represents the debtor corporation . . . and, therefore, there is no requirement to make a demand prior to initiating suit against

the Director Defendants. Accordingly, the Trustee has standing to bring [derivative claims for breach of fiduciary duty].

(b) Creditors: derivative actions belong to the Trustee / Debtor in Possession; demand upon the Trustee and court approval are prerequisites to pursuing a claim derivatively on behalf of the estate

Canadian Pacific Forest Products, Ltd. v. J.D. Irving, Ltd. (In re The Gibson Group, Inc.), 66 F.3d 1436 (6th Cir. 1995).

4. Standing to pursue securities fraud cases in bankruptcy

Several courts have held that a Trustee in bankruptcy has standing to assert a private right of action for violations of Section 10(b) and Rule 10b-5 against corporate directors. See Profilet v. Cambridge Fin. Corp., 231 B.R. 373 (S.D. Fla. 1999); Estate of Soler v. Rodriguez, 63 F.3d 45, 54 (1st Cir. 1995) ("It is now well-established that a corporation has a claim under § 10(b) if the corporation was defrauded in respect to the sale of its own securities by some or even all of its directors."); In Re Stat-Tech Securities Litig., 905 F. Supp. 1416, 1423 (D. Colo. 1995) (holding that corporation emerging from bankruptcy has standing under 10b-5 because "it is 'well established' that § 10(b) and Rule 10b-5 protect corporations as well as individuals. Thus a corporation that issues its own stock in reliance on another's deceptive or manipulative practice may be deemed a 'seller' with standing to sue under § 10(b) and Rule 10b-5.") (citing Hooper; Superintendent of Ins. Of New York v. Bankers Life & Casualty Co., 404 U.S. 6, 30 L. Ed. 2d 128, 92 S. Ct. 165 (1971)).

5. Statutes of limitations issues

Avoidance Actions

11 U.S.C. § 546

- (a) An action or proceeding under section 544, 545, 547, 548, or 553 of this title may not be commenced after the earlier of—
- (1) the later of—
 - (A) 2 years after the entry of the order for relief; or
 - (B) 1 year after the appointment or election of the first trustee under section 702, 1104, 1163, 1202, or 1302 of this

title if such appointment or election occurs before the expiration of the period specified in subparagraph (A); or
(2) the time the case is closed or dismissed.

Other Actions

11 U.S.C. § 108

(a) If applicable nonbankruptcy law, an order entered in a nonbankruptcy proceeding, or an agreement fixes a period within which the debtor may commence an action, and such period has not expired before the date of the filing of the petition, the trustee may commence such action only before the later of—

- (1) the end of such period, including any suspension of such period occurring on or after the commencement of the case; or
- (2) two years after the order for relief.

C. D&O Insurance Issues

The “Insured versus Insured” Exclusion

Many directors’ and officers’ insurance policies contain an “insured versus insured” exception to coverage. The “insured versus insured” exception prevents one insured from claiming coverage for suits initiated by another insured. This exclusion is generally intended to prevent collusive suits between insureds, i.e., the company and its officers and directors. See Sphinx Int’l, Inc. v. Nat’l Union Fire Ins. Co. of Pittsburgh, Pa., 412 F.3d 1224, 1229 (11th Cir. 2005).

Upon the filing of a bankruptcy petition, the trustee becomes successor in interest to the pre-petition debtor and the trustee’s rights with respect to the debtor’s property are generally subject to the same restrictions that existed pre-petition. Relying on this logic, D&O carriers frequently attempt to exclude from coverage any claims brought by a bankruptcy trustee on behalf of a bankruptcy estate against other insured parties, such as corporate directors. Courts vary widely on whether insurance carriers may deny coverage to a trustee on the basis of an “insured versus insured” exclusion. C.f. Reliance Insurance Co. of Ill. v. Weiss, 148 B.R. 575 (E.D. Mo. 1992), aff’d 5 F.3d 532 (8th Cir. 1993) (ruling that there is “no significant legal distinction between [the pre-petition debtor] and its bankruptcy estate” for purposes of application of the “insured versus insured” exclusion); Nat’l Union Fire Insur. Co. of Pittsburgh, PA v. Olympia Holding Corp., 1996 U.S. Dist. LEXIS 22806 (N.D. Ga. Jun. 4, 1996) (aff’d 148 F.3d 1070 (11th Cir. 1998) (“for purposes of this litigation, there is no legal distinction between [the insured company] and

