Hastings Business Law Journal

Volume 3
Number 1 *Fall 2006*

Article 5

Fall 1-1-2006

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THE MYTH OF THE ZONE OF INSOLVENCY: *PRODUCTION RESOURCES GROUP v. NCT GROUP*

*Robert K. Sahyan**

I. INTRODUCTION

Normally, directors and officers of a financially sound corporation have well-established fiduciary duties to the corporation and its shareholders.[1] Although directors and officers are not technically considered trustees, they "stand in a fiduciary relation to the corporation and its stockholders."[2] As agents of the corporation, directors and officers must act in the best interests of both the corporation and its shareholders.

In contrast, although corporate directors may also need to act in good faith in dealing with creditors of the corporation, the board of directors' fiduciary duties generally do not extend to creditors when the corporation is financially sound.[3] Instead, the rights of creditors are governed by the terms of their contracts, and creditors are not entitled to any special consideration on the part of corporate directors.[4]

The situation changes, however, when the corporation becomes insolvent. It is generally accepted that directors of insolvent corporations

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* J.D. Candidate, University of California, Hastings College of the law, 2007. Special thanks to Professor Linda Ekstrom Stanley for her comments and advice.

1. *See generally* JAMES A. FANTO, DIRECTORS' AND OFFICERS' LIABILITY § 2:2 (2nd ed. 2005). *See also* In re Walt Disney Co. Derivative Litig., No 15452, 2004 Del. Ch. LEXIS 132, at 14 (Del. Ch. Sept. 10, 2004) (analyzing the fiduciary duties of directors as identical to those of officers).

2. Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939).

3. Lorenz v. CSX Corp., 1 F.3d 1406, 1417 (3d Cir. 1933) ("It is well-established that a corporation does not have a fiduciary relationship with its debt security holders, as with its shareholders.").

4. *Id.* ("The relationship between a corporation and its debentures is contractual in nature."); Mann v. Oppenheimer & Co., 517 A.2d 1056, 1061 (Del. 1986) ("The rights of debenture holders are controlled by the terms of the indenture under which the securities are issued."); Harff v. Kerkorian, 324 A.2d 215, 222 (Del. Ch. 1974) ("It is apparent that unless there are special circumstances which affect the rights of the debenture holders as creditors of the corporations, e.g., fraud, insolvency, or a violation of a statute, the rights of the debenture holders are confined to the terms of the indenture agreement pursuant to which the debentures were issued."), *aff'd in part, rev'd in part*, 347 A.2d 133 (Del. 1975).

owe fiduciary duties to the corporate creditors whose rights have been transformed into ownership-type rights as a result of insolvency.[5] And although few cases have held directors liable to creditors for breach of fiduciary duties when the corporation is insolvent, "there is no shortage of language exhorting directors to recognize that they must act in the interests of firm creditors once the firm is in financial distress."[6]

In recent years, some courts have been receptive to claims by creditors urging the expansion of directors' fiduciary duties to creditors before insolvency ensues—when a corporation is still technically solvent but within what has been termed the "vicinity of insolvency,"[7] the "brink of insolvency,"[8] or the "zone of insolvency."[9] As a result of the recent upsurge in bankruptcy filings, corporate directors and officers have had to confront a new kind of risk they had not previously anticipated.[10]

In a recent decision of potentially great impact in this area, the Delaware Court of Chancery addressed the issue of whether directors owe any fiduciary duties to creditors when a corporation is in the zone of insolvency.[11] The court's discussion of the issue casts doubt on the validity of the zone of insolvency theory as a basis for giving creditors direct claims of breach of fiduciary duties against directors of corporations.[12] Should creditors' claims be recognized under Delaware law when a corporation is in the zone of insolvency? This note addresses the reasoning the Delaware

5. Geyer v. Ingersoll Publ'ns Comp., 621 A.2d 784, 787 (Del. Ch. 1992) ("When the insolvency exception does arise, it creates fiduciary duties for directors for the benefit of creditors.").

6. Jonathan C. Lipson, *Directors' Duties to Creditors: Power Imbalance and the Financially Distressed Corporation*, 50 UCLA L. REV. 1189, 1202 (2003).

7. Official Comm. Of Unsecured Creditors of Buckhead Am. Corp. v. Reliance Capital Group, Inc. (*In re* Buckhead Am. Corp.), 178 B.R. 956, 968-69 (Bankr. D. Del. 1994) (denying motion to dismiss creditors' breach of fiduciary duty claim where defendants argued that the firm was not insolvent when the relevant decisions were made; the court found that the firm was within the "vicinity of insolvency").

8. Brandt v. Hicks, Muse & Co., Inc. (*In re* Healthco Int'l, Inc.), 208 B.R. 288, 300 (Bankr. D. Mass. 1997) ("When a transaction renders a corporation insolvent, or brings it to the brink of insolvency, the rights of the creditors become paramount.").

