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THE FIDUCIARY DUTIES OF DIRECTORS AND OFFICERS IN INSOLVENT CORPORATIONS: A UNIFORM INTERNATIONAL STANDARD?

William H Hudson

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"Expanded Duty revisits the fundamental question: for whom should corporate managers manage?"[1]

INTRODUCTION

There is very little international uniformity on the law of debtor-creditor relations when it comes to insolvency.[2] Starting with the global downturn in 2008, insolvency proceedings on an international scale have moved to the forefront of business news.[3] As the globalization of commerce continues, numerous companies have expanded their business bases to other nations in search of higher profits. While expanding customer bases is generally seen as a positive sign, these developments pose new legal challenges. The global downturn has complicated proceedings when it comes to debtor-creditor relations because case law in this area is still in its infancy.[4] There exists limited international uniformity in this important sector of insolvency law.

At the heart of this evolving case law are the fiduciary duties and potential liabilities of directors and officers[5] in troubled companies. Because the courts have yet to establish a consensus on numerous issues relating to the fiduciary duties of directors and officers, ambiguity

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[1] Frederick Tung, *The New Death of Contract: Creeping Corporate Fiduciary Duties for Creditors*, 57 Emory L.J. 809, 814 (2008).

[2] J. WILLIAM BOONE, MULTINATIONAL ENTERPRISE LIABILITY IN INSOLVENCY PROCEEDINGS, at v (1st ed. 2006).

[3] *See Lehman Bros Files for Bankruptcy*, BBC.COM, (Sept. 16, 2008) http://news.bbc.co.uk/2/hi/7615931.stm

[4] J. WILLIAM BOONE, MULTINATIONAL ENTERPRISE LIABILITY IN INSOLVENCY PROCEEDINGS, at v (2nd ed. 2010).

[5] The Supreme Court of Delaware has recently stated that corporate officers and directors owe fiduciary duties of care and loyalty to the corporation. The fiduciary duties of an officer are identical to those of a director. *See* Gantlyer v. Stephens, No. Civ. A. 2392, 2009 WL 188828, at *9 (Del. 2009). For the purposes of this comment, directors and officers will be discussed jointly.

and uncertainty abounds. This has created an environment of unpredictability and has posed difficult challenges to corporate directors and officers in companies with an international business base. This Article will highlight the broad range of fiduciary duties imposed on directors and officers in insolvent companies. This Article will also survey the different approaches nations have taken to impose those duties and their corresponding liabilities on corporate officers in financially distressed companies. Additionally, this Article will argue that an international standard of clear and uniform rules will lead to a more predictable legal position for the directors and officers of troubled corporations. An international standard will allow them to manage the risks of litigation and make informed decisions based on measureable and predictable rules. Specifically, this Article will argue that instituting a precise definition of insolvency (the "equity definition"), imposing requirements to file for bankruptcy in a timely manner once insolvency has been reached, and allowing courts to disqualify directors and officers to practice as board members is the most prudent approach to establishing predictable legal rules that will promote economic stability and growth.

Part I of this Article will explain and provide a background to the lack of international uniformity of the fiduciary duties owed by directors and officers in troubled corporations. It will explore why imposing such fiduciary duties on corporate directors and officers is worth the price paid in regulatory and transaction costs. Part II will provide specific goals for imposing fiduciary duties on directors and officers in troubled corporations and address the benefits of establishing well-defined goals when proposing suggestions. Part III will discuss and provide a macro-level look at the fiduciary duties imposed on corporate directors and officers around the world and address the discrepancies found in legislating and enforcing those fiduciary duties. Part IV will provide a much closer look into the anatomy of the fiduciary duties imposed by corporate law in the United States, United Kingdom, and Germany. Finally, Part V will provide useful suggestions for creating a more consistent and efficient set of fiduciary duties for corporate directors and officers. These will include establishing a uniform measurement for determining insolvency, creating a legal obligation to file for insolvency proceedings within a set time period with the risk of civil (and not criminal) penalties, and giving courts the power to disqualify directors and officers who have proven unable or unwilling to manage the troubled company.

I. BACKGROUND

The United Nations has attempted to address the void in uniform insolvency laws through the United Nations Commission on International Trade Law and through the publication of its Legislative Guide on Insolvency Law and the Model law on Cross-Border Insolvency.[6] These efforts have been successful in that many nations have recently updated their insolvency laws to better conform to the modern realities of business and finance.[7] Even with the recent changes, however, much of the law is still in its infancy and most companies dealing with multinational insolvency issues must face them on an *ad hoc* basis.[8] Inefficient, antiquated, and inconsistent guidelines on the director and officer obligations as a company approaches insolvency have the potential to undermine the necessary framework for efficient restructuring or orderly liquidation of financially distressed companies.[9]

Traditionally, there have been very few incentives for directors and officers to take advantage of insolvency laws in a timely fashion.[10] This state of affairs is troublesome for two

[6] BOONE, *supra* note 4, at iv.
[7] U.N. COMM. ON INTERNATIONAL TRADE LAW, DIRECTORS' RESPONSIBILITIES IN INSOLVENCY AND PRE-INSOLVENCY CASES, A/CN.9/WG.V/WP.96, 2 (Aug. 27, 2010).
[8] BOONE, *supra* note 4, at vi.
[9] U.N. COMM. ON INTERNATIONAL TRADE LAW, DIRECTORS' RESPONSIBILITIES IN INSOLVENCY AND PRE-INSOLVENCY CASES, A/CN.9/WG.V/WP.96, 2 (Aug. 27, 2010).
[10] *Id*.

reasons. First, the longer directors and officers wait to file for insolvency, the greater the change few resources will be left to pay the company's debts to creditors. Second, financial decline usually occurs at a faster pace than many of the parties realize and often leaved the creditors with very few assets to cover their losses.[11] As the financial position of a company worsens, the options offered by insolvency law also rapidly diminish.[12] For these reasons, the importance of commencing insolvency proceedings at the earliest opportunity cannot be overstated.

Although numerous countries purport to have legislation that imposes an obligation to directors and officers to file proceedings within a certain time period once the company is near insolvency, these requirements are rarely enforced.[13] In some jurisdictions, this problem is aggravated by the requirement that directors and officers actually engage in "fraudulent trading" for liability to exist.[14] "Fraudulent trading" is generally defined as a general course of action or omission by a director or officer that fails to minimize the financial loss to creditors once a company is near insolvency.[15]

Imposing additional fiduciary obligations on directors and officers has its costs.[16] In practice, these duties increase transaction costs when they are invasive and inflexible.[17] Granting fiduciary duties to creditors and other parties increases the risk of litigation and its associated costs.[18] Directors and officers may decide not to engage in potentially profitable transactions if doing so would expose them to an increased risk of litigation.[19] Expanding fiduciary duties to

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[11] *Id*.
[12] *Id*.
[13] *Id*. at 3.
[14] *Id*.
[15] PAUL L. DAVIES, PRINCIPLES OF MODERN COMPANY LAW 153 (6th ed. 1997).
[16] Tung, *supra* note 1, at 816.
[17] REINIER R. KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW 73 (2004).
[18] Tung, *supra* note 1, at 816.
[19] *Id*.

other parties could also increase the likelihood that litigation will take place in order to determine whether directors and officers have acted in a manner that creates value maximization.[20] In addition, granting fiduciary duties to creditors would require directors and officers to get permission from the numerous creditors to pursue a profitable venture, thus increasing the venture's transaction costs and diminishing its profitability.[21]

Given the regulatory costs of enforcing mechanisms for creditor protection, why should corporate law implement fiduciary rules on directors and officers to protect creditors? Two main reasons exist. First, corporations may lie about their assets and overall financial health to secure a loan (known as the *ex ante* problem).[22] This could lead to a much greater chance that the issuing creditor will never receive payment for the outstanding debt because the creditor issued the capital on faulty information. Second, debtors may breach the terms of their agreements either by diluting the company's assets that are within reach of the creditors or by engaging in risky investments that shift the risk of failure to the creditors (known as the *ex post* problem).[23] The *ex post* problem poses challenges to creditors because shareholder opportunism is especially likely when the corporation is near insolvency.[24] In these circumstances, directors and officers may be willing to engage in very risky financial maneuvers that have little upside to creditors.

