California Court Clarifies Directors’ Duties When a Corporation Is Insolvent or in the Zone of Insolvency

By Gary O. Ravert

On October 29, 2009, the California Court of Appeal, Sixth District, in *Berg & Berg Enterprises, LLC v. Boyle, et al.*, unequivocally ruled that, under California law, directors of either an insolvent corporation or a corporation in the more elusively defined “zone of insolvency” do not owe a fiduciary duty of care or loyalty to creditors. In so ruling, California joins Delaware in clarifying directors’ duties when the corporation is insolvent or in the zone of insolvency.

Background

Berg & Berg Enterprises LLC was the largest creditor of the failed Pluris, Inc. In July 2002, Pluris’s directors elected to enter into an assignment for the benefit of creditors (ABC) under California law. Berg brought a complaint against Pluris’s directors alleging that while Pluris was insolvent or in the zone of insolvency, Pluris’s directors breached their fiduciary duties to Pluris’s creditors by failing to examine a range of possible courses of action to maximize the value of the remaining assets and not merely to take the most expedient step of entering into the ABC. Berg alleged that the directors failed to explore ways to preserve, among other things, the value of $50 million in net operating losses (NOLs) that were lost upon the execution of the ABC. Further, Berg alleged that the directors failed to do the following:

- Seek alternative sources of financing
- Make any reasonable inquiry into alternative ways to derive additional value for Pluris’s creditors
- Consider other benefits of a chapter 11 reorganization, such as Berg’s purported agreement to reduce its claim and contribute cash for the benefit of Pluris’s other creditors

Berg alleged that once the directors determined that Pluris’s equity interests had no value, the directors abdicated their duty to Pluris’s creditors by entering into the ABC.

The directors moved to dismiss the complaint, and the trial court granted the motion. The trial court based its decision on *CarrAmerica Realty Corp. v. nVIDIA Corp.*, a 2006 case from the U.S. District Court for the Northern District of California. *CarrAmerica* held that California follows the “trust fund doctrine” with respect to a director’s fiduciary duty to creditors. According to the trial court, *CarrAmerica* held that a director’s fiduciary duty to creditors only arises upon a corporation’s insolvency. The scope of this fiduciary duty is to avoid self-dealing, preferential treatment of creditors, diversion, dissipation or undue risk to the insolvent corporation’s assets. Because Berg could not allege that the directors breached such a duty by entering into the ABC, the trial court granted the motion to dismiss without leave to amend. Berg appealed.

The Appeals Court’s Analysis

On appeal, the California Court of Appeal analyzed what, if any, fiduciary duty individual directors owe to creditors. The appeals court first noted that under California statute, “corporate directors owe a fiduciary duty to the corporation and its shareholders . . . and must serve ‘in good faith, in a manner such director believes to be in the best interests of the corporation and its shareholders.’” Next, the appeals court noted that with respect to a duty to creditors, there is “no analogous statutory authority in California establishing or recognizing that upon a corporation’s insolvency, or more vaguely when it enters into a ‘zone of insolvency,’ directors instead or also owe a duty to the corporation’s creditors.” The appeals court further noted that it was “easy to see that especially when a corporation is in financial distress, the interests of the shareholders and the corporation itself may inherently collide with those of the creditors, making any respective duties owed by directors to each constituency potentially in conflict and making the scope of each respective duty elusive and difficult to ascertain.”

Credit Lyonnais and the Evolution of the Purported Duty of Care and Loyalty to Creditors

The appeals court next considered California and other post–*Credit Lyonnais Bank Nederland N.V. v. Pathe Communications Corp.* decisions addressing a director’s fiduciary duties of care and loyalty to creditors upon insolvency. The appeals court noted the well-known footnote in *Credit Lyonnais* in which the Delaware Court of Chancery posited that where a corporation was operating in the vicinity of insolvency, a board of directors is not merely the agent to the shareholders but also to the creditors. The appeals court further noted that a recognition of such expanded fiduciary duties of care and loyalty was thought to minimize the risk to creditors of “opportunistic behavior” such as the sale of corporate property at “fire-sale prices” or unreasonable risk taking with corporate assets for the sole benefit of shareholders.

The appeals court next observed that the establishment of a director’s fiduciary duties of care and loyalty to creditors has generated controversy and broad criticism from commentators. The criticism largely focuses on “the difficulty in perceiving insolvency, or worse, the zone of insolvency, which is when such duties arise, and the practical difficulties and inefficiencies inherent in directors managing conflicting duties owed to disparate interests, thereby diluting the continuing and historic duty owed by directors to shareholders.” Finally, the appeals court noted that there are no published decisions that rely on, or post-date, *Credit Lyonnais* that determine that corporate insolvency triggers fiduciary duties of care and loyalty to creditors. However, there are decisions that rely on the trust fund doctrine to satisfy a creditor’s claim against an insolvent corporation.