9. Zale Corporation Jewel Recovery, L.P. v. Gordon (*In Re* Zale Corporation), 196 B.R. 348, 355 (Bankr. N.D. Tex. 1996) (citing *In re Buckhead Am. Corp.*, 178 B.R. at 968-69) ("Delaware may have expanded [directors' fiduciary] duty, as distinguished from the directors' fiduciary duty to the corporation, when the corporation operates within a zone of insolvency.").

10. Thomas R. Califano, *A Shift in Fiduciary Duties*, THE NATIONAL LAW JOURNAL, Sept. 17, 2001, http://www.mackrell.net/pdfs/bankruptcy.pdf (last visited Nov. 5, 2006). However, the zone of insolvency theory is sometimes confused with another type of creditors' claim related to what is called "deepening insolvency." *See* Helen Shaw, *Fiduciary Duty in the Zone of Insolvency*, CFO, Aug. 25, 2005, http://www.cfo.com/article.cfm/4316005/c_2984395/?f=archives (last visited Nov. 5, 2006). The deepening insolvency claimant seeks to hold managers liable for the additional loss incurred by the company after bankruptcy. *See* William Bates III, *Deepening Insolvency: Into the Void*, 24-2 AM. BANKR. INST. J. 1, 60 (Mar. 2005). *See generally* Daniel E. Harrell, Comment, *Pandora's Bankruptcy Tort: The Potential for Circumvention of the Business Judgment Rule Through the Tort Theory of Deepening Insolvency*, 36 CUMB. L. REV. 151 (2006) (explaining deepening insolvency theory).

11. Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772 (Del. Ch. 2004).

12. *Id.* at 787-94.

Court of Chancery used to answer this question and concludes that, before insolvency ensues, directors owe their fiduciary duties to the corporation and its shareholders and not to its creditors.

Part II provides an overview of the fiduciary duties of directors, the limitations on the liability arising from the breach of such duties, and an explanation of who benefits from these duties. Part III examines the origin of the zone of insolvency theory. Part IV discusses the recent decision by the Delaware Court of Chancery, which undermined the validity of the zone of insolvency claims. Part V addresses the soundness of that decision.

II. THE FIDUCIARY DUTIES

Fiduciary duties are generally recognized in a relationship in which one person (the fiduciary) acts on behalf and for the benefit of another (the beneficiary).[13] In such a relationship, the beneficiary relies or depends on the fiduciary for the performance of a particular service.[14] Although the fiduciary may be entitled to receive compensation for her service, the fiduciary relation imposes on her a duty to act unselfishly for the benefit of the beneficiary.[15]

Legal scholars have taken two differing approaches to the development of fiduciary duties in corporate law based on their views of the nature of the corporation. These two views have been classified as the contractual view, or "contractarianism," on the one hand, and the anti-contractual view, or "anti-contractarianism, on the other."[16] Under the contractual view, a corporation is considered to be no more than a set of contracts among those participating in the business, including managers, shareholders, employees, creditors and others.[17] Hence, the proponents of the contractual view believe that the law should impose as few duties as possible and that the fiduciary duties are consensual in nature because they are simply a "term of the corporate contract."[18] But the opponents of this

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13. *See* RESTATEMENT (SECOND) OF TORTS § 874 cmt. a (1977) (defining a fiduciary relation as one that exists between two persons when one person is under a duty to act for the benefit of the other). *Cf.* Tamar Frankel, *Fiduciary Law*, 71 CALIF. L. REV. 795, 800 (1983) (indicating that the fiduciary relation contains characteristics relevant to two other important relations: status and contract relations).

14. Frankel, *supra* note 13, at 800.

15. *In re* USACafes, L.P. Litig., 600 A.2d 43, 48 (Del. Ch. 1991) ("[T]he principle of fiduciary duty, stated most generally, [is] that one who controls property of another may not, without implied or express agreement, intentionally use the property in a way that benefits the holder of the control to the detriment of the property or its beneficial owner.").

16. *See* Stephen M. Bainbridge, *Community and Statism: A Conservative Contractarian Critique of Progressive Corporate Law Scholarship*, 82 CORNELL L. REV. 856, 856 (1997); Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 432-434 (1993); Henry N. Butler & Larry E. Ribstein, *Opting out of Fiduciary Duties: A Response to the Anti-contractarians*, 65 WASH. L. REV. 1, 1 (1990).

17. Bainbridge, *supra* note 16, at 859.

18. Butler & Ribstein, *supra* note 16, at 28; Easterbrook & Fischel, *supra* note 16, at 427

view believe that fiduciary duties are necessary due to the inherent risk of "abuse of power" in relationships where one entrusts her property to another.[19] Accordingly, the opponents believe that the law should make fiduciary duties mandatory in order to guard against potential abuse of delegated power.[20]

Implied in the fiduciary relation is a transfer of authority to the fiduciary.[21] The fiduciary's exercise of that authority produces consequences that must be borne by the beneficiary.[22] The imposition of a fiduciary duty allows the court to scrutinize the conduct of the fiduciary and guard against potential misuse and self-dealing.[23] The remedy for the breach of such duty is normally the disgorgement of profits gained from the breach, which operates as an effective deterrent against self-dealing.[24]

Since directors stand in a fiduciary relation to the corporation, they are required to act in the best interest of the corporation rather than in their own interests. They owe the corporation complete loyalty, care, and good faith, each of which requires that directors refrain from elevating their own interests above the corporation's.