Traditionally, corporate directors owe their duties to the shareholders of a corporation because the shareholders are entitled to the lasting value of the corporation.[25] Upon insolvency, a corporation undergoes a profound change. When a corporation is insolvent, the creditors harbor

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[20] *Id*. at 848.
[21] *Id*. at 851
[22] KRAAKMAN, *supra* note 17, at 71.
[23] *Id*. at 71-72.
[24] *Id*. at 73.
[25] Royce de R. Barondes, *Fiduciary Duties of Officers and Directors of Distressed Corporations*, 7 Geo. Mason L. Rev. 45, 63 (1998).

the risk in the residual value of the company and the traditional economic justification for promoting the shareholder's interests no longer exists.[26]

Upon insolvency, the shareholders no longer have anything to lose because little value remains in the company.[27] Shareholders only have everything to gain because the value of their shares is essentially worthless.[28] As a result, a rational shareholder would prefer a high risk maneuver with high profit potential because he cannot lose any more money than what has already been lost.[29] At least one scholar has commented that "post-insolvency investments by the firm are in effect gambles with the creditors' money."[30] In these situations, directors and officers making decisions based on shareholder interests could make inefficient investments that are profitable for shareholders[31] but harmful to other claimants and the firm.[32] Potential victims may include banks, bondholders, company founders, early investors, and other parties who are owed money in the troubled company.[33]

For this reason, courts and scholars have interpreted corporate case law to hold that upon insolvency, the duties of directors and officers shift to the company's creditors.[34] Why have courts in the past extended the fiduciary duties of corporate directors and officers to creditors? Two main reasons have been suggested: the "trust fund doctrine" and the "at risk doctrine."

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[26] *Id*.
[27] Cory Dean Kandestin, *The Duty to Creditors in Near-Insolvent Firms: Eliminating the "Near-Insolvency" Distinction*, 60 Vand. L. Rev. 1235, 1237 (2007).
[28] *Id*.
[29] *Id*.
[30] Tung, *supra* note 1, at 820.
[31] For more discussion on the risk of opportunism related to shareholder interest, *see* BRIAN R. CHEFFINS, COMPANY LAW: THEORY, STRUCTURE AND OPERATION 75-78 (1997).
[32] Tung, *supra* note 1, at 809.
[33] *Id*. at 812.
[34] Barondes, *supra* note 25, at 63.

The "trust fund doctrine" stipulates that upon insolvency, the directors and officers become trustees of the company's assets which should be held primarily for the creditor's benefits and then for the shareholder's financial benefit.[35] Thus, the directors and officers owe a fiduciary duty to the creditors just as any trustee would owe a fiduciary duty to a trust beneficiary.[36] Additionally, anyone who breaches this trust may be held personally liable.[37] The "trust fund doctrine" changes the original contractual relationship between the insolvent corporation and the creditors to that of a trustee and its beneficiaries.

The "at risk doctrine" is a competing theory to explain the reason behind extending the corporate director's duties to creditors.[38] The "at risk doctrine" holds that corporate directors owe an obligation to creditors because the creditors of an insolvent firm bear most, if not all, of the risk associated with the collapse of the troubled company.[39] This is because the shareholders have already lost the value of their shares in the company at the point of insolvency.[40] The stockholders bear a low level of risk and the "at risk doctrine" tries to protect creditors from opportunistic shareholders.[41] In this situation, creditors are more likely to lose a larger amount than shareholders could gain.[42]

In addition, why is it important to have international uniformity when it comes to this area of insolvency law? The unpredictability and ambiguity surrounding what fiduciary duties director and officers owe could impact a company's ability to make accurate business decisions.

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[35] *See, e.g.*, American Nat'l Bank v. Mortgage America Corp., 714 F.2d 1266, 1268-69 (5th Cir. 1983)
[36] Kandestin, *supra* note 27, at 1238.
[37] *American Nat'l Bank*, 714 F.2d at 1269.
[38] Kandestin, *supra* note 27, at 1236-39.
[39] *Id*. at 1238.
[40] Tung, *supra* note 1, at 820-23.
[41] Kandestin, *supra* note 27, at 1238.
[42] Tung, *supra* note 1, at 821.

This problem is exacerbated by globalization because corporations often have business dealings in different nations with drastically different rules. Juggling different fiduciary rules and regulations that have not been succinctly drafted creates an environment of uncertainty. Indeed, nations could lose out on valuable tax revenue by imposing ambiguous or draconian fiduciary rules on corporate directors and officers. To face these problems and to give fair weight to the interests of the creditors while still avoiding excessive transaction and regulatory costs, clear goals must be identified. These rules will allow drafters to create efficient fiduciary duties for directors and officers in corporations currently in or approaching insolvency.

II. GOALS OF WELL-DEFINED RULES FOR DIRECTORS AND OFFICERS OF DISTRESSED COMPANIES

For the proposed insolvency regulations to be effective, the goals of such regulations must first be identified. Because directors and officers in insolvent companies often have to juggle difficult financial decisions, effective legislation and regulation of director and officer duties should seek to balance the competing interests of stockholders and creditors. These regulations should allow corporate officers to the freedom to exercise their business acumen. Additionally, well-drafted regulations should promote responsible behavior and encourage early restructuring while minimizing incentives for unreasonable risk taking.

Although no clear goals of harmonized international insolvency regulations relating to the duties of directors and officers have been issued by States, the United Nations' Legislative Guide on Insolvency Law provides useful objectives for any proposed regulation. Four main goals are applicable to any proposed rule relating to the duties owed by directors and officers of troubled companies. First, the proposed rules should provide certainty in the marketplace in order to promote economic stability and growth.[43] Second, the proposed rules should enable the maximization of value of assets.[44] This would allow companies to make the most out of the capital and assets that remain. Third, there should be provisions for timely, efficient, and impartial resolution to the company's insolvency.[45] Lastly, the drafters should make sure that transparent and predictable insolvency laws contain incentives for gathering and dispensing accurate and reliable information.

Additionally, the Organization for Economic Co-operations and Development's (OECD) Principles of Corporate Governance provide a good rubric for the goals of insolvency regulation. The OECD is an organization created with the goal of promoting and developing polices that will improve economic and social development around the world.[46] The OECD principles state that rules pertaining to corporate governance should "promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities."[47] The proposed rules should also be examined on a macro level to determine their overall impact on economic performance and market integrity and their incentives to create transparent and efficient markets.[48] Further, enforcement authorities should have the resources and authority to fulfill their role as supervisors

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[43] U.N. COMM. ON INTERNATIONAL TRADE LAW, LEGISLATIVE GUIDE ON INSOLVENCY LAW 10 (2005).
[44] *Id*.
[45] *Id*. at 12
[46] Organization for Economic Co-operation and Development, http://www.oecd.org/pages/0,3417,en_36734052_36734103_1_1_1_1_1,00.html (last visited Feb. 26, 2012).
[47] ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, OECD PRINCIPLES OF CORPORATE GOVERNANCE 19 (2004) *available at* http://www.oecd.org/dataoecd/32/18/31557724.pdf.
[48] *Id*.

of the newly proposed rules.[49] Most importantly, any regulations should be timely, transparent, and fully explained[50] to allow market participants to conform.

With these goals in mind, this Article will survey different approaches nations have taken to impose fiduciary duties on directors and officers in troubled companies. As the survey will show, these approaches vary from nation to nation and often remain unclear even within a single country. A clear set of rules pertaining to the duties owed by directors and officers in troubled companies would eliminate some of the ambiguity and allow corporate officers to make business decisions based on well-defined regulations. Companies in business across multiple nations will benefit from clear and uniform rules because they will be able to make reasonable and calculated decisions across multiple jurisdictions.

