

**ARE UNITED STATES COURTS DEVELOPING A UNITED KINGDOM
APPROACH TO THE LIABILITY OF DIRECTORS OF INSOLVENT COMPANIES?**

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As creditors of insolvent and nearly insolvent companies struggle with recovering the amounts they are owed, they have increasingly sought relief against directors (and sometimes officers) of their debtors. Many of these cases seek to hold directors liable on the theory that they violated a duty owed directly to creditors because the company was insolvent or in the “vicinity of insolvency.” Indeed, some actions seem to take the position that, so long as directors allow a company to operate while a company is *in extremis*, they should be held liable to creditors for the decrease in the net value of the corporation’s assets when the company first came into the vicinity of insolvency until creditors are paid on their claims.²

This article will discuss whether these cases are the beginning of a trend towards increasing the liability of directors to their companies by moving to an approach similar to the United Kingdom (“UK”) doctrine of liability for directors who allow their companies to engage in “wrongful trading”

THE UK DOCTRINE OF WRONGFUL TRADING

In the UK, a director may be personally liability to a liquidator if he allows a company to continue to operate as it approaches insolvency. Under Section 214 of the UK Insolvency Act, a director may liable for his failure to protect creditor’s interests under the civil offense of *wrongful trading*. Liability under wrongful trading arises when a director knows, or ought to

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² See generally, Siegel, Gordon and Luria, *When Bondholders Feel Threatened – What Relief?*, New York Law Journal (February 17, 2004); Siegel, Gordon and O’Malley, *What Duty Is Owed in the Vicinity of Insolvency?*, New York Law Journal (February 19, 2002).

conclude, that the company has no reasonable prospect of avoiding a bankruptcy filing.³

Directors need to be aware at what point they “ought to have concluded” that duties are owed to creditors. As summarized by one commentator

Section 214 is triggered only if at some time before the commencement of the liquidation the directors knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation. It requires identification of the precise date at which the director knew or ought to have known that the company's assets were insufficient for the payment of its debts and other liabilities and the expenses of the winding up.

But the bullet does not hit the director if the court is satisfied that after the director so concluded, or ought to have so concluded, the director took every step with a view to minimising the potential loss to the company's creditors as he ought to have taken, assuming him to have known that there was no reasonable prospect that the company would avoid going into insolvent liquidation. The director is therefore required to be demonstrably pro-active in seeking to protect creditors' interests. The section does not just apply to new debt, it embraces the interests of

³ § 214 **Wrongful trading.**

(1) Subject to subsection (3) below, if in the course of the winding up of a company it appears that subsection (2) of this section applies in relation to a person who is or has been a director of the company, the court, on the application of the liquidator, may declare that that person is to be liable to make such contribution (if any) to the company's assets as the court thinks proper.

(2) This subsection applies in relation to a person if—

(a) the company has gone into insolvent liquidation,

(b) at some time before the commencement of the winding up of the company, that person knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation, and

(c) that person was a director of the company at that time;

but the court shall not make a declaration under this section in any case where the time mentioned in paragraph (b) above was before 28th April 1986.

(3) The court shall not make a declaration under this section with respect to any person if it is satisfied that after the condition specified in subsection (2)(b) was first satisfied in relation to him that person took every step with a view to minimising the potential loss to the company's creditors as (assuming him to have known that there was no reasonable prospect that the company would avoid going into insolvent liquidation) he ought to have taken.

(4) For the purposes of subsections (2) and (3), the facts which a director of a company ought to know or ascertain, the conclusions which he ought to reach and the steps which he ought to take are those which would be known or ascertained, or reached or taken, by a reasonably diligent person having both--

(a) the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company, and (b) the general knowledge, skill and experience that that director has.

all creditors, new and old alike. The section applies notwithstanding that the company may not be trading or may cease trading.⁴

The applicable test is both an objective and subjective test. A UK liquidator will always look to see what an individual director knew, and what a reasonable director should have known in the circumstances.