A. DUTY OF LOYALTY

Directors are given substantial powers to run corporations that are owned by passive, diversified shareholders who cannot effectively supervise the conduct of the directors.[25] Therefore, the law tackles the potential conflict of interest that directors might face and ensures their faithfulness to the corporation's interest through the imposition of duty of loyalty.[26] Under this duty, directors are required to subordinate their own interests to those of the corporation and its shareholders and to refrain from engaging in transactions that raise self-dealing concerns.[27] A director

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("Fiduciary duties are not special duties; they have no moral footing; they are the same sort of obligations, derived and enforced in the same way, as other contractual undertakings.").

19. Frankel, *supra* note 13, at 808-12.

20. *See generally* Melvin Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461 (1989).

21. Larry E. Ribstein, *Are Partners Fiduciaries?*, 2005 U. ILL. L. REV. 209, 217 (2005).

22. Ribstein, *supra* note 21, at 217.

23. Lawrence A. Hamermesh, *Calling Off the Lynch Mob: The Corporate Director's Fiduciary Disclosure Duty*, 49 VAND. L. REV. 1087, 1100 (1996) ("The traditional fiduciary principle applies where a person who is empowered to manage the property of others for their benefit uses such property for personal benefit."); *See also* Frankel, *supra* note 13, at 821 ("When a fiduciary relation is deemed to exist, the parties . . . cannot 'shake off' judicial intervention.").

24. Hamermesh, *supra* note 23, at 1100.

25. *See* DEL. CODE ANN. tit. 8, § 141(a) (2006).

26. Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939) (stating the duty of loyalty "requires an undivided and unselfish loyalty to the corporation [and] demands that there shall be no conflict between duty and self-interest").

27. Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361-62 (Del. 1993); Norlin Corp. v. Rooney, Pace, Inc., 744 F.2d 255, 264 (2d Cir. 1984).

breaches her duty of loyalty when she appropriates a corporate asset, usurps a corporate opportunity, or uses her position to advance a transaction that is not fair to the corporation.[28]

B. DUTY OF CARE

Under the duty of care, directors are required to make their managerial decisions on an informed basis.[29] Before making these decisions, directors have a duty to consult the relevant information reasonably available to them, and to use due care in making these decisions.[30] The Delaware Supreme Court has held that the duty of care is breached if directors act in a grossly negligent manner.[31] The duty of care becomes more relevant in the context of a "sale or change of control transaction."[32]

C. LIMITATIONS ON FIDUCIARY DUTIES

Directors are afforded an important protection against liability arising from a breach of fiduciary duty under what is called the business judgment rule, which "is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[33] Because judges have limited business expertise and directors often make decisions under uncertain market conditions, the business judgment rule recognizes that it is often unwise for the court to "substitute its own notions of what is or is not sound business judgment."[34] Accordingly, under the business judgment rule, courts give directors' decisions great deference, disturbing them only if the presumption that the directors complied with their fiduciary duties is rebutted.[35]

To alleviate some of the worries and concerns of corporate directors, the Delaware legislature passed section 102(b)(7) of the state's General Corporation Law, which permits corporations and their shareholders to voluntarily limit the liability of directors for certain forms of breach of fiduciary duties.[36] Many Delaware corporations subsequently revised their

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28. Robert L. Messineo, *Fiduciary Duties of Officers and Directors of the Financially Troubled Company: A Primer*, 971 PRACTICING L. INST. CORP. L. AND PRAC. HANDBOOK SERIES 171, 174 (1996).

29. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1988). *See generally*, Henry Ridgely Horsey, *The Duty of Care Component of the Delaware Business Judgment Rule*, 19 DEL. J. CORP. L. 971 (1994) (discussing the history of the duty of care).

30. *Id.* at 812; DEL. CODE ANN. tit. 8, § 141(e) (2003).

31. Smith v. Van Gorkom, 488 A.2d 858, 873 (Del. 1985). *See, e.g.*, Paramount Commc'ns Inc. v. QVC Network, Inc., 637 A.2d 34, 43-44 (Del. 1994).

32. *See, e.g.*, Paramount Commc'ns Inc. v. QVC Network, Inc., 637 A.2d 34, 43-44 (Del. 1994).

33. *Aronson*, 473 A.2d at 812.

34. Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971).

35. *Aronson*, 473 A.2d at 812.