III. THE FIDUCIARY DUTIES OF DIRECTORS & OFFICERS – A GLOBAL SURVEY

A. *The Survey*

This survey was conducted with the help the International Insolvency Institute, its members, and specifically, William Boone. The distinguished members of the International Insolvency Institute were asked to identify the country where they practice and to fill out a survey detailing the duties owed by corporate directors and officers in insolvent companies in their jurisdiction.. This survey highlights the broad spectrum of approaches taken in relation to corporate officer and director's fiduciary duties. It will provide a macro-level look at the fiduciary duties of corporate directors and officers in insolvent corporations. The large scale of this survey will highlight the various approaches and inconsistencies employed to instill fiduciary duties to corporate directors and officers. The survey represents the current law

[49] *Id.*
[50] *Id.*

pertaining to director and officer fiduciary duties in 23 countries.[51] The number of countries surveyed directly correlates to the responses received from members of the International Insolvency Institute. In all, over 40 surveys were completed. . I have permission to publish the results of the survey. To my knowledge, no other survey has ever been done to highlight the different approaches imposed by nations in regards to director and officer fiduciary duty in insolvent companies.

Do the specific duties and responsibilities of directors and officers change after commencement of an insolvency/reorganization proceeding with respect to:

	YES	NO
Creditors?	42.9% (6)	57.1% (8)
Employees?	42.9% (6)	57.1% (8)
Shareholders?	26.7% (4)	73.3% (11)
The Government?	26.7% (4)	71.4% (10)

Do directors and officers have criminal exposure if they violate their duties and responsibilities?

	Response Percent	Response Count
YES	86.7%	13
NO	13.3%	2
		(skipped question: 27)

Are they subject to imprisonment?

	Response Percent	Response Count
YES	80.0%	12
NO	20.0%	3
		(skipped question: 31)

Are they subjected to criminal fines or restitution?

	Response Percent	Response Count
YES	86.7%	13

[51] The countries surveyed include Argentina, Australia, Brazil, Canada, China, Croatia, Denmark, England, Estonia, Finland, France, Germany, Gibraltar, Greece, Hong Kong, Hungary, Italy, Kosovo, Mexico, Slovenia, South Africa, Spain, and the United States.

NO	13.3%	2
		(skipped question: 31)

Do the officers and directors have exposure to civil claims for the violations of the following duties?

	YES	**NO**
Failure to take reasonable steps to minimize losses to creditors?	66.7% (10)	33.3% (5)
Misappropriation of corporate assets?	100.0% (15)	0.0% (0)
Undervaluation of corporate assets in a preference or other transaction to the detriment of creditors?	100.0% (15)	0.0% (0)
Failure to inform creditors of insolvency?	46.2% (6)	53.8% (7)
Preferring payments to one creditor as opposed to another when insufficient monies are available to pay both?	71.4% (10)	28.6% (4)
Continuing to trade when there is little prospect of being able to pay when due?	80.0% (12)	20.0% (3)

Before the company becomes financially distressed, what duties, if any, do directors and officers have to:

	Response Percent	**Response Count**
Creditors?	100%	14
Employees?	100%	14
Shareholders?	100%	14
Government?	100%	14
		(skipped question: 32)

After the company becomes financially distressed (i.e. after it enters the "vicinity or zone of insolvency") what duties, if any, do directors and officers have to the following:

	Response Percent	**Response Count**
Creditors?	100%	14

Employees?	100%	14
Shareholders?	100%	14
Government?	92.9%	14
		(skipped question: 32)

Do the directors and officers have exposure to the groups in:

	YES	NO
Creditors?	70.0% (7)	30.0% (3)
Employees?	55.6% (5)	44.4% (4)
Shareholders?	80.0% (8)	20.0% (2)
The Government?	60.0% (6)	40.0% (4)

Who may bring civil claims against directors and officers for violation of their duties and responsibilities?

	YES	NO
Creditors?	100% (15)	0.0% (0)
Employees?	76.9% (10)	23.1% (3)
Shareholders?	100% (14)	0.0% (0)
The Government?	83.3% (10)	16.7% (2)
The Company itself through an administrator, trustee, or equivalent?	100% (15)	0.0% (0)

Can directors and officers be sued for alleged violation of their duties and responsibilities prior to the commencement of an insolvency/reorganization procedure?

	Response Percent	Response Count
YES	100%	15
NO	0%	0

Can directors and officers be sued for alleged violation of their duties and responsibilities prior to the commencement of an insolvency/reorganization procedure?

	Response Percent	Response Count
YES	100%	15
NO	0%	0

Does the existence of potential personal civil or criminal liability become a factor in officers and directors deciding when and if to put the company in a formal insolvency or reorganization procedure?

	Response Percent	Response Count
YES	73.3%	11
NO	26.7%	4

Is insurance available at realistic premiums which are designed to protect officers and directors from claims that arise while operating a financially distressed company?

	Response Percent	Response Count
YES	57.1%	8
NO	42.9%	6

Is there any personal civil or criminal exposure which acts to prevent directors and officers from resigning their positions once the company becomes financially distressed?

	Response Percent	Response Count
YES	21.4%	3
NO	78.6%	11

Are lawsuits against directors and officers for violation of their duties after the commencement of an insolvency/organization procedure typically successful?

	Response Percent	Response Count
YES	30.8%	4
NO	69.2%	9

What defenses against civil and/or criminal sanctions, if any, are available to directors and officers under general corporate law?

	Response Percent	Response Count
Good Faith?	60.0%	9
Due Diligence (for example, obtaining valuation of assets)?	93.3%	14
Reliance on outside consultants or professionals (such as accountants, legal	86.7%	13

advice, or financial advisors)?		
Exercise of reasonable judgment with intent to preserve the "on going value" of the enterprise?	80.0%	12

If it appears that the "going concern values" will result in a higher payout to creditors than a liquidation of assets, can directors and officers be protected if they decide to continue operations in order to protect those values for the benefit of all creditors?

	Response Percent	**Response Count**
YES	50.0%	7
NO	50.0%	7

Is the answer to the question above the same if the result is an increase of debt owed to creditors, even though the directors and officers were acting in good faith?

	Response Percent	**Response Count**
YES	57.1%	8
NO	42.9%	6

In the event that a company becomes insolvent, is a director and/or officer of the insolvent company legally restricted from acting as an officer or directors in another company?

	Response Percent	**Response Count**
YES	26.7%	4
NO	73.30%	11

In the event an officer or director becomes personally insolvent, is he/she legally restricted from continuing to act as an officer or director of:

	YES	**NO**
His/her current company?	46.7% (7)	53.3% (8)
Another company?	42.9% (6)	57.1% (8)

In the event that a company becomes insolvent, is an officer or director of the insolvent company legally restricted from obtaining credit as a promoter of a second company?

	Response Percent	**Response Count**

YES	6.7%	1
NO	93.3%	14

If the officer or director is restricted from acting as an officer/director in another company or from being a promoter in another company, is the legal restriction imposed when the officer or director has been found to have committed malfeasance?

	Response Percent	Response Count
YES	42.9%	3
NO	57.1%	4

If the officer or director is restricted from acting as an officer/director in another company or from being a promoter in another company, is the legal restriction imposed when the officer or director has been found to have committed mismanagement?

	Response Percent	Response Count
YES	42.9%	3
NO	57.1%	4

B. *Analysis and Specific Comments*

As the survey shows, there is a great deal of inconsistency when it comes to how countries deal with instituting fiduciary duties to corporate directors and officers. For example, when asked whether the duties imposed on directors and officers change after the commencement of insolvency, only 42.9% of respondents claimed that the fiduciary relationship towards creditors undergoes a change. In other words, 57.1% of respondents asserted that the fiduciary relationship between creditors and directors or officers does not change once a company undergoes insolvency proceedings. This split is almost 50-50 and signals great international inconsistency. Additionally, nearly a third of respondents claimed that directors and officers do not have exposure to civil claims for failure to take reasonable steps to minimize losses to creditors. This trend is worrisome because it could lead creditors into becoming much more risk averse and unwilling to lend capital to start-up organizations or struggling companies.