As to the standard expected of the director in question in predicting insolvent liquidation, he is to be judged on "the general knowledge, skill and experience that may reasonably be expected of a person carrying out the same functions as are carried out by that director in relation to the company." More will, of course, be expected of a director in a larger company with sophisticated accounting procedures and equipment. Furthermore, if his general knowledge, skill and experience exceeds that required for the job, then he is expected to discharge his responsibilities in accordance with those skills. He is thus judged according to the appropriate standard expected either for the job or of that individual, whichever is the higher. Of particular importance, therefore, is that inadequate expertise necessary for a particular job does not excuse a director from failing to reach the inevitable conclusion. It is also worth noting that as individual directors will be judged by differing standards, the moment at which each individual should have reached the conclusion may differ. For example, a finance director's liability may run from an earlier time than a non-executive director's."⁵

While there are several reported decisions finding directors liable for wrongful trading,⁶ the commentators are split on the effectiveness of the remedy given the difficulty in proving the exact time at which a director should have caused a company to liquidate,⁷ the inability of a

⁴ Marion Simmons, *Wrongful Trading*, *Insolv. Int.* 2001, 14(2), 12-13 (hereinafter, Simmons). See , Andrew Hicks, *Advising on Wrongful Trading: Part 1*, *Comp. Law* 1993, 14(1), 16-20 (hereinafter, Hicks 1)

⁵ T.E. Cooke and Andrew Hicks, *Wrongful Trading - Predicting Insolvency*, *J.B.L.* 1993, Jul, 338, 338-339 (footnotes omitted) (hereinafter, Cooke and Hicks).

⁶ See e.g., *Official Receiver v. Doshi*, [2001] 2 B.C.L.C. 235 (Ch. D); cited in Adrian Walters, *Wrongful Trading: Two Recent Cases*, *Insolvency L.J.* 2001, 6(DEC), 211-214 (hereinafter, Walters); and *Re Brian D. Pierson (Contractors) Ltd.*, [1999] B.C.C. 26; *Re DKG Contractors Ltd*, [1990] B.C. 903, *Re Purpoint Ltd.*, [1991] B.C.C. 121, *Re Produce Marketing Consortium Ltd*, [1989] B.C.L.C. 520 each cited in Carol Cook, *Wrongful Trading – Is It A Real Threat To Directors Or A Paper Tiger*, *Insolvency L.J.* 1999, 3 (APR), 99105 (hereinafter, Paper Tiger).

⁷ Simmons at 13; *In re Sherborne Associates Ltd.* [1995] BCC 40 cited in Ian F. Fletcher, *Wrongful Trading: "Reasonable Prospect" of Insolvency*, *Insolv. Int.* 1995, 8(2), 14-15; *Continental Assurance Co of London Plc, re* (Unreported, April 27, 2001) (Ch D) cited in Walters.

liquidator to get paid from the bankrupt's assets if he is unsuccessful,⁸ and the possibility that any recovery would be fully payable to a bank receiver because of the bank's floating charge⁹.

THE DUTIES OF U.S. DIRECTORS OF COMPANIES IN THE "VICINITY OF INSOLVENCY"

In the United States, directors of a solvent corporation only owe fiduciary duties to shareholders of the corporation; their only duty to creditors is to meet their contractual obligations.¹⁰ However, case law has made clear that when a company becomes insolvent, directors owe a duty to creditors as well as shareholders. These duties include a duty to be loyal, to act solely for the financial benefit of the creditors in all matters, and to enhance the financial interest of the insolvent corporation.¹¹

The seminal case in Delaware law treating this issue is *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corporation* (hereinafter, *Credit Lyonnais*)¹², where the court found the board's duties shift when a company is in the vicinity of insolvency.

The possibility of insolvency can do curious things to incentives, exposing creditors to risks of opportunistic behavior and creating complexities for directors.... [D]irectors 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.¹³

⁸ Simmons at 15; Richard Schulte, *Enforcing Wrongful Trading As A Standard Of Conduct For Directors And A Remedy For Creditors: The Special Case Of Corporate Insolvency*, Comp. Law. 1999, 20(3), 80, 81 (hereinafter, Schulte).

⁹ Hicks 1 at 19.

¹⁰ See *Geyer v. Ingersoll Publications Company*, 621 A.2d 784, 787 (Del. Ch., 1992).

¹¹ See *Brandt v. Hicks, Muse & Co. (In re Healthco International)*, 208 B.R. 288, 302 (Bankr. Mass. 1997)

¹² 1991 WL 277613 (Del. Ch.), 17 Del. J. Corp. L. 1099 (1991).

¹³ *Credit Lyonnais* at n. 55.