... [the] Trustee for the bankruptcy estate.”) with In re County Seat Stores, 280 B.R. 319, 329 (S.D.N.Y. 2002) (finding that an “insured versus insured” exclusion did not bar the trustee’s recovery because “[t]he trustee, as a truly adverse party, does not, or should not, raise concerns of collusion” because the trustee does not represent the interests of any party that could be a participant of a conspiracy to collude); and In re Molten Metal Technologies, Inc., 271 B.R. 711 (Bankr. D. Mass. 2002) (holding that the trustee is not the legal equivalent of the prepetition debtor for purposes of the “insured versus insured” exclusion).

D. Reservation / Limitations of claims in the Plan

1. Claims not expressly preserved in the Plan may be barred.

“Like final judgments, confirmed plans of reorganization are binding on all parties, and issues that could have been raised pertaining to such plans are barred by res judicata.” D&K Properties Crystal Lake v. Mutual Life Ins. Co. of New York, 112 F.3d 257, 260 (7th Cir. 1997). Generally speaking, therefore, claims of the bankruptcy estate that have not been expressly preserved in the Plan are barred by res judicata and may not be asserted following confirmation. See id. (citing Apparel Art Intern. v. Amertex Enters., 48 F.3d 576, 586 (1st Cir. 1995) (“Under a generally accepted exception to the res judicata doctrine, a litigant’s claims are not precluded if the court in an earlier action expressly reserves the litigant’s right to bring those claims in a later action.”) Accordingly, “the debtor must specifically identify in its reorganization plan the claims it wishes to pursue post confirmation.” P.A. Bergner & Co. v. Bank One, Milwaukee, N.A. (In re P.A. Bergner & Co.), 140 F.3d 1111, 1117 (7th Cir. 1998).

2. Some courts have required a very explicit and specific reservation.

Relying on language from the 1997 case of D&K Properties Crystal Lake v. Mutual Life Ins. Co. of New York, 112 F.3d 257 (7th Cir. 1997), some courts have required very explicit and specific reservations in the Plan. In D&K Properties, the 7th Circuit found that a debtor’s claim against a life insurance company was barred by res judicata because a reservation of claims contained in the debtor’s plan, which purported to reserve “all causes of action existing in favor of the Debtor and the Debtor in possession,” was not sufficiently specific. The Court held: “[t]he identification [of reserved claims] must not only be express, but also the claim must

be specific. A blanket reservation that seeks to reserve all causes of action reserves nothing. To hold otherwise would eviscerate the finality of a bankruptcy plan containing such a reservation, a result at odds with the very purpose of a confirmed bankruptcy plan” D&K Properties, 112 F.3d at 259-60).

The 7th Circuit clarified this language from D&K Properties in P.A. Bergner & Co. v. Bank One, N.A. (In re P.A. Bergner & Co.), 140 F.3d 1111 *(7th Cir. 1998). In Bergner, the Court held:

The language of § 1123(b)(3)(B) is broad enough to encompass both those situations where a debtor is trying to preserve a potential future claim about which the affected party had no notice and the subset of claims that have already been filed (and are thus a matter of public record) but that remain unresolved. . . . While there might be some logic in requiring "specific and unequivocal" language to preserve claims belonging to the estate that have never been raised, the statute itself contains no such requirement. The courts that have spoken of the need for "specific" and "unequivocal" language have focused on the requirement that plans unequivocally retain claims of a given type, not on any rule that individual claims must be listed specifically.