When it comes to the options available to creditors, the results are surprising. Respondents were asked if lawsuits against director and officer misconduct for violation of fiduciary duties are typically successful. Only 30.8% of respondents answered affirmatively. These results do not look favorable to creditors seeking redress from corporate misconduct.

In addition to the statistical questions, respondents were asked to comment on the current state of corporate law involving directors and officers in their jurisdiction. In Spain for example, a respondent answered that "directors may be liable for the liabilities arising for mismanagement or if they do not file for liquidation or bankruptcy on time." This statement can be distinguished to that of a respondent from Finland who replied that "there are no specific rules which will change as far as there or any other duties are concerned of officers and directors if the company becomes financially distressed." Being that both nations are members of the European Union, this inconsistency is surprising.

In Greece, a respondent answered that "Greek law does not establish a duty for directors or administrators to consider the interests of creditors." In Mexico, on the other hand, a respondent stated that "in addition to the corporation itself and the shareholders, the responsibility with . . . the creditors . . . all come into play. Directors are learning fast that they cannot stand idle." Based on these results, instituting an international standard could greatly reduce the inconsistencies found throughout corporate law.

III. ANALYSIS OF THE DUTIES AND OBLIGATIONS OF CORPORATE DIRECTORS AND OFFICERS AROUND THE WORLD.

Now that a macro-level analysis of the fiduciary duties of corporate directors and officers has been provided, a closer look into the specific laws of certain countries is needed to show the great degree of divergence throughout jurisdictions. Specifically, an analysis of the corporate laws in the United Stated, United Kingdom, and Germany will show the different approaches employed by these nations. This analysis will enable readers to identify both policies worthy of imitation and policies better off ignored. For example, the United States is an excellent illustration of the ambiguity and varying interpretations regarding director and officer's fiduciary duties in troubled corporations. The United Stated, United Kingdom, and Germany are excellent sources of study because they employ different policies and different enforcement mechanisms. A micro-level examination of these policies will shed light into the strategies used to provide protections to creditors and enable corporate managers to exercise their business acumen.

A. UNITED STATES

The survey of the duties and obligations of directors and officers in the United States focuses primarily on Delaware law because of the persuasiveness of Delaware court decisions in the area of corporate law. Over 40 percent of the corporations listed in the New York Stock Exchange and over 50 percent of Fortune 500 companies are incorporated in Delaware.[52] The Delaware court system is often viewed as the "Mother Court of corporate law."[53]

1. Duties Owed by Directors and Officers in Solvent Corporations

In the United States, directors and officers in solvent corporations owe fiduciary duties to the company they serve and its shareholders.[54] In general, courts have ruled that directors and officers in solvent companies do not owe duties to other groups, including creditors.[55] However, some states have adopted statutes that allow corporate directors to take into account other

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[52] DENNIS J. BLOCK, ET AL., THE BUSINESS JUDGMENT RULE 1 (5th ed. 1998).
[53] Kamen v. Kemper Fin. Servs., Inc., 908 F.2d 1338, 1343 (7th Cir. 1990), rev'd on other grounds, 500 U.S. 90 (1991).
[54] BLOCK, *supra* note 52, at 1. *See also* Arnold v. Society for Sav. Bancorp, Inc., 678 A2d 533, 539 (Del. 1996).
[55] Katz v. Oak Indus., 508 A.2d 873, 879 (Del. Ch. 1986).

constituencies, including creditors, in carrying out corporate decisions.[56] These statutes do not seem to impose new fiduciary duties on directors and officers but rather give them the latitude to consider others outside the company and its shareholders. However, these statutes do not give directors or officers permission to make decisions in favor of other constituencies at the expense of shareholders as doing so would likely violate their fiduciary duties.[57]

Under state corporate law, directors and officers in solvent corporations have two main duties: the duty of care and the duty of loyalty.[58] These fiduciary duties require that directors exercise the same care that an ordinarily prudent and diligent person would in the same circumstances.[59] The duty of care generally requires that directors and officers exercise their duties in good faith and in a responsible manner that a reasonably prudent person in the same position would.[60] The duty of loyalty generally requires that directors and officers act solely on behalf of the company and its shareholders and abstain from actions that would be self-serving or harmful to the company and its owners.[61]

Corporate directors and officers in troubled companies often face litigation and courts must then analyze the business dealings of these board members. When courts are required to examine the practices of directors and officers, the business judgment rule is the standard of judicial review.[62]

a) The Business Judgment Rule

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[56] *See e.g.*, Or. Rev. Stat. § 60.357(5).
[57] Revlon v. MacAndrews & Forbes Holdings Inc., 506 A.2d 173 (Del. 1986).
[58] *See* Gantlyer v. Stephens, No. Civ. A. 2392, 2009 WL 188828, at *9 (Del. 2009).
[59] BLOCK, *supra* note 52, at 1.
[60] *See e.g.*, Or. Rev. Stat. § 60.357(1)
[61] *See e.g.*, Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939)
[62] BLOCK, *supra* note 52, at 4.

The business judgment rule is a policy of judicial restraint born of recognition that directors are, in most cases, more qualified than judges to make business decisions.[63] Under the business judgment rule, courts presume that business decisions are made in an informed basis by disinterested and independent directors based on the belief that the decision will be in the best interests of the corporation.[64] This creates a rebuttable presumption that the directors acted in good faith. If the directors are sued based on their business decisions by an eligible litigant, the court will examine the actions and decisions of the corporate directors in a limited extent.[65] The court will only seek to determine whether the plaintiff has provided enough evidence to overcome the rule's presumption of good faith and informed decision-making.[66] If the presumption is not defeated, the business judgment rule prohibits the court from scrutinizing the merits of the corporate officer's decisions and second guessing their actions.[67] The business judgment rule has two main components. First, it provides a shield that protects corporate directors from personal liability if they follow the rule's requirements.[68] Second, the rule restricts a court from intervening into the business decisions made by a company's directors.[69] Thus, the rule protects directors and the decisions they make.

There are five rationales for the business judgment rule.[70] First, the legal system realizes that even well-informed and well-intentioned directors and officers can make decisions that

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[63] *See* International Insurance Co., v. Alfred M. Johns, 874 F.2d 1447 (11th Cir. 1989).
[64] BLOCK, *supra* note 52, at 5.
[65] *Id*.
[66] *Id*.
[67] *Id*.
[68] Lee v. Interinsurance Exch., 50 Cal. App. 4th 694, 714, Cal. Rptr. 2d 798, 810 (Cal. Ct. App. 1996).
[69] *Id*.
[70] BLOCK, *supra* note 52, at 12.

ultimately cause great harm to the company.[71] With this fact in mind, the business judgment rule creates an incentive for individuals to engage in corporate governance when they would otherwise abstain due to the threat of litigation and personal liability.[72] Second, the rule recognizes that business ventures come with a degree of risk. The rule grants directors and officers the freedom to make profit-seeking decisions without the fear of a judge's scrutiny further down the road.[73] By acknowledging that business ventures are often riddled with risk, the rule incentivizes business actors to innovate and to enter new markets.[74]

Third, the business judgment rule prevents courts from conducting armchair quarterbacking in an area where they not qualified to opine.[75] Fourth, the business judgment rule prevents shareholders from managing the company's decisions instead of duly appointed directors and officers.[76] If shareholders had the ability to demand judicial oversight of corporate officer's decisions, the outcome would be a transfer of the decision-making capabilities to any shareholder willing to engage in litigation.[77] Fifth, shareholders have other avenues available to protest the business decisions made by the board. Directors and officers serve at the pleasure of the shareholders; shareholders can voice their displeasure with business decisions by voting them out of office.[78]

In addition to the rationales behind the business judgment rule, the rule is generally interpreted as requiring five elements: (1) a business decision, (2) disinterestedness and