The Trust Fund Doctrine

The appeals court next analyzed the trust fund doctrine, which numerous courts have relied on since it was first espoused in the 1939 seminal decision by the Supreme Court of the United States in *Pepper v. Litton*. Under the trust fund doctrine, “all of the assets of a corporation, immediately upon becoming insolvent, become a trust fund for the benefit of all creditors” in order to satisfy their claims. In California, application of the trust fund doctrine requires a showing “that directors have engaged in conduct that diverted, dissipated, or unduly risked corporate assets that might otherwise have been used to satisfy creditor claims.”

The Appeals Court’s Decision

No Fiduciary Duty of Care or Loyalty to Creditors

Relying on its analysis of California statutory and common law, *Credit Lyonnais* and subsequent decisions, and on the application of the trust fund doctrine, the appeals court concluded that "under the current state of California law, there is no broad paramount fiduciary duty of due care or loyalty that directors of an insolvent corporation owe the corporation's creditors solely because of a state of insolvency, whether derived from *Credit Lyonnais* or otherwise." The appeals court "decline[ed] to create such a duty, which would conflict with and dilute the statutory and common law duties that directors already owe to shareholders and the corporation. We also perceive practical problems with creating such a duty, among them a director's ability to objectively and concretely determine when a state of insolvency actually exists such that his or her duties to creditors have been triggered."

The appeals court held that "the scope of any extra-contractual duty owed by directors to the insolvent corporation's creditors is limited in California, consistently with the trust fund doctrine, *to the avoidance of actions that divert, dissipate, or unduly risk corporate assets that might otherwise be used to pay creditors [sic] claims* . . . [including] acts that involve self-dealing or the preferential treatment of creditors." Further, the appeals court held that because all California cases applying the trust fund doctrine have done so solely with respect to insolvent entities "and because the existence of a zone or vicinity of insolvency is even less objectively determinable than actual insolvency, . . . there is no fiduciary duty prescribed under California law that is owed to creditors by directors of a corporation solely by virtue of its operating in the 'zone' or 'vicinity' of insolvency."

Applying the scope of a director's fiduciary duty under California law, the appeals court affirmed the trial court's decision that Berg's complaint failed to plead adequate facts to support a claim that the Pluris directors breached their fiduciary duties under the trust fund doctrine. The appeals court agreed with the trial court that Berg's complaint did not plead that Pluris's directors had diverted, dissipated or unduly risked corporate assets. Instead, Berg merely asserted that the Pluris directors had not done enough (*i.e.,* had not investigated or explored whether a chapter 11 reorganization would have maximized the value of Pluris's NOLs). The facts as alleged did not involve self-dealing or prohibited preferential treatment of creditors and did not constitute any diversion, dissipation or undue risking of the corporate assets that otherwise could have been used to satisfy creditors' claims. Accordingly, the appeals court concluded that "no matter how Berg . . . characterizes or packages the basic factual underpinnings of its claim," as a matter of law, Berg's claim was inadequate to sustain a cause of action that the Pluris directors breached their fiduciary duties under the trust fund doctrine in California.

Business Judgment Rule

Further, the appeals court addressed the protection offered to directors under the business judgment rule. The business judgment rule, which is well-settled statutory and common law in California, "immunizes directors from personal liability if they act in accordance with" California law. The business judgment rule establishes a presumption that "directors' decisions are based on sound business judgment and it prohibits courts from interfering in business decisions made by directors in good faith and in the absence of a conflict of interest." The appeals court concluded that Berg's allegations did not rebut the presumption afforded by the business judgment rule. Accordingly, even if

Berg had otherwise stated a claim for which relief could be granted, its claim would still be barred by the business judgment rule.

Conclusion

The appeals court's clear holding in *Berg* will aid directors and officers in the performance of their well-established statutory and common law duties to shareholders and the corporation. The *Berg* decision makes clear that, in California, directors owe no fiduciary duty of care or loyalty to creditors, whether the corporation is insolvent or otherwise. However, liabilities may arise under the trust fund doctrine where self-dealing, preferential treatment of creditors, and diversion, dissipation or undue risk of corporate assets is proved.

As the appeals court noted in *Berg*, the *Credit Lyonnais* decision has generated substantial controversy and commentary over the last 19 years regarding a director's fiduciary duties to creditors. The *Berg* decision joins the Delaware Supreme Court's 2007 decision in *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla, et al.,* in clarifying a director's duties when a corporation is insolvent or in the zone of insolvency. The *Gheewalla* decision held that "the creditors of a Delaware corporation that is either insolvent or in the zone of insolvency have no right, as a matter of law, to assert direct claims for breach of fiduciary duty against a corporation's directors." The Delaware court held that "[w]hen a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must discharge their duty to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of the shareholder owners." However, when a corporation is insolvent, a creditor has standing to maintain derivative claims against directors for breach of their fiduciary duties of care and loyalty. Together, the *Berg* and the *Gheewalla* decisions form what is expected to be a growing body of case law clarifying a director's fiduciary duties to a corporation's constituents when the corporation is insolvent or in the zone of insolvency.

See *Berg & Berg Enterprises, LLC v. Boyle, et al.*, 178 Cal.App.4th 1020 (Cal.App. 2009).

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