36. Act of June 18, 1986, ch. 289, §§ 1-2, 65 Del. Laws 544 (codified at DEL. CODE ANN. tit. 8, §

Articles of Incorporation by inserting a liability-limiting provision that would immunize directors against liability for breach of fiduciary duty as long as the directors' actions were in good faith and did not constitute a breach of loyalty.[37]

D. WHO BENEFITS FROM DIRECTORS' FIDUCIARY DUTIES?

In situations where the corporation is either solvent or bankrupt, the nature of the corporate director's fiduciary duties is clear. If a corporation is solvent, directors, as fiduciaries, are expected to protect the interests of the shareholders.[38] On the other hand, the duties of directors of an insolvent corporation run to the creditors of the corporation.[39] The reason for the shift in fiduciary duties is that the interests of shareholders are subordinated to those of creditors as a result of bankruptcy. This can be best understood by appreciating how bankruptcy affects the rights of shareholders and creditors. Shareholders normally have the right to receive a return on their investment after paying the costs of servicing the debt.[40] Creditors, on the other hand, have the right to repayment of their debts with interest.[41] In bankruptcy, the assets of the bankrupt corporation are not enough to cover its liabilities.[42] Because of the limited liability that the corporate entity confers on shareholders, creditors can generally look only to the corporation's assets for recovery.[43] Hence, the preservation of the value of the bankrupt corporation's assets for the benefit of creditors becomes critical in bankruptcy.[44] The shift in fiduciary duties occurs to ensure that the value of these assets is preserved for creditors who are the parties for whom the corporation's assets matter the most.[45]

102(b)(7) (2001)).

37. Section 102(b)(7) allows the adoption of such provision "provided that [it does 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; . . . (iv) for any transaction from which the director derived an improper personal benefit."

38. *See supra* Part I.

39. *See supra* Part I.

40. Steven L. Schwarcz, *Rethinking a Corporation's Obligations to Creditors*, 17 CARDOZO L. REV. 647, 666 (1996).

41. *Id.* at 667.

42. The Bankruptcy Code defines the term "insolvent" when the debtor is a corporation as the state when "the sum of [the corporation's] debts is greater than all of [its] property." 11 U.S.C. § 101(32) (2000).

43. Schwarcz, *supra* note 40, at 667.

44. Under the Bankruptcy Code's "absolute priority rule," a corporation's plan of reorganization may provide for recovery for shareholders only if creditors are either paid in full or accept less than full payment. 11 U.S.C. §§ 1129(a)(8)(A), 1129(b)(2)(B)(ii) (2000).

45. One school of thought has considered this shift as an application of the "trust fund" doctrine in that "once a company is insolvent, its assets are to be managed as though held in trust for the benefit of creditors." Martin J. Bienenstock & Robert L. Messineo, *When Financial Trouble Comes: A Guide for Directors*, DIRECTOR'S MONTHLY (Nat'l Assn. of Corp. Directors, Washington, D.C.), Sept. 2001, at 4,

III. THE ORIGIN OF ZONE OF INSOLVENCY THEORY

Although the nature of directors' fiduciary duties is clear when the corporation is either financially sound or clearly insolvent, it is far from clear to whom these duties are owed when the corporation is not yet bankrupt, but remains in the twilight zone between solvency and insolvency. Courts and scholars have concluded that directors owe fiduciary duties to creditors when a corporation is in this zone.[46] They base this conclusion on a famous dictum by Chancellor William Allen in *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*[47]

Credit Lyonnais arose out of the leveraged buyout of MGM by Pathe Communications Corp. (PCC), a corporation controlled by Giancarlo Parretti. Credit Lyonnais Bank (CLB) was the principal lender in the transaction.[48] Five months after the acquisition, MGM's trade creditors forced it into bankruptcy court.[49] To get MGM out of bankruptcy, the parties entered into a Corporate Governance Agreement under which CLB provided the much-needed funds to MGM. In exchange, MGM agreed to change its management structure by requiring Mr. Parretti to turn over control of MGM to an executive committee that would dissolve once the CLB debt was paid down to a certain amount.[50] However, the battle for control of MGM soon after erupted, and the management structure intended by the agreement proved "entirely unworkable."[51] CLB brought an action to remove Mr. Parretti from office for breach of the agreement.[52] Mr. Parretti countered that the executive committee members breached their fiduciary duties to him as a controlling shareholder when they rejected his proposal to sell some of MGM's assets to pay down the debt, which would have restored his control of MGM.[53]

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available at http://www.nacdonline.org/images/DM_sep01.pdf (last visited Nov. 5, 2006). *See generally* Ann E. Conaway Stilson, *Reexamining the Fiduciary Paradigm at Corporate Insolvency and Dissolution: Defining Directors' Duties to Creditors*, 20 DEL. J. CORP. L. 1 (1995) (critiquing the application of the trust fund doctrine in corporate insolvency).

46. Richard M. Cieri & Michael J. Riela, *Protecting Directors and Officers of Corporations That Are Insolvent or in the Zone or Vicinity of Insolvency: Important Considerations, Practical Solutions*, 2 DEPAUL BUS. & COMM. L.J. 295, 301 (2004) ("Directors and officers owe their fiduciary duties to creditors even if the corporation is not yet insolvent, but is rather in the 'zone of insolvency' or 'vicinity of insolvency.'"); Messineo, *supra* note 28, at 187 ("Directors' duties to creditors may arise even where the corporation is actually solvent but is nearly insolvent.").

47. Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'n Corp., No. 12150, 1991 Del. Ch. LEXIS 215, at *108 (Del. Ch. Dec. 30, 1991).

48. *Id.* at *7-8 (noting that in a leveraged buyout financing, the assets of the corporation being acquired are used to secure the purchase price paid for those assets).

49. *Id.* at *8.

50. *Id.* at *35-37.

51. *Id.* at *71.

52. *Id.*

53. *Id.* at *106-08.

In considering whether the members of the executive committee breached any fiduciary duties, Chancellor Allen began his analysis by stating that "[a]t least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise."[54] Chancellor Allen then went even further in his analysis, positing a hypothetical situation in a footnote explaining his statement.[55] Chancellor Allen explained:

> The possibility of insolvency can do curious things to incentives, exposing creditors to risks of opportunistic behavior and creating complexities for directors. Consider, for example, a solvent corporation having a single asset, a judgment for \$ 51 million against a solvent debtor. The judgment is on appeal and thus subject to modification or reversal. Assume that the only liabilities of the company are to bondholders in the amount of \$ 12 million. Assume that the array of probable outcomes of the appeal is as follows:

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

> Thus, the best evaluation is that the current value of the equity is \$ 3.55 million. (\$ 15.55 million expected value of judgment on appeal \$ 12 million liability to bondholders). Now assume an offer to settle at \$ 12.5 million (also consider one at \$ 17.5 million). By what standard do the directors of the company evaluate the fairness of these offers? The creditors of this solvent company would be in favor of accepting either a \$ 12.5 million offer or a \$ 17.5 million offer. In either event they will avoid the 75% risk of insolvency and default. The stockholders, however, will plainly be opposed to acceptance of a \$ 12.5 million settlement (under which they get practically nothing). More importantly, they very well may be opposed to acceptance of the \$ 17.5 million offer under which the residual value of the corporation would increase from \$ 3.5 to \$ 5.5 million. This is so because the litigation alternative, with its 25% probability of a \$ 39 million outcome to them (\$ 51 million—\$ 12 million \$ 39 million) has an expected value to the residual risk bearer of \$ 9.75 million (\$ 39 million x 25% chance of affirmance), substantially greater than the \$ 5.5 million available to them in the settlement. While in fact the stockholders' preference would reflect their appetite for risk, it is possible (and with diversified shareholders likely) that shareholders would prefer rejection of both settlement offers.
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> But if we consider the community of interests that the corporation represents it seems apparent that one should in this hypothetical accept

54. *Id.* at *108.
55. *Id.* at *108 n.55.

> the best settlement offer available providing it is greater than $ 15.55 million, and one below that amount should be rejected. But that result will not be reached by a director who thinks he owes duties directly to shareholders only. It will be reached by directors who are capable of conceiving of the corporation as a legal and economic entity. Such directors will recognize that in managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act.[56]

Finally, Chancellor Allen found that the members of the executive committee did not breach their fiduciary duties owed to "the corporate entity."[57] Their obligation was to "the community of interest that sustained the corporation, to exercise judgment in an informed, good faith effort to maximize the corporation's long-term wealth creating capacity."[58] Hence, their refusal to bow to Mr. Parretti's demand was not considered to be disloyal since they owed "their supervening loyalty to MGM, the corporate entity."[59]

It is important to note that whether or not MGM was operating in the zone of insolvency was not an issue because, during the relevant time, MGM was either in a bankruptcy proceeding or laboring in the threat of that prospect after creditors had agreed to dismiss their bankruptcy proceeding.[60] after creditors had agreed to dismiss their bankruptcy proceeding. Also, the claim of breach of fiduciary duty was brought not by a creditor but by Mr. Parretti, a ninety-eight percent shareholder.[61] Consequently, Chancellor Allen's comments regarding the fiduciary duties directors owe to creditors when a corporation is in the vicinity of insolvency are dicta.

Accordingly, this led some to conclude that directors owe their fiduciary duties not only to shareholders when a corporation is nearing bankruptcy but also to creditors.[62] One court went even further and indicated that it was "*universally agreed* that when a corporation *approaches insolvency* or actually becomes insolvent, directors' fiduciary

56. *Id.* at *108 n.55.
57. *Id.* at *109.
58. *Id.* at *109.
59. *Id.*
60. *Id.* at *108.
61. *Id.* at *20.
62. Weaver v. Kellogg, 216 B.R. 563, 583-84 (Bankr. S.D. Tex. 1997) ("[I]t appears that under both Delaware and Texas law, corporate insiders . . . may have a fiduciary duty to the corporation's creditors even when the corporation was not insolvent."); Messineo, *supra* note 28, at 187 ("The *Credit Lyonnais* decision stands for [proposition that] directors' responsibility shifts to creditors while in the 'vicinity of insolvency' and not only during liquidation.").