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[71] *Id*.
[72] *Id*.
[73] *Id*. at 12-13.
[74] *Id*. at 13.
[75] *Id*. at 15. *See also* International Ins. Co. v. Johns, 874 F.2d 1447, 1458 (11th Cir. 1989) saying that "Directors are, in most cases, more qualified to make business decisions than are judges."
[76] BLOCK, *supra* note 52, at 17.
[77] *Id*.
[78] *Id*. at 18.

independence, (3) due care, (4) good faith, and (5) no abuse of discretion.[79] The first element is satisfied if the decision in question involves a business or profit-seeking judgment.[80] The business judgment rule provides no protection for inaction, unless the inaction was a deliberate choice by the corporate officer.[81] In other words, a director should not benefit from the business judgment rule if the decision will provide a personal financial benefit disproportional to the overall benefit shared by the stockholders[82] When the decision of the corporate directors involves motives primarily benefiting the directors and adverse to the company, the court's traditional reluctance to scrutinize the merits of the business decisions necessarily must end.[83] Additionally, the second element requires decision-making independence in the sense that the director's decision should be based on the benefits of the action instead of extraneous influences not directly relating to the company's profit-seeking motives.[84]

Due care, the third element of the business judgment rule, must also be present for directors to take advantage of the rule's protections. Due care mandates that corporate directors make their business decisions based on a reasonably informed position.[85] The due care standard does not apply to the specific decision made by the directors and officers but instead refers to the decision-making process that they follow.[86] Therefore, satisfaction of the duty of care requirement cannot be determined by the specific outcome of a decision, but instead must be

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[79] *Id*. at 39.
[80] *Id*. at 40-41.
[81] *Id*. at 40.
[82] *Id*. at 43.
[83] *Id*. at 44.
[84] *Id*. at 45. *See also* Cede & Co. v. Technicolor, Inc., 634 A.2d 345 (Del. 1993) and Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156 (Del. 1995).
[85] BLOCK, *supra* note 52, at 74.
[86] *Id*.

determined on the merits of the decision-making process.[87] The fulfillment of the due care element hinges on "whether the directors have informed themselves 'prior to making a business decision, of all material information reasonably available to them.'"[88]

Good faith is the fourth element required in the business judgment rule. Dealing in good faith presumes that the directors make decisions and take actions that they believe are in the best interest of the company.[89] Entering into a transaction for any purpose other than the company's welfare constitutes dealing in bad faith.[90] However, the test for determining bad faith is a high one. Bad faith may be determined if the decision is beyond any reasonable judgment and inexplicable on any other ground besides bad faith.[91] Finally, the business judgment rule requires that there be no abuse of discretion by the directors and officers. Abuse of discretion is defined as conduct "so egregious on its face that board approval cannot meet the test of business judgment."[92] With this requirement in mind, the business judgment rule does not completely bar courts a role in examining the decisions made by corporate directors.[93] Instead, the fifth element of the business judgment rule allows judges to review corporate board decisions not to substitute their personal business viewpoints but instead to search for abuses of discretion.[94]

2. For Whom Should Corporate Managers Manage? Extending Fiduciary Duties to Creditors

Given the protections afforded to directors and officers by the business judgment rule, should corporate law go against the pattern of being debtor-friendly and extend fiduciary duties

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[87] *Id*. at 75.
[88] Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).
[89] BLOCK, *supra* note 52, at 81.
[90] *Id*.
[91] *Id*. at 82.
[92] *Id*. at 84 (citing Aronson v. Lewis, 473 A.2d 815).
[93] *Id*.
[94] *Id*.

to creditors as a corporation nears or enters insolvency? This question poses numerous challenges. As stated earlier in this Article, the "trust fund doctrine" and the "at risk doctrine" have been proposed as reasons to extend fiduciary duties to creditors. In *Geyer v. Ingersoll Publications Co.,*[95] the court solidified the trust fund doctrine in Delaware's corporate case law.[96] The court wrestled with the difficult task of identifying when exactly a firm has become insolvent. The creditor, Thomas Geyer, sued to collect an outstanding claim alleging that Ingersoll Publications Co. entered into transactions that caused its demise.[97] The plaintiff further alleged that the corporate officer turned over company assets while still indebted to him, thus violating the duties owed to the company's creditors.[98] In its motion to dismiss, the defendant alleged that it owed no insolvency duties to the plaintiff because such duties only arise when the company actually files for bankruptcy.[99] Holding for the plaintiff, the court rejected the defendant's assertion and concluded that the duties owed to creditors arise upon insolvency in fact, no when a company files for bankruptcy.[100] Hence, it is now settled case law[101] that directors owe a duty to creditors when a corporation is insolvent in fact. However, precisely how far this duty reaches beyond insolvency is uncertain.[102]

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[95] Geyer v. Ingersoll Publ'ns Co., 621 A.2d 784 (Del. Ch. 1992).
[96] Kandestin, *supra* note 27, at 1235.
[97] *Geyer*, 621 A.2d at 786.
[98] *Id*.
[99] *Id*. at 787.
[100] *Id*. at 790.
[101] This is the current case law in Delaware. For a contrasting opinion, *see* Berg & Berg Enterprises, LLC v. Boyle, 178 Cal. App. 4th 1020, 100 Cal. Rptr. 3d 875 (2009), review denied (Feb. 3, 2010), reh'g denied (Nov. 24, 2009) (holding that California did not recognize a broad fiduciary duty to creditors from directors based solely on the company's state of insolvency).
[102] Kandestin, *supra* note 27, at 1246.

Even though it is now settled that once a company enters into insolvency the corporate directors owe fiduciary duties to creditors,[103] it appears that courts are divided on the issue of whether corporate directors continue to owe any fiduciary duties to shareholders. Some courts hold that directors no longer have duties to shareholders upon insolvency.[104] Other courts hold that directors and officers owe their duties to both shareholders and creditors.[105]

In jurisdictions where there exists a dual entitlement of duties, case law provides limited guidance on a method to balance these two seemingly competing interests.[106] In *Omnicare, Inc. v. NCS Healthcare, Inc.*[107] the court held that the corporate directors had breached their duty to stockholders by not completing their due diligence in attempting to find a better buyer.[108] In contrast, the Chancery Court of Delaware held that corporate directors did not breach their duties when they approved the sale of most of the corporation's debt but failed to provide anything to the stockholders.[109]

3. Duties owed by Directors and Officers in Corporations in the "Twilight of Insolvency"

a) Credit Lyonnais

A company enters the "twilight of insolvency" when it has not officially filed for insolvency proceedings and is instead in a position where its finances point to insolvency in the near future. Exactly when a company has entered the "twilight of insolvency" is difficult to

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[103] *Id*. at 1238.
[104] *See* FDIC v. Sea Pines Co., 692 F.2d 973, 977 (4th Cir. 1982) (embracing the "trust fund doctrine" in holding that directors owe duty to creditors as trustees of the insolvent corporation's assets).
[105] *See* WILLIAM E. KNEPPER & DAN. A. BAILEY, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS 204-05 (6th ed. 1998).
[106] *Id*. at 205.
[107] 818 A.2d 914 (Del. 2003).
[108] Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 937 (Del. 2003)
[109] Blackmore Partners v. Link energy, CA. No. 454-N, 2005 Wl 2709639 (Del. Ch. Oct 14, 2005).

determine. The most prominent case in regards to corporate officer's expanded duties in the "twilight of insolvency" is *Credit Lyonnais Bank Nederland N.V. v. Pathe Communications Corp.*[110] The *Credit Lyonnais* decision pioneered a new viewpoint regarding corporate director's duties.[111] In reaching its decision, the court stipulated that when a company is "operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue [sic] risk bearers, but owes its duty to the corporate enterprise."[112] While the court refers to the corporate director's duty to the "corporate enterprise" instead of creditors specifically, it seems clear from the court's reasoning that it has the interest of the creditors in mind.[113] Although the court extended the fiduciary duties of corporate directors, the decision caused many more questions than it answered.[114] Interestingly, the court refused to shed light on where the business judgment rule fits in with this new arrangement and failed to define the vicinity of insolvency that it advocated.[115]