This 1991 Delaware Chancery case concerned a dispute over the LBO of MGM /UA Communication Company by Pathe Communication. Credit Lyonnais was the principal lender. Pathe was the 98.5 % shareholder in MGM. To help MGM escape bankruptcy, Credit Lyonnais provided financing to MGM pursuant to a new corporate governance agreement under which, amongst others, a power to veto transactions exceeding \$10 million was reserved to the board with a simple majority and the permission of Credit Lyonnais. The board delayed the sale of MGM's interest in a foreign movie distribution consortium. It was claimed that the board had breached its duties to the 98.5% shareholder. Instead, the court held "[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, but owes its duty to the corporate enterprise."¹⁴ The court here recognized that insolvent or nearly insolvent companies may attempt to restructure or reorganize outside of bankruptcy - but if they do, duties are owed to creditors. *Credit Lyonnais* uses a "creditors at risk" theory to justify a transfer of duties, *i.e.* the possibility of insolvency invoking more high-risk strategies of directors who consider their duties owed to shareholders alone.

Courts in Delaware, New York and some other states have used the trust-fund doctrine (in which directors are considered trustees of the company's assets which are held for the benefit of creditors when the corporation is insolvent) to shift fiduciary duties to creditors by imposing a trust on upon directors of an insolvent company to protect its assets for creditors.¹⁵ Florida bankruptcy court applied the trust fund theory to a company in the vicinity of insolvency in *Miramar v Shultz*.¹⁶ The court held that a company was "*on the brink of insolvency*", and a

¹⁴ 1991 WL 277613 at 34, 17 Del. J. Corp. L. at 1155.

¹⁵ The courts of some states take the view that upon insolvency, directors' duties shift entirely to the creditors, and no longer have duties to shareholders. *FDIC v Sea Pines Co*, 692 F.2d 973, 977 (4th Cir., 1982)(where the board of an insolvent corporation used its assets to secure a loan for the benefit of a parent.).

¹⁶ *Miramar Resources Inc. v Shultz (In re Shultz)*, 208 B R. 723 (Bankr. M.D. Fla. 1997).

director was a trustee under the trust fund doctrine. The director was in breach of his fiduciary duties to the company by failing to disclose some transactions, including transfers that were purely for his own benefit.

This transfer of duties is perhaps at its most stark in *Brandt v. Hicks, Muse & Co. (In re Healthco International, Inc)* (“Healthco”),¹⁷ where the Massachusetts Bankruptcy Court ruled, in interpreting Delaware law, that directors who voted to approve the sale of a company’s stock as part of a leveraged buyout could not rely on the business judgment rule where creditors alleged that the transaction left the company insolvent or with unreasonably small capital. The board did not review cash flow projections for the post-LBO company and concluded that the proposals were in the best interests of shareholders. The company subsequently defaulted on its loans. The court held “when a transaction renders a corporation insolvent, or brings it to the brink of insolvency, the rights of creditors become paramount”.¹⁸ Nonetheless, the jury found for the directors.

DO US CASES APPLY UK PRINCIPALS?

The reason for the imposition of a duty on directors of companies in the vicinity of insolvency is similar under US and UK law. In both instances there is recognition that in the absence of the imposition of a duty, directors are likely to make decisions that risk the assets currently available to satisfy creditor claims based upon the possibility that shareholders can eventually recover value. As one UK commentator states:

Nevertheless, the *raison d'être* for this section [214] is stated as being that it acts as a counter-incentive for directors to maximise their own position as shareholders by seeking to trade out of insolvency, a course of action that is unlikely to have a great chance of success, because they enjoy the protection of

¹⁷ 208 B.R. 288 (Bankr. D. Mass. 1997)

¹⁸ 208 B.R. at 300.

limited liability should they fail. The imposition of liability would tend to make directors consider the interests of the creditors more, given that the creditors' interests are most at stake in situations where shareholders' equity has already been exhausted and the company is in effect trading with the creditors' money, supplies and credit. This is perhaps one of the more cogent justifications for retaining a rule that in its original form was intended to allay concerns about the ineffectiveness of the fraudulent trading provisions, owing to the criminal burden of proof being necessary, by introducing a civil version.¹⁹

Similarly, under US law, the imposition of a duty upon directors of companies in the vicinity of insolvency serves a similar purpose however the standards for imposing liability on directors have some differences.

When Does The Duty Arise?