duties expand to include general creditors."[63] (emphasis added). This expansion of directors' fiduciary duties in the zone of insolvency has led directors facing potential liability to search frantically for strategies on how to "immunize the risks they face."[64]

IV. THE WINDS OF CHANGE

Recently, the Delaware Court of Chancery had an opportunity to address a creditor's claim of breach of fiduciary duties against directors and voiced doubt whether such fiduciary duties should be recognized when a corporation is operating in the zone of insolvency.[65] Although the court's discussion consists mostly of dicta,[66] it nevertheless lends further support to the argument that the zone-of-insolvency theory does not provide direct claims to creditors against directors; instead, it was only intended to provide directors with protection from potential liability.[67]

A. FACTUAL BACKGROUND

The plaintiff in the case, Production Resources Group, L.L.Cm (PRG), had obtained a 2 million dollar judgment against the defendant, NCT Group, Inc. (NCT), for breach of contract for sale of computer systems to NCT.[68] PRG's efforts to collect on the judgment were unsuccessful, and NCT continued to owe more than ninety percent of the total judgment amount.[69] Moreover, despite NCT's obligation to pay the judgment, it continued to operate and incur debt by borrowing several million dollars from the wife of a former NCT director.[70] Despite working as a legal secretary, she was NCT's primary creditor, loaning NCT more than $28 million and holding liens on most of its assets.[71] In addition, NCT had a history of defaulting on her loans, incurring penalties and refinancing them, and obtaining more loans from her in exchange for convertible notes and warrants, which, if exercised, would have made her "NCT's de facto controlling shareholder."[72]

Following through with its collection efforts, PRG brought suit against NCT in the Delaware Court of Chancery seeking the appointment of a

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63. *In re* Kingston Square Assocs., 214 B.R. 713, 735 (Bankr. S.D.N.Y. 1997).

64. Cieri & Riela, *supra* note 46, at 312; *See also* Bienenstock & Messineo, *supra* note 44, at 7-8.

65. Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 777 (Del. Ch. 2004).

66. The judge stated, "Fortunately this case does not require me to explore the metaphysical bodies of the zone of insolvency. Instead, it requires me to apply a more well-settled line of authority, albeit a line of authority that is perhaps less well understood." *Id.* at 790.

67. *Id.* at 788-89.

68. *Id.* at 777.

69. *Id.* at 778.

70. *Id.* at 780.

71. *Id.*

72. *Id.* at 781.

receiver and alleging that NCT's directors had committed various breaches of fiduciary duty and that, because these breaches were committed when NCT was insolvent, PRG could bring these claims against the directors and at least one of its officers (the "NCT defendants").[73] The NCT defendants moved to dismiss PRG's complaint for failure to state a claim.[74] Regarding plaintiff's claim to appoint a receiver, the defendants argued that PRG failed to allege that NCT was insolvent and, in the alternative, that if it was insolvent, PRG failed to allege additional facts that would allow the court to appoint one.[75] As to PRG's claim of breach of fiduciary duties, NCT argued that, even if it was insolvent, those claims belonged to the company, not to its creditors, and NCT's article of incorporation exculpated NCT's directors pursuant to Section 102(b)(7) of the Delaware General Corporation Law.[76]

B. Court's Decision

The court denied the NCT defendants' motion to dismiss for failure to state a claim, finding that PRG pleaded sufficient facts to survive a motion to dismiss with respect to NCT's insolvency.[77] Indeed, NCT's own public filings revealed that it was balance-sheet insolvent and was unable to service its debts as they came due.[78] Accordingly, the court found that PRG's complaint stated sufficient facts to support the discretionary appointment of a receiver.[79]

Next, the court addressed the issue of NCT's fiduciary duty to PRG, which it found to be "a bit more problematic."[80] PRG tried to circumvent the exculpatory provision contained in NCT's certificate of incorporation by arguing that since NCT was in the zone of insolvency when its directors breached their fiduciary duties, under *Credit Lyonnais*, PRG, as NCT's creditor, had a direct claim against NCT's directors.[81] However, the court disagreed. The court found that most of PRG's claims were based on generalized and conclusory allegations of mismanagement by NCT's directors.[82] Further, the court emphasized that these claims are "classically derivative, in the sense that they involve an injury to the corporation as an entity and any harm to the stockholders and creditors is purely derivative of

73. *Id.* at 775.
74. *Id.*
75. *Id.* at 775.
76. *Id. See* discussion *supra* part II, section D, and notes 33, 34.
77. *Id.* at 775-76.
78. *Id.* at 778.
79. *Id.* at 776.
80. *Id.*
81. *Id.* at 776.
82. *Id.*

the direct financial harm to the corporation itself."[83] The mere fact that a firm has become insolvent, the court further opined, does not transform such claims into direct claims by creditors, but it simply affords creditors standing to bring these claims on behalf of the corporation.[84] This means that the exculpatory provision would still protect directors in these circumstances.[85]

C. THE COURT'S RATIONALE

The court began its analysis by starting from the fundamental principle that the corporate law expects directors to manage the corporation for the benefit of the corporation and its shareholders and that creditors' interests are governed by the contractual agreements—not by claims of breach of fiduciary duties against directors.[86]