In addition, the standard created by the *Credit Lyonnais* court creates other problems with ambiguity not related to deciding when a company has entered insolvency. In stating its opinion, the court failed to articulate a standard as to when a corporation is in the twilight of insolvency.[116] The goal announced in the *Credit Lyonnais* case is to maximize the distressed corporation's "wealth creating capacity" and cannot be substituted by a company's "net income"

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[110] Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., 17 Del. J. Corp. L. 1099, (1991).
[111] Kandestin, *supra* note 27, at 1250.
[112] *Credit Lyonnais*, 17 Del. J. Corp. L. at 1155.
[113] Ramesh K.S. Rao, et al., *Fiduciary Duty a la Lyonnais: An Economic Perspective on Corporate Governance in a Financially Distressed Firm*, 22 Iowa J. Corp. L. 53, 65 (1996).
[114] Kandestin, *supra* note 27, at 1250.
[115] *Id.*
[116] Barondes, *supra* note 25, at 72.

because it is not always deterministic.[117] Even if the "wealth creating capacity" could be determined with the metrics of Generally Accepted Accounting Principles, a reviewing court would often be unable to accurately assess whether the decisions of corporate directors maximize "wealth" because businesses are routinely presented with options which are not easily quantified without a prohibitively expensive consulting or research.[118] Thus, the developments created by *Credit Lyonnais* created a nebulous standard that is difficult to apply.[119] The uncertainty and liability created by the legal framework in a company near or in insolvency can create or accelerate defections by corporate board members at the expense of the distressed company.[120]The fallout created by *Credit Lyonnais's* ambiguity would be tackled by subsequent decisions, discussed below.

b) Credit Lyonnais's Progeny

Courts have primarily interpreted the *Credit Lyonnais* opinion in three ways. First, some courts have found that *Credit Lyonnais* serves simply as a shield for directors who are protected from liability for considering the interests of others (at the expense of the shareholders).[121] Second, other courts have read *Credit Lyonnais* to mean that a breach of the fiduciary duties owed to other constituencies will only occur on a narrow set of circumstances including fraudulent conveyance and engaging in self-dealing.[122] Lastly, other jurisdictions have

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[117] *Id*.
[118] *Id*. at 73.
[119] *Id*. at 76.
[120] *Id*.
[121] Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 788 (Del. Ch. 2004).
[122] Steinberg v. Kendig (In re Ben Franklin Retail Stores, Inc.), 225 B.R. 646, 655-56 (Bankr. N.D. Ill. 1998).

interpreted *Credit Lyonnais* as giving creditors the judicial tools to litigate breaches in fiduciary duties with the zone of insolvency.[123]

c) *Attempts at Clarity: The Gheewalla Decision*

The Delaware Supreme Court addressed many of the issues and ambiguity created by past judicial decisions when it issued the decision in *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*.[124] Until recently, some judges in Delaware believed that fiduciary duties shifted when a corporation entered the "zone of insolvency."[125] The Delaware Supreme Court attempted to put an end to that viewpoint by stating that "no direct claim for breach of fiduciary duties may be asserted by creditors of a solvent corporation that is operating in the zone of insolvency."[126] The court asserted that at all times, the fiduciary duties of corporate directors and officers were to maximize the value of the enterprise for the stakeholders.[127] The stakeholders were identified as the shareholders when the corporation is solvent and as the creditors when the corporation enters insolvency.[128] However, problems remain. The decision in *Gheewalla* is only binding in Delaware and not all courts will necessarily follow its reasoning.[129] Additionally, ambiguities still exist when it comes to determining when exactly insolvency has taken place.

5. When Do Fiduciary Duties Arise? Determining Insolvency

[123] Jewel Recovery, L.P. v. Gordon (In re Zale Corp.), 196 B.R. 348, 354-55 (Bankr. N.D. Tex. 1996).
[124] 930 A.2d 92 (Del. 2007).
[125] *See generally,* Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., 17 Del. J. Corp. L. 1099 (1991).
[126] North American Catholic Educational Programming Foundation, Inc. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007).
[127] *Id.*
[128] *Id.*
[129] *See* In re Dulgerian, 388 B.R. 142, 150 (Bankr. E.D. Pa. 2008) (stating that the *Gheewalla* decision goes against other cases interpreting Pennsylvania law).

a) The Equity and Balance Sheet Definitions:

Under the current interpretation of U.S. law, there exist 4 main approaches to identify insolvency. Each definition carries potential problems in calculation. Under the "equitable definition test" a firm is deemed insolvent if it cannot pay its debts as they become due in the normal course of its business dealings.[130] Under the "balance sheet test,"[131] a firm is deemed insolvent when its liabilities exceed its assets.[132] However, substantial doubt remains in instituting this definition because often times, the true market value of the company's assets are hard to determine.

c) A Mix of the Equity and Balance Sheet Definitions:

To complicate matters, both definitions of insolvency have been used together to determine the point of insolvency. In *In Re Marvel Entm't Group, Inc*., the court applied both tests.[133] Courts even combine the two definitions to form their own test as to when insolvency actually arises. In *Geyer*, the court combined the definitions to find that a corporation "is insolvent when it is unable to pay its debts as they fall due in the usual course of business. That is, an entity is insolvent when it has liabilities in excess of a reasonable market value of assets held."[134] Indeed, there exists no established agreement as to whether directors and officers should consider the firm insolvent when the fair value of the company's assets are less than its liabilities or when the company can no longer pay its debts as they come due.[135]

d) The "Unreasonably Small Capital Test" – Insolvency Before Actual Insolvency

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[130] Kandestin, *supra* note 27, at 1244.
[131] The "balance sheet test" is also referred to as the "bankruptcy test." *See* Rao, *supra* note 113 at 63.
[132] Kandestin, *supra* note 27, at 1244.
[133] 274 B.R. 99, 110 (D. Del 2002).
[134] Geyer v. Ingersoll Publ'n Co., 621 A.2d 784, 789 (Del. Ch. 1992).
[135] Rao, *supra* note 113 at 63.

Adding to the definitional ambiguity of identifying insolvency, some courts have used the nebulous "unreasonably small capital" test to determine when insolvency has taken place.[136] Because the equity and balance sheet definitions leave open the possibility that a company is technically solvent but will nevertheless fail in the future, leaving creditors without a right to fiduciary duties, courts instituted the "unreasonably small capital" test. Through this framework, fiduciary duties are delegated to creditors when the company has an unreasonably small level of capital to continue doing business.[137] This test levies a fiduciary duty upon corporate directors when a transaction imposes an unreasonable risk of insolvency or when the onset of insolvency is reasonably foreseeable.[138]

The biggest hurdle in satisfying these new duties imposed on corporate directors lies in the ambiguity created by the new obligations.[139] If corporate insolvency is defined as having more liabilities than assets on hand, or as an inability to pay debt as it becomes due, reasonable individuals may reach different conclusions as to when exactly insolvency has taken place because these definitions may be hard to apply to a specific fact pattern. [140] This problem is aggravated because uncertainty exists as to the proper accounting treatment of write-offs during restructuring.[141] Given the difficulties associated with pinpointing when insolvency has taken place, directors and officers may be unaware when their duties have expanded to other constituencies.[142] The ambiguity is worrisome because often corporate directors must make business decisions and be open to liability without being able to pinpoint when their duties have

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136 Pereira v. Cogan, 294, B.R. 449, 521 (S.D.N.Y. 2003).
137 *Id.*
138 Miramar Resources, Inc. v. Shultz (In re Shultz), 208 B.R. 723, 729 (Bankr. M.D. Fla. 1997)
139 Barondes, *supra* note 25, at 71.
140 *Id.*
141 *Id.*
142 Rao, *supra* note 113 at 64.

shifted or become available to other constituencies.[143] With these problems in mind, an international legal standard would greatly help in dispelling the ambiguity in determining when insolvency has actually taken place. With companies participating in business across numerous countries, these problems will only be exacerbated. An international standard would aid in dispelling both domestic and international ambiguity.