Under UK law, the duty arises when “the directors knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation.”²⁰ The cases rely on a subjective and objective test reviewing the companies books and financial condition with a view towards determining the reasonable level of capitalization.

Under US law, there is no clear test although it is certainly clear that a duty is owed when a company is insolvent under the test of the fair value of its assets exceeding its liabilities (balance sheet insolvency)²¹ or when it cannot pay its debts when they become due (equitable insolvency).²²

The recent decision in *Pereira v. Cogan*,²³ contains the clearest statement of when a company is in the “vicinity of insolvency.” It suggests that the duty arises when a company

¹⁹ Paul J. Omar, *The European Initiative on Wrongful Trading*, *Insolvency L.J.* 2003, 6(NOV), 239-249 [Footnotes omitted]

²⁰ *Supra*, note 4.

²¹ US Bankruptcy Code 11 U.S.C. §§101(32) (A)

²² See also Model Business Corporation Act §§ 6.40 (c)(2) (1985)

²³ 294 B.R. 449, 520-521 (S.D.N.Y., 2003).

meets the fraudulent conveyance standard of “unreasonably small capital.”²⁴ The court looked not just at the debts that currently existed, but the projected obligations in the future and business requirements for working capital and expenditures. The court applied this test because it reasoned that by the time a company cannot pay its current debts it would be too late to protect creditors. By applying this test, the court extended the period of heightened duty to four years before an actual crisis without regard to the foreseeability of loss of liquidity.

The court found that the directors’ failed to investigate undeclared dividends and blindly voted to ratify compensation set by the company’s CEO Michael Cogan. The court found that Cogan used the company as his personal fund while knowing it was insolvent, approving large personal loans and dividends, including birthday party expenses.

One of the issues *Cogan* addressed was the ability of a director to carry out his duties when there is a controlling shareholder, who is their boss, and who acts in a way that is personally beneficial. The court imposed a duty on the directors (and even some of the officers) even though they could have been summarily replaced and there was no evidence that they should have known the company would be experiencing a liquidity crisis.

It was held that the directors had abdicated their fiduciary duties and breached duties of loyalty and due care. In that case, they had failed to question the calculations ostensibly showing a surplus. Even more importantly, the directors were held liable even though there was no personal benefit to them. Their failure to block the unilateral decisions of Cogan made them liable.

²⁴ See also *Healthco*, 208 B.R. at 302 (“[i]n other words, a transaction leaves a company with unreasonably small capital when it creates an unreasonable risk of insolvency, not necessarily a likelihood of insolvency”).

In short, in the US, varying standards are used by different courts leaves directors with a great deal of uncertainty as to what duties are owed to shareholders or creditors, and when in the context of a near-insolvent company.

What Defenses Are Available?

In UK law, the only issue is at what point in time a director should have know things were hopeless²⁵, once that is determined, the only issue is whether the company went into a proceeding rapidly enough.

Under US law, directors of insolvent corporations may still rely upon the business judgment test in determining whether they behaved reasonably.²⁶ The business judgment rule presumes that directors act in good faith and in the best interest of the company and a court will rarely second-guess a director who has no conflict of interest, and satisfies duties of care and loyalty.²⁷ In *Angelo Gordon v Allied Riser*,²⁸ the Delaware Chancery court applied it the rule to a board which decided to effect a merger rather than file for bankruptcy. Noteholders sued the board alleging a breach of duty to creditors since they asserted the merger benefited the shareholders to the detriment of the creditors.

²⁵ *Supra*, at n3.

²⁶ William L Norton Jr, *The Corporation In The Vicinity Of Insolvency* 4 Norton Bankr. L. & Prac 2d && 77A:3 (2003)

²⁷ *Official Committee v. Liberty Savings Bank (In re Toy King Distributors)* 256 B.R. 1,168 (Bankr., M.D.Fla. 2000)

²⁸ *Angelo Gordon v Allied Riser*, 805 A.2d 221 (Ch. Del.2002).

What Is The Extent Of A Director's Liability?