In 2011, the Bankruptcy Court for the Northern District of Illinois further explained D&K Properties and Bergner in finding that a Liquidation Trustee was not barred from asserting avoidance claims due to an insufficient reservation of claims in the debtor’s plan. KHI Liquidation Trust v. Wisenbaker Builder Servs. (In re Kimball Hill, Inc.) 449 B.R. 767, 774 (N.D. Ill. 2011). In Kimball Hill, the avoidance action defendants claimed that the Plan’s “categorical description of avoidance claims with no reference to the names of the entities against whom the Debtors hold the claims . . . is not a specific identification and it was therefore ineffective to retain the claims asserted in the Amended Complaint.” The Court disagreed, holding:

[M]any defendants in post confirmation litigation seize on the quote in D & K Properties that “[a] blanket reservation that seeks to reserve all causes of action reserves nothing,” to show that the Seventh Circuit

does indeed reject the efficacy of a categorical description in a retention provision.

. . . [R]eading Bergner and D & K Properties together, certain conclusions can be reached with respect to the requisites of a valid retention provision. First, and most obviously, there must be a reservation of something. Plans with no retention provisions at all will not suffice to protect the claim from the binding effect of the plan. . . . Attempts to manufacture an 1123(b)(3) reservation by resorting to other plan provisions, such as those relating to reservation of jurisdiction or appointment of estate representative, are vulnerable to failure. . . .

Second, a blanket or general provision, i.e., one that does not clearly evince the debtor's intent to reserve claims, will not suffice to defeat the preclusive effect of the confirmation order. Bergner stands for the proposition that plan provisions identifying causes of action by type or category are not mere blanket reservations. Therefore, categorical reservation can effectively avoid the res judicata bar. Dispensing with a requirement of cataloging claims by name comports with the Court's view in Bergner that section 1123(b)(3) does not require "specific and unequivocal" identification.

Kimbal Hill, 449 B.R. 767, 774 (internal citations omitted). Accordingly, the Court denied the avoidance defendants' motion to dismiss on the basis of res judicata. See also Kmart Corp. v. Intercraft Co. (In re Kmart Corp.), 310 B.R. 107, 120 (Bankr. N.D. Ill. 2004) ("Bergner stands for the proposition that plan provisions identifying causes of action by type or category are not mere blanket reservations. Therefore, categorical reservation can effectively avoid the res judicata bar. Dispensing with a requirement of cataloging claims by name comports with the Court's view in Bergner that section 1123(b)(3) does not require "specific and unequivocal" identification.").

Browning v. Levy, 283 F.3d 761 (6th Cir. 2002)

After confirmation of the debtor's plan, the debtor's successor ("NW") intervened as plaintiff in a lawsuit against the debtor's

majority shareholder. NW then joined a law firm as a defendant asserting causes of action for legal malpractice and a breach of duty arising from the firm's representation of the majority shareholder before bankruptcy. The law firm claimed that the claim had not been properly reserved. The reservation provision in the disclosure statement provided:

In accordance with section 1123(b) of the Bankruptcy Code, the Company shall retain and may enforce any claims, rights, and causes of action that the Debtor or its bankruptcy estate may hold against any person or entity, including, without limitation, claims and causes of action arising under section 542, 543, 544, 547, 548, 550, or 553 of the Bankruptcy Code.

The Sixth Circuit found that "[the debtor's] blanket reservation was of little value to the bankruptcy court and the other parties to the bankruptcy proceeding . . . it neither names [the defendant] nor states the factual basis for the reserved claims. We therefore conclude that [the debtor's] blanket reservation does not defeat the application of res judicata to its claims against [the defendant]." *Id.* (citing Micro-Time Management Systems, Inc. v. Allard & Fish, P.C. (In re Mico-Time Management Systems, Inc.), 983 F.2d 1067, 1993 WL 7524, at *5 (6th Cir. 1993) (table decision), cert. denied, 510 U.S. 906, 114 S. Ct. 287, 126 L. Ed. 2d 237 (1993)).

Elk Horn Coal Co., LLC v. Conveyor Mfg. & Supply, Inc. (In re Penn Holdings, Inc.), 316 B.R. 495 (Bankr. M.D. Tenn. 2004)

The Bankruptcy Court for the Middle District of Tennessee distinguished Browning: "Perhaps the rule to draw from Browning and Micro-Time is that a general reservation of "causes of action" is not specific enough in the Sixth Circuit to avoid the res judicata effect of confirmation with respect to a malpractice action against counsel to the debtor or to the trustee." The Court then cited D&K Properties, Bergner, and K-Mart from the 7th Circuit, and concluded that "Browning does not establish a general rule that naming each defendant or stating the factual basis for each cause of action are the only ways to preserve a cause of action at confirmation of a Chapter 11 plan." While a "close case," the Court found that a plan that reserved "Avoidance Actions" – a term that was defined in the Plan to include "all preference claims under Section 547" – was

sufficient to preserve preference claims against the defendant creditors.