B. UNITED KINGDOM

1. Corporate Law Framework

Unlike the United States, which is commonly seen as being debtor-friendly, the United Kingdom is often portrayed as being creditor-friendly.[144] In fact, corporate law in the United Kingdom provides a cause of action in favor of creditors against *any person* that acts on company business with the intent to defraud creditors.[145] More importantly, directors and officers can be held liable under the Insolvency Act for responding negligently to their company's insolvency.[146] Within the United Kingdom, there are five main categories when it comes to director and officer fiduciary duties.[147] First, there is the duty to act in good faith in the interests of the company.[148] Second, directors must utilize their powers for their intended purpose.[149] Third, directors are seen as trustees of the company's property and liable for any misuse.[150]

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143 Kandestin, *supra* note 27, at 1244.
144 KRAAKMAN, *supra* note 17, at 78.
145 *Id*. at 94.
146 *Id*. at 73.
147 JOHN DE LACY, THE REFORM OF UNITED KINGDOM COMPANY LAW 152 (2002).
148 *Id*.
149 *Id*. at 153.
150 *Id*.

Fourth, directors have an obligation to avoid conflicts of interest.[151] Lastly, directors are held liable for any secret profit derived from holding their positions on the board.[152]

Corporate law within the United Kingdom is very distinct when compared to the recent developments in Delaware corporate law. In the United Kingdom, the interests of creditors are predominant when a company is insolvent or within the "twilight of insolvency."[153] Once a company is insolvent, directors and officers are liable for any actions considered to be fraudulent or wrongful trading.[154] The reviewing court can declare a corporate officer or director guilty of "wrongful trading" if it finds that board member did not take all reasonable steps to minimize the loss to creditors once he realized that the company was headed toward insolvency.[155] In addition, the Insolvency Act adds additional restrictions to corporate officers in an insolvent corporation. The Act makes it unlawful for a director or officer in the original company to form or manage a new company with same or similar name and with the purpose of suggesting association with the troubled company.[156] This restriction is applicable to any director who was a member of the company within the last 12 months preceding its insolvency.[157] Additionally, any person in breach of this regulation can be held personally liable for the debts and liabilities of the corporation.[158]

Article 214 of the Insolvency Act has introduced personal liability to directors and officers for the wrongful trading in the vicinity of insolvency.[159] This personal liability can be

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[151] *Id*.
[152] *Id*.
[153] *Id*. at 163.
[154] PAUL L. DAVIES, PRINCIPLES OF MODERN COMPANY LAW 151 (6th ed. 1997).
[155] *Id*. at 153.
[156] *Id*. at 156.
[157] *Id*.
[158] *Id*.
[159] WOLFGANG SCHÖN, TAX AND CORPORATE GOVERNANCE 41 (3rd ed. 2008).

enforced by the company's liquidator once the company undergoes formal insolvency proceedings.[160] For example, in *Re Purpoint*,[161] the court held the company director personally liable for unpaid corporate taxes under Article 214 IA.[162] The director was forced to secure payment for the outstanding tax debt.[163] In addition to extending personal liability, United Kingdom corporate law utilized the disqualification approach to regulate the actions of corporate directors and officers.

2. The Disqualification Approach

United Kingdom corporate law imposes a duty on directors and officers to pay special attention to creditor interests when the corporation is in the vicinity of insolvency.[164] Recently, the country has increased the regulation of directors and officers through more robust enforcement[165] of the Company Directors Disqualification Act of 1986.[166] The Act gives courts the power to disqualify directors and officers from carrying on their managerial duties.[167] When issuing a disqualification, the court essentially declares that the directors and officers have proven to be inadequate in managing the troubled corporation.[168] . Nevertheless, the requirements for disqualification include engaging in reckless conduct and negligently managing the company's accounting matters.[169] According to some scholars, punishment by means of

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160 *Id*.
161 *Re Purpoint* [1991] BCLC 491
162 SCHÖN, *supra* note 159, at 41.
163 *Id*.
164 KRAAKMAN, *supra* note 17, at 91.
165 For the year 2000-01, the Disqualification Unit's success rate amounted to 94% in their prosecution of directors and officers who had violated their fiduciary duties. *See* DE LACY, *supra* note 147, at 211.
166 KRAAKMAN, *supra* note 17, at 91.
167 *Id*.
168 *Id*.
169 *Id*.

disqualification can be a more effective approach than imposing liability to the insolvent company's directors and officers.[170]

The courts, however, have limited the application of the disqualification standard in certain situations. For example, courts have refused to disqualify a director or officer if his act or omission is due to a naïve or foolish standard.[171] The reasoning behind this is that court would like to avoid infringing on the director or officer's freedom to manage the company as he sees fit.[172] This philosophy can be equated with the American business judgment rule where courts are reluctant to scrutinize the decisions of board members in order to avoid unnecessarily questioning their judgment. Through the disqualification method, courts look to reprimand directors or officers who have willfully and/or maliciously sought to exploit the privileges associated with their position for their own advantage.[173]

The disqualification process serves to protect the public from inadequate directors and officers by not permitting them to manage other companies for set period of time.[174] This penalty is a noteworthy punishment because it affects the director or officer's earning potential and may cause personal and professional disgrace.[175] Additionally, the director who contests his disqualification may face steep costs associated with the litigation involved.[176] Given the nature and effects of the disqualification process, it seems that the penalties associated with this punishment would deter corporate directors and officers in large companies more than small business owners. This could be because a director or officer in a smaller company may still be

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[170] *Id*.
[171] DE LACY, *supra* note 147, at 207.
[172] *Id*. at 207-08.
[173] *Id*. at 208.
[174] *Id*. at 203.
[175] *Id*. at 203-04.
[176] *Id*. at 204.

able to run a small business as the sole owner. That option is likely not feasible in a large corporation.

3. Analysis of the United Kingdom Model

As a whole, it seems that the United Kingdom's disqualification approach could be a very powerful incentive to influence the actions of corporate directors and officers within insolvent corporations. The United Kingdom effectively avoids the disqualification option from becoming a draconian rule through the requirement that the director's conduct be wanton and reckless and not just imprudent. However, in light of these positive developments, challenges remain. For example, it seems that the United Kingdom has not created a clear definition of insolvency or when exactly a company lies within the twilight of insolvency. An international model could help alleviate this ambiguity and add certainty to the marketplace. In addition, attaching personal liability to corporate directors and officers could backfire in the long run. This approach could be detrimental to attracting the best talent because many potential corporate officers or directs could be scared away by the prospect of being held personally liable for problems related to the company's financial health later down the road. In all, a study of the current state of director and officer fiduciary duty in the United Kingdom reveals some approaches that could be useful in created an efficient international standard. The disqualification approach is could be particularly effective in other nations.

C. GERMANY

Like most other nations, Germany has faced increased exposure to bankruptcies with the recent global downturn.[177] In recent history, Germany's 120 year old *Bankruptcy Act* and the 70 year old Composition Rules have proven antiquated in dealing with complex insolvency

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[177] WORLD INSOLVENCY SYSTEMS: A COMPARATIVE STUDY 241 (OTTO EDUARDO FONSECA LOBO ed.) (2009).

issues.[178] For this reason, efforts were started as early as 1970 to deal with the challenges posed by modern bankruptcy.[179] These efforts came to fruition with the promulgation of the *Insolvency Statute*[180] ("InsO") which came into effect on January 1, 1999. When assessing the fiduciary duties of corporate directors and officers, the InsO is the guiding authority.