The court further clarified that *Credit Lyonnais* did not alter this principle when the firm is in zone of insolvency and did not, as some have "[s]omewhat oddly" concluded, create "a new body of creditor's rights law."[87] *Credit Lyonnais*, the court further indicated, emphasized that directors' obligations in the zone of insolvency would remain "'to the community of interest that sustained the corporation . . . .' and to preserve, and, if prudently possible, to maximize the corporation's value to best satisfy the legitimate claims of all its constituents, and not simply to pursue the course of action that stockholders might favor as best for them."[88] The language in *Credit Lyonnais*, in the court's view, was intended to give directors a "shield" against claims by shareholders who would demand that directors engage in high-risk transactions as part of their fiduciary duty to them.[89]

Thus, the court's discussion of the zone of insolvency theory in *Production Resources* calls into question the concept of direct claims of fiduciary duties by creditors against directors, reaffirms the fundamental principle requiring directors to maintain their obligation to the corporation and its shareholders, and rejects shifting directors' fiduciary duties to

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83. *Id.* For more on distinguishing between derivative claims from individual claims, *see* Jonathan Shub, *Distinguishing Individual and Derivative Claims in the Context of Battles for Corporate Control: Lipton v. News International, Plc*, 13 DEL. J. CORP. L. 579, 581-82 (1988).

84. *Prod. Res.*, 863 A.2d at 776.

85. Nevertheless, the court concluded that it did not have to rule on the zone of insolvency claim since NCT was actually insolvent and that PRG's claim of fiduciary duty should not be dismissed considering that the acts of disloyalty by NCT's directors would not be immunized by the exculpatory provision. *Id.* at 777.

86. *Id.* at 787.

87. *Id.* at 787-88.

88. *Id.* at 788 (quoting Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., No. 12150, 1991 Del. Ch. LEXIS 215, at *109 (Del. Ch. Dec. 30, 1991).

89. *Id.* at 788.

creditors before bankruptcy ensues.

V. DOES *PRODUCTION RESOURCES'* RATIONALE HOLD WATER?

The reading of *Credit Lyonnais* undertaken by the court in *Production Resources* seems to tease out what Chancellor Allen really meant to convey through his discussion of directors' obligations during financial uncertainty. This reading seems to be in line with the view that the contractarians hold of the nature of the corporation.[90] In addition, practical considerations provide further support for the *Production Resources'* rationale disposing of zone of insolvency theory as a basis for claims of fiduciary duties by creditors.

A. *CREDIT LYONNAIS* AND THE ZONE OF INSOLVENCY

It is important to note that what Chancellor Allen was addressing in *Credit Lyonnais* was a claim of breach of fiduciary duty brought by a controlling shareholder and not by a creditor.[91] This distinction is critical, especially when one considers how Chancellor Allen ruled on the claim. Chancellor Allen rejected the shareholder's claim of breach of fiduciary duty against the directors who refused his demand to sell MGM's assets despite his need for capital in order to regain control of MGM.[92] The court defended the directors' decision as "valid" since the directors did not blindly comply with the personal demand of the shareholder and instead "acted prudently."[93] The reason for Chancellor Allen's dismissal of the shareholder's claim was not based on the principle that directors did not owe their fiduciary duty to the shareholders but to the creditors—a principle that may have supported the conclusion that directors owed their fiduciary duty to creditors in the zone of insolvency. Instead, Chancellor Allen reasoned that this duty is owed to MGM as a "legal and economic entity" reflecting the interests of not only the shareholders but also of other constituents.[94] In effect, directors have an obligation of value-maximization of the whole corporation.[95] Therefore, to assert that *Credit Lyonnais* supports extending directors' fiduciary duties to corporations' creditors before insolvency ensues would be to extend its rule beyond its logical significance.

The holding in *Credit Lyonnais* recognizes the reality of a business world that is fraught with financial uncertainty: sometimes directors face

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90. *See supra* Part II.

91. *Credit Lyonnais*, 1991 Del. Ch. Lexis 215, at *106.

92. *Id.* at *107. In addition, Chancellor Allen found this sale to be "too little, too late." *Id.*

93. *Id.* at *108.

94. *Id.* at *108 n.55.

95. *See* Gregory Scott Crespi, *Rethinking Corporate Fiduciary Duties: The Inefficiency of the Shareholder Primacy Norm*, 55 SMU L. REV. 141, 152-53 (2002).

situations where the interests of the constituents involved (shareholders, creditors, employees, and others) are not necessarily harmonious. In essence, what Chancellor Allen intended to do, and what the court in *Production Resources* was able to clarify, was to afford directors protection against claims by shareholders based on hindsight and not to expand the pool of claimants to include creditors. Thus, directors' duties in the zone of insolvency area remain guided by the general principles of fiduciary duties of loyalty and care, and directors' decisions continue to benefit from judicial deference under the business judgment rule.