E. Non-Debtor Releases in the Plan

1. Bankruptcy discharge applies only to the debtor.

11 U.S.C. § 524

. . . (e) Except as provided in subsection (a)(3) of this section, discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt.

2. Some Circuits have adopted a *per se* rule that non-debtor releases in a plan of reorganization are invalid.

In re Lowenschuss, 67 F.3d 1394, 1402 n.6 (9th Cir. 1995), cert. denied, 517 U.S. 1243 (1996) (“This court has repeatedly held, without exception, that §524(e) precludes bankruptcy courts from discharging the liabilities of non-debtors.”).

In re Zale Corp., 62 F.3d 746 (5th Cir. 1995) (“Section 524 prohibits the discharge of debts of nondebtors. Accordingly, we must overturn a §105 injunction if it effectively discharges a nondebtor.”)

In re Western Real Estate Fund Inc., 922 F.2d 592 (10th Cir. 1990) (declining to give effect to a non-debtor release).

3. Other Courts rely on § 105(a) to permit non-debtor releases under limited circumstances.

Class Five Nev. Claimants v. Dow Corning Corp. (In re Dow Corning Corp., 280 F.3d 648 (6th Cir. 2002)

In 1995, Dow Corning filed a Chapter 11 petition after being sued by thousands of silicone breast implant recipients. Dow’s plan of reorganization established a \$2.35 billion settlement fund. As a quid pro quo for making proceeds available for the settlement fund, the Plan also released Dow’s insurers and shareholders from any further liability on personal injury claims and also permanently enjoined any party holding a released claim from bringing an action against Dow’s insurers or shareholders.

The bankruptcy court confirmed the Plan, but construed the non-debtor release and injunction provisions to apply only to consenting creditors. On appeal the Sixth Circuit addressed the question of “whether a bankruptcy court has the authority to enjoin a non-consenting creditor’s claims against a non-debtor to facilitate a reorganization plan under Chapter 11 of the Bankruptcy Code.” The Court found that § 105(a) provides Bankruptcy Courts with “considerable discretion” to approve plans of reorganization and that § 1123(b)(6) permits a reorganization plan to “include any . . . appropriate provision not inconsistent with the applicable provisions” of the Code. . . Thus, the bankruptcy court, as a forum for resolving large and complex mass litigations, has substantial power to reorder creditor-debtor relations needed to achieve a successful reorganization.”

The Court acknowledged that “some courts have found that the Bankruptcy Code does not permit enjoining a non-consenting creditor’s claims against a non-debtor” based on the plain language of Section 524(e). However, the Court construed section 524(e) as merely explaining the effect of a debtor’s discharge, not prohibiting the release of a non-debtor. The Court then determined that “enjoining a non-consenting creditor’s claim against a non-debtor is not inconsistent with the Code.” However, the Court found that “such an injunction is a drastic measure to be used cautiously” and only in “unusual circumstances.” The Court found that “unusual circumstances” existed when the following seven factors are present: (1) There is an identity of interests between the debtor and the third party, usually an indemnity relationship, such that a suit against the non-debtor is, in essence, a suit against the debtor or will deplete the assets of the estate; (2) The non-debtor has contributed substantial assets to the reorganization; (3) The injunction is essential to reorganization, namely, the reorganization hinges on the debtor being free from indirect suits against parties who would have indemnity or contribution claims against the debtor; (4) The impacted class, or classes, has overwhelmingly voted to accept the plan; (5) The plan provides a mechanism to pay for all, or substantially all, of the class or classes affected by the injunction; (6) The plan provides an opportunity for those claimants who choose not to settle to recover in full and; (7) The bankruptcy court made a record of specific factual findings that support its conclusions. (Citing In re A.H. Robins Co., 880 F.2d 694 (4th Cir. 1989); MacArthur v. Johns-Manville, Corp., 837 F.2d 89 (2nd Cir. 1988); In re Continental Airlines, 203 F.3d 203 (3d Cir. 2000)).

