

**DIRECTOR LIABILITY TO CREDITORS
AN ENCOURAGING TREND?**

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DIRECTOR LIABILITY TO CREDITORS An Encouraging Trend?

In the aftermath of recent high-profile corporate scandals stemming from the misdeeds of management, an expansion of liability against these individuals has been undertaken by shareholders in an effort to protect their financial investment in a company. Since most corporate charters mandate that those serving on the company's board be insured against harm causing conduct, directors are an increasingly common target and deep pocket from which shareholders, acting on behalf of the corporation, may recover.

But where do creditors fit into this equation? Typically, the interests of creditors are not jeopardized until a corporation becomes insolvent or is in the “zone of insolvency.” A corporation unable to satisfy its obligations to creditors is, in essence, a troubled corporation; its relationship with its creditors is damaged and the value of the corporation (and, consequently, a shareholder's investment) is weakened. Do creditors have recourse against directors if the actions of these individuals leave the company unable to meet its obligations? Can any such action be brought directly against directors or must these suits be brought on behalf of the corporation? Similarly, what rights do creditors have against directors should the directors' tortious acts diminish the value of collateral, cause a conversion of trust funds or harm the remarkatability of leased equipment?

A recent decision by a Delaware Court, Production Resources Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772 (Del. Ch. 2004) has attempted to illuminate these issues, although the effect of the Court's decision has presented yet new questions regarding the rights of creditors of an insolvent company. This decision supports the notion that directors face liability, particularly when their actions can be described as self-dealing or conscious, serve to favor one creditor to the detriment of another or occur in the absence of exculpatory provisions found in many

corporate charters. An understanding of this decision is therefore of critical importance for creditors in assessing the viability of any potential cause of action brought against directors officers.

Production Resources Group, L.L.C. (PRG) first brought suit in Connecticut to recover payments owed to PRG by NCT Group, Inc. (NCT), arising from PRG's sale of a computer system to NCT. After obtaining a judgment against NCT in the amount of \$2,000,000.00 and frustrated in its efforts to enforce the judgment, PRG then brought suit in the Delaware requesting a receiver be appointed and that NCT's directors be held liable for various breaches of their fiduciary duties of due care and loyalty owed to NCT's creditors.

PRG's claim against NCT's directors alleged the directors had attempted to subordinate the claims of PRG, and NCT's other creditors, to the interests of NCT's controlling shareholder. PRG buttressed its claim by alleging the directors also accepted excessive salaries from NCT, despite NCT's inability to meet its obligations to creditors such as PRG. Conversely, the directors argued they were shielded from any liability by an explicit waiver of the directors' duty of due care found in many corporate charters, including NCT. They maintained they owed no duty of care to any constituency other than a corporation's shareholders, and that even if they did owe a duty of care to NCT's creditors, any action arising from a breach of this duty could only be brought in a derivative action on behalf of the corporation and not by a creditor for itself.

PRG's theory of directorial liability was based, in part, on a prior Delaware decision, Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., 1991 WL 277613 (Del.Ch.). Though the essential holding in the Credit Lyonnais decision had caused a split among various state and federal courts regarding its effect, the decision was read by many as establishing a duty of care owed by directors to a corporation's creditors. This duty, however,

does not arise until the corporation is insolvent or approaching insolvency (which has been referred to as the “zone of insolvency”).

Board members are typically given wide latitude to take action on behalf of the corporation, as it is presumed that their actions are taken in the best interests of the corporation. In order to limit actions of board members that are motivated by bad faith or self-interest, the courts have developed the business judgment rule as a means of holding board members liable for their wrongdoing. This rule states a director is not personally liable for the losses of a corporation resulting from his or her decisions if the director acted in good faith and with due care. The party alleging any wrongdoing must establish gross negligence or deliberate misconduct by the accused directors.

Although the court in the Credit Lyonnais held that board members acted properly in adopting a less risky set of business decisions that actually favored creditors but may not have benefited shareholders, the clear import of the opinion is that the Court will consider the duty of care owed by directors to creditors. The Court specifically held that the directors owe a duty of care not simply toward the stockholders of the corporation, but toward a “corporate enterprise” comprised of members of the “community of interest that sustained the corporation.” This constituency includes a company’s creditors. When a corporation is insolvent or in the “zone of insolvency,” creditors cannot be taken for granted; they are essential to the sustenance of the corporation thus ensuring the continued provision of their services. Creditors would have little incentive to deal with corporations otherwise.

The decision in Production Resources supports the Credit Lyonnais decision; confirming a duty of care to a corporation’s creditors when the corporation is insolvent or nearly insolvent. The Court stated “[w]hen a firm has reached the point of insolvency, it is settled that under Delaware law, the firm’s directors are said to owe fiduciary duties to the companies creditors.

The Court likened the position of creditors, in the event of insolvency, to the position ordinarily occupied by the corporation's shareholders while the corporation is solvent. Essentially, in insolvency, the shareholders' are no longer interested in the corporation, as their shares are valueless. The corporation's assets, however, remain of value to its creditors who maintain an interest in preserving these assets for their benefit, thus justifying the imposition of a duty of care owed by the directors to the company's creditors.

The Production Resources holding nevertheless makes it clear that most causes of action brought by creditors are derivative in nature, to be raised for the benefit of the corporation. This Court also recognized that directors might escape liability by operation of exculpatory provisions contained in the corporation's charter, even where the actions and decisions of directors are in violation of the business judgment rule. The Court did, however, recognize alternative theories of recovery available to creditors, suggesting instances where the directors may violate the business judgment rule but are not saved by exculpatory Charter provisions. In addressing one such scenario, the Court suggested that a direct action against directors might be viable where the directors' conduct did not diminish the value of the company as a whole, but rather, caused particularized harm to one creditor. It also found that when "directors have engaged in conscious wrongdoing or in unfair self-dealing, the exculpatory charter provision does not insulate them from fiduciary duty claims asserted on the firm's behalf by creditors." Directors may also be vulnerable to suits based upon their misrepresentations or tortious interference with contractual relations. Thus, to the extent directors' misconduct is of an intentional and disloyal nature, harming the company's creditors, creditors may assert causes of action against the company's directors.

Equipment lessors should be vigilant to the activities of a corporation's directors when the lessor discerns that the corporation's inability to meet its obligations traces back to self-

dealing. These decisions supporting director liability and the recognition of a duty owed to creditors can also be useful where a lessor is considering an action against a lessee's directors where the value of the equipment has been diminished because of the directors' intentional torts.

In Smith v. Arthur Anderson LLP, et al, 421 F.3d 989 (9th. Cir. 2005), the court, citing Production Resources, compared its theory of law to that of a related, but largely unsettled area, “deepening insolvency” referring to the injuries sustained to debtor’s corporate property resulting from fraudulent expansion of corporate debt and a prolongation of corporate life. The Smith Court postulated on the theory of “deepening insolvency” as it relates to a corporation’s creditors. However, both causes of action rest with the corporation, as it is the entity itself that is disabled from satisfying its obligations to its creditors and the company’s assets experience a diminution of value.

Directors owe a duty of care to the corporation's creditors according to Production Resources. The Delaware Court unequivocally held that if directors act in bad faith, the harm suffered by creditors is actionable and will lead to the creditor's recovery against the directors. While NCT's exculpatory provision shielded its directors from liability, board members of corporations without such provisions in their charter are not immune when the directors violate the business judgment rule. And, in the event that directorial misconduct is intentional, exculpatory provisions do not shield directors from liability. In such instances, a creditor should be confident that its investment is protected and any malfeasance on the part of the corporation's directors may expand the available avenues of recovery.