B. PRACTICAL DIFFICULTIES WITH ZONE OF INSOLVENCY

Extending fiduciary duties to creditors when a corporation is in the zone of insolvency requires defining the boundaries of this area if directors are to be expected to discharge these duties for the benefit of constituents with different, and sometimes conflicting, interests. This, however, can be an elusive goal.[96] To begin with, determining insolvency is not always simple.[97] Several methods have been suggested.

Under the Bankruptcy Code, insolvency is the financial state in which the sum of the corporation's liabilities is larger than the fair market value of all its assets, excluding exempted property and property concealed from the corporation's creditors in order to defraud them.[98] Valuation methods of a corporation's assets "complicate matters" further.[99] In addition, this bankruptcy test is relevant only if there has been a bankruptcy case initiated. Therefore, it is limited to cases where the corporation is in liquidation or reorganization proceedings.

Another method that can be used to define insolvency is what is called the "equitable test."[100] Under this test, a corporation is insolvent if it cannot pay its liabilities as they come due in the ordinary course of its business.[101] This means that a corporation may be deemed insolvent according to this test even though the corporation is asset-rich but cash-flow-poor. Applying this test strictly would lead to unwarranted results "since many corporations fail for any number of reasons to pay some debts in the ordinary course."[102]

In sum, if it is considerably challenging to determine whether a

96. Lipson, *supra* note 6, at 1211 (The zone of insolvency "will axiomatically arise prior to insolvency, although at what point is hardly clear.").

97. In Delaware, directors' fiduciary duties to creditors arise before bankruptcy proceedings are initiated upon insolvency in fact. Geyer v. Ingersoll Publ'ns Comp., 621 A.2d 784, 787 (Del. 1992).

98. 11 U.S.C. § 101(32) (2000).

99. Messineo, *supra* note 28, at 186.

100. Lipson, *supra* note 6, at 1233.

101. *Id.*

102. *Id.*

corporation is insolvent, then determining when the corporation has entered the zone of insolvency is truly problematic. This confusion is bound to cause a chilling effect on directors' risk-taking endeavors. It may also cause directors to abandon failing firms far in advance [0]of any financial trouble to avoid any potential liability for claims that creditors might bring.

Another issue that complicates matters further for directors is the difference between the nature of the interests of shareholders and creditors. Although both are contributors of capital, shareholders and creditors often have conflicting expectations.[103] Shareholders are owners of the equity whereas creditors are debt holders. Accordingly, shareholders expect to receive the profits of the corporation in the form of dividends and to share in the residual value of the corporation in case of its dissolution. On the other hand, creditors' claims against the corporation are fixed by the amount they contribute in addition to a pre-determined rate of interest. Creditors do not expect to get anything more than this specified amount. Hence, while shareholders generally favor riskier investments, creditors tend to opt for the least risky transactions that satisfy their claims.[104]

Chancellor Allen attempted to demonstrate this divergence between the interests of shareholders and creditors in his hypothetical situation.[105] Since shareholders enjoy limited liability, the maximum loss that they might incur is capped by the amount they contribute.[106] But, in case the higher-risk investments undertaken prove to be profitable, shareholders stand to gain all of the profits minus the debts.[107] However, the situation is different for creditors whose losses are measured by the fixed amount of their debts and interest and whose gains are also fixed by these same amounts.[108] In other words, creditors do not share in the upside.[109] Hence, creditors have little incentive to encourage "business strategies that would risk the payment of the bulk of their claim."[110]

As a result, this tension between the interests of shareholders and creditors creates a dilemma for directors trying to choose a course of action when the corporation is in the zone of insolvency. In such a situation, the party to whom the fiduciary duty is owed is not at all clear. The corporate director thus finds herself in a complicated situation, especially in light of the added difficulty of determining whether a particular corporate

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103. Schwarcz, *supra* note 40, at 649.

104. "[T]ension between the interests of shareholders and creditors is inherent in every decision that increases a corporation's risk in order to make it more profitable." *Id.* at 650.

105. *Credit Lyonnais*, 1991 Del. Ch. LEXIS 215, at *109 n.55.

106. Laura Lin, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 VAND. L. REV. 1485, 1490 (1993).

107. *Id.*

108. *Id.*

109. Schwarcz, *supra* note 40, at 667.

110. Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 790 n.56 (Del Ch. 2004).

obligation is debt, equity or, a mixture of both.[111]

VI. CONCLUSION

Corporate directors have fiduciary duties to maximize the wealth of the corporation for the benefit of its different constituents. In times of financial uncertainty, directors' fiduciary duties inure to the benefit of the corporation as a whole, just as they do during solvency. As fieduciaries, directors continue to owe the duties of loyalty and care to the corporation, and they should continue to benefit from the business judgment rule when they decide what course of action to undertake. The discretion that is afforded to directors entails the ability to judge on whose behalf they should act. Creditors' rights continue to be determined by their contractual agreements with the corporation and not by extending fiduciary duties for their benefit.

111. Lipson, *supra* note 6, at 1234-35.