4. Read the Plan carefully.

Example of Non-Debtor Release provisions in a Plan

Example 1:

TREATMENT OF CLASSIFIED CLAIMS

Pursuant to Section 1123 of the Bankruptcy Code, the Claims and Interests as classified herein shall be satisfied in the manner set forth in this Article. Except as specifically provided in the Plan, the treatment of, and the consideration to be received by Entities holding Allowed Claims against the Debtor Estate pursuant to this Plan, shall be in full settlement, satisfaction, release and discharge of their respective Allowed Claims against the Debtor Estate, the Assets of the Estate, the Assets of the Reorganized Debtor, the **officers, members, employees, and agents of the Debtor**, and all Guarantors.

Example 2:

Released Claims. As of the Effective Date, the Confirmation Order shall constitute an injunction permanently enjoining any Person that has held, currently holds or may hold a Claim, demand, debt, right, Cause of Action or liability that is released pursuant to Section 10.03 of the Plan from enforcing or attempting to enforce any such Claim, demand, debt, right, Cause of Action or liability against (i) any Debtor, (ii) the Liquidating Trustee, (iii) any Releasee, (iv) any D&O Releasee, or (v) any Exculpated Person, or any of their respective Property, based on, arising from or relating to, in whole or in part, any act, omission, or other occurrence taking place on or prior to the Effective Date with respect to or in any way relating to the Chapter 11 Cases, all of which claims, demands, debts, rights, Causes of Action or liabilities shall be deemed released on and as of the Effective Date . . .

F. Different rules for LLCs?

Creditors of an insolvent LLC do not have standing to pursue a derivative claim for breach of fiduciary duty under Delaware's LLC statute.

CML V, LLC v. Bax, 6 A.3d 238 (Del. Ch. 2010)

CML V, LLC (“CML”) was a creditor of JetDirect Aviation Holdings LLC. CML filed a complaint in Delaware Chancery Court against several of JetDirect’s managers, alleging that JetDirect was insolvent and asserting, among other things, derivative claims for breach of fiduciary duty. The managers moved to dismiss the derivative claims based on Section 18-1002 of the Delaware LLC Act. Section 18-1002 of the Delaware LLC Act provides:

In a derivative action, the plaintiff must be a member or an assignee of a limited liability company interest at the time of bringing the action and: (1) At the time of the transaction of which the plaintiff complains; or (2) The plaintiff’s status as a member or an assignee of a limited liability company interest had devolved upon the plaintiff by operation of law or pursuant to the terms of a limited liability company agreement from a person who was a member or an assignee of a limited liability company interest at the time of the transaction.

The Court granted the motion to dismiss, finding that the Delaware LLC statute “limits standing to bring a derivative claim to holders of a membership interest in a limited liability company (“LLC”) and their assignees. Section 18-1002 does not grant standing to creditors JetDirect is not a corporation. JetDirect is an LLC, and the plain language of the LLC Act controls.”

* * * *

Note: Contrast the exclusive language in the Delaware statute with that of other states, e.g., Tennessee:

DERIVATIVE PROCEEDINGS AND EQUITABLE REMEDIES

801. Right to Bring Proceeding.

(a) Manager-Managed or Director-Managed LLC. A member or holder of financial rights of a director-managed LLC or of a manager-managed LLC may bring a proceeding in the right of an LLC to recover a judgment in its favor if:

(1) The member or holder of financial rights, as applicable, was a member or holder of financial rights of the LLC when the transaction complained of occurred; or

(2) The member or holder of financial rights, as applicable, became a member or holder of financial rights through transfer by operation of law from a person who was a member or holder of financial rights, as applicable, when the transaction complained of occurred.

(b) Member-Managed LLC. A member or holder of financial rights of a member managed LLC may bring a proceeding in the right of an LLC to recover a judgment in its favor if members or other persons with authority to do so have refused to bring the proceeding or if an effort to cause those members or other persons to bring the proceeding is not likely to succeed.