Under UK law, a director can potentially be found liable for the difference between the value of the company's assets at the time it should have ceased trading and the time it actually ceased trading.²⁹

The extent of a US director's liability is less clear since a director that can meet the standards of the business judgment rule is unlikely to be found liable for a similar decline in value. For example, in *Committee v. Beckoff (In re Primecall)*³⁰ the New York bankruptcy court considered a claim that the directors breached their fiduciary duties to creditors by wrongfully prolonging the corporate existence of RSL USA and operating it well past insolvency. In rejecting any duty of directors to liquidate the company upon learning of insolvency (the court retained a claim relating to the \$1.6 billion guarantee of debt of PLC a UK sub, 13 months prior to RSL's chapter 11 filing) the court stated

There is no authority that supports Plaintiffs' position that there is a blanket duty to liquidate upon insolvency, untempered by the business judgment rule. Plaintiffs have not cited any case in the United States that supports this bald proposition. It would require directors to determine what standard of insolvency might apply—two possibilities are inability to pay debts as they come due (as used in [§ 303\(b\)\(1\) of the Bankruptcy Code](#)) and balance sheet insolvency (as defined in § 101(32)). See [Geyer v. Ingersoll Publ'ns Co., 621 A.2d. at 789](#), which refers to them both. It would then require them to make a determination as to the exact status of the corporation's financial affairs, on pain of liability to creditors. In the absence of the protection of the business judgment rule, a director would ordinarily have to opt for an insolvency filing, as the director could have little confidence that the corporation would not, in the bright light of hindsight, be deemed to have been insolvent under one definition or the other. It has never been the law in the United States that directors are not afforded significant discretion as to whether an insolvent company can "work out" its problems or should file a bankruptcy petition.³¹

²⁹ Simmons at 14.

³⁰ 2003 WL 22989669 (Bankr. S.D.N.Y.)

³¹ 2003 WL 22989669 at 8 [citations omitted].

Thus, despite superficial a similarity between the US and UK regimes, one significant difference is the refusal to impose strict liability on directors on insolvent companies for failure to liquidate. It is simply insufficient under US law to hold a director responsible for its refusal to order liquidation. More is required. As stated by the court in *Steinberg v. Kendig (In re Ben Franklin Retail Stores)*

The "insolvency exception" to the general rule that directors owe no duty to creditors is, after all, an exception. Its scope should be no greater than the problem it was intended to solve. That problem is the risk that creditors' rights would be defeated by directors' who gave shareholders prior claims to assets. This is not to say that the duty could not be violated by causing the corporation to incur unnecessary debt to or for the benefit of shareholders. Subjecting assets to unwarranted claims is a way of diverting them from legitimate corporate uses. In an appropriate case, therefore, directors who cause their corporation to incur debt may be in breach of duties enforceable by creditors. This is not such a case.

[T]he Trustee does not allege that any assets were dissipated or diverted or put at undue risk for the benefit of shareholders or preferred creditors. He does allege that the Defendants prolonged the debtors' corporate lives by incurring debt on the basis of misleading financial information. The result was to sink the debtors deeper into insolvency. The Trustee does not allege, however, that the debtors did not get full value for the debts they incurred, or that they did not use that value in an effort to restore the corporation to financial health.³²

Nevertheless, a couple of courts have suggested that a claim for deepening insolvency could be asserted but then have found other reasons to deny recovery.³³

CONCLUSION

It has been argued that the vague nature of director's US fiduciary duties to shareholders and creditors before and after insolvency lends itself to a reluctance to file early bankruptcy

³² 225 B.R. 646, 656 (Bankr. N.D. Ill. 1998)

³³ See *Official Comm. of Unsecured Creditors v R F Lafferty*, 267 F.3d 340 (3rd Cir. 2001); *Tabas v Greenleaf (In re Flagship Health Care)*, 269 B.R. 721 (Bankr. S.D. Fla 2001)

petitions.³⁴ In the UK, the reverse is the case - in the light of statutory offences, UK directors tend to file for bankruptcy earlier.

There has been a large amount of case law in different states addressing the issue of a wider set of director's fiduciary duties. Directors must be wary for their duties extend to include creditors when a company is in the vicinity of insolvency. The lack of clarity as to what insolvency test is applicable only adds to the level of care directors now require to exercise their duties.

However, US director's fiduciary duties have not yet been extended to the UK level. US directors are still empowered to attempt to trade out of insolvency without the threat of personal liability by relying on the business judgment principle, and affecting their fiduciary duties properly.

It does appear that increasing attempts by creditors will revisit these issues.

³⁴ Dickerson, *A Behavioral Approach To Analyzing Corporate Failures*, 38 Wake Forest L. Rev. 1 (2003)