1. Corporate Law Framework

The corporate governance structure used in Germany differs from the U.S. model in a both structural and substantive sense.[181] German companies employ a two-tier system[182] of boards of directors to protect the interests of the shareholders.[183] The U.S., on the other hand, utilizes a single-tier system of corporate governance. The two boards in Germany are organized vertically with an elected supervisory board that appoints the managing board.[184] The managerial board's members, in turn, are principally in charge of the corporation.[185] Simply because the supervisory board has the power to appoint the managerial board does not mean that the supervisory board wields all of the power. The supervisory board cannot expel the managerial board without due cause.[186] Additionally, the supervisory board may even be overruled on decisions if the managerial board obtains a three-quarter majority in the disputed decision.[187]

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[178] *Id*.
[179] *Id*.
[180] For the text of the law, *see*: www.iuscomp.org/gla/ (last visited Feb. 25, 2012).
[181] Justin Wood, *Director Duties and Creditor Protections in the Zone of Insolvency: A Comparison of the United States, Germany, and Japan*, 26 Penn St. Int'l L. Rev. 139, 152 (2007).
[182] France allows company boards to be structured in this manner and the Netherlands requires the same two-tier board system in open companies. *See* KRAAKMAN, *supra* note 17, at 35.
[183] Wood, *supra* note 181, at 152.
[184] KRAAKMAN, *supra* note 17, at 35.
[185] *Id*.
[186] *Id*.
[187] *Id*. at 90.

2. Definition of "Insolvency" and the Obligation to File a Petition for Insolvency Proceedings

Under German law, insolvency proceedings *must* be filed if a company is deemed to be over-indebted or insolvent.[188] German directors are negligent *per se* when they fail to follow capital maintenance regulations.[189] During the insolvency proceedings, it must be determined whether the corporation should be allowed to continue doing business or whether it should be liquidated for the benefit of the creditors.[190] In contrast to the ambiguity in American jurisprudence relating to exactly what constitutes "insolvency," §17(2) of the InsO succinctly defines insolvency as the condition in which a company is unable to meet its due payment obligations.[191] This definition is much like the "equity definition" employed by some courts in the United States. Even more succinctly, the Federal High Court of Justice defined insolvency as when a company lacks more than 10% of the necessary funds to meet its obligations in the next 21 days and it is not foreseeable when the 10% financial breach will be improved.[192]

In addition to the requirement to file for an insolvency proceeding when a corporation is deemed to be insolvent, over-indebtedness also triggers the requirement to file for formal proceedings. Unlike the definition for insolvency, over-indebtedness is more challenging to define. Over-indebtedness could exist if the company's obligations to creditors are no longer covered by the company's financial assets.[193] In assessing whether over-indebtedness has taken place, it is imperative to determine if company is able to accurately determine if and when its

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188 WORLD INSOLVENCY SYSTEMS: A COMPARATIVE STUDY, *supra* note 177, at 282.
189 KRAAKMAN, *supra* note 17, at 35.
190 WORLD INSOLVENCY SYSTEMS: A COMPARATIVE STUDY, *supra* note 177, at 283.
191 *Id*. at 282.
192 *Id*. at 283
193 *Id*.

business dealings are likely to improve.[194] The company's directors and officers are to base their decision to file for insolvency proceedings based on these prognoses.

Unlike the United States, if the directors and/or officers of a legal entity arrive at the conclusion that the corporation is either insolvent or has incurred too much debt, the board is obligated to file for insolvency with the applicable court within a three week window.[195] Under Section 15a of the Germany Insolvency Code, a managing director can be held personally liable in tort if he is proven to have delayed the filing a corporate bankruptcy petition. Additionally, there may be an injunction to practice a profession for a five year period placed on the managers who fail to follow these regulations.[196] This approach is very similar to the one employed in the United Kingdom where courts are empowered to disqualify directors for willful and wonton actions detrimental to the insolvent company's finances.

Germany's three week limit may be fully exhausted only if the insolvency procedures are actually initiated.[197] Merely waiting for the three week time period to lapse is not sufficient, but instead bankruptcy proceedings must be filed immediately and without a culpable delay.[198] Hence, the three week time limit is the maximum allowed and should not be permitted to lapse even if restructuring negotiations are underway.[199]

Often, the time period for filing for insolvency is too short for restructuring negotiations to take place.[200] In such a situation, the only feasible option for an insolvent company is to

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[194] *Id*. at 284.
[195] *Id*.
[196] *Id*.
[197] *Id*.
[198] *Id*. at 284-285.
[199] *Id*. at 285.
[200] *Id*. at 284.

encumber more loans in the form of either a bridge or a restructuring loan.[201] A bridge or restructuring loan is a form of credit given to a troubled company that could help it bridge the gap between when its debts are due and when it expects to be in a better financial position. At times, these loans are granted by creditors who are already owed a substantial amount of capital by the troubled corporation.[202] These types of bridge or restructuring loans involve substantial risk for the lenders and may have the added drawback of creating criminal liability for the lenders for aiding and abetting protracted insolvency.[203] It is therefore a difficult balancing act for the directors and officers to decide if the legal obligation to file for insolvency proceedings within the three week period will involve great risks of personal and civil liability should the company come into economic difficulty.[204]

3. Director and Officer Duties Once Insolvency Has Taken Place

Under German law, once insolvency proceedings have been filed, the company's management by the usual directors and officers ends.[205] From then on, those management duties are taken over by the administrator-in-insolvency who will make decisions on behalf of the company.[206] Hence, the struggle between duties owed to creditors or shareholders by officers and directors of an insolvent company does not take place because those decisions are to be made by an appointed administrator. However, the duty of the administrator is in the first place to the creditors.[207]

4. Analysis of the German Model

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[201] *Id*. at 285.
[202] *Id*.
[203] *Id*.
[204] *Id*.
[205] BOONE, *supra* note 2, at 116.
[206] *Id*.
[207] *Id*.

The German model has many positive aspects. The problems of ambiguity related to determining when insolvency has taken place are greatly curtailed with the German definition of insolvency. Although arguably arbitrary, the definition of insolvency as when a company lacks more than 10% of the necessary funds to meet its obligations in the next 21 days and it is not foreseeable when the 10% financial breach will be improved is very explicit. Corporate directors and officers facing insolvency will be able to pinpoint when that criteria has been reached. This will enable them to be in a better position to plan the company's pre and post-insolvency strategy.

However, certain aspects of the German model could be improved. Germany's 3-week window in which to file for insolvency is too short. This deadline could add increased risk to creditors. The 3-week window is too short because the time period is not long enough for successful restructuring negotiation to take place. This will leave creditors in an exposed position because they have little recourse but to lend even more money to the company as a bridge or restructuring loan in order to avoid filing for insolvency. Even more worrisome, creditors could incur criminal liability for aiding and abetting the delay in filing for insolvency. Additionally, the 3-week time limit could cause a talent drain in management positions because able managers could be hesitant to practice under harsh rules. Even with these critiques, the German model has much to offer in creating an international standard. The precise definition of insolvency is a good example for other nations to follow.

V. CONCLUSION

The micro and macro-level study of corporate director and officer fiduciary duties in troubled companies reveals that there is great international inconsistency involving these laws. Some nations, like the United Kingdom and Germany, provide creditor-friendly approaches in applying fiduciary rules on directors and officers. Other nations, like the United States, choose a debtor-friendly model by allowing directors and officers more leeway in deciding when to file for insolvency proceedings and generally make them accountable only to the firm. However, there are inconsistencies even within one model, as the United States has proven. Given these variations, corporate boards have reason to be confused. A uniform international standard towards instituting and expanding the fiduciary duties of directors and officers in troubled companies provides many advantages. With clear rules, corporate boards will be able to make clear and calculated decisions based on a uniform standard. In analyzing the rules across several jurisdictions, 3 main reforms stand out.

First, nations should create a standard definition of insolvency and how to measure it. Proposed rules could use the German model as a guideline where insolvency is defined discretely as taking place when a company lacks more than 10% of the necessary funds to meets its obligations for the next 21 days and does not foresee being able to close the 10% gap. This 10% definition will be much easier to determine than the amorphous standard used in other nations such as the United States. Board members will be able to pinpoint when they company has reached insolvency and plan accordingly. Once insolvency has taken place, directors and officers will be able to determine to whom they owe fiduciary duties and what legal liabilities they must now plan for.

Second, imposing a requirement to file for bankruptcy within a set period of time, as in Germany, is a prudent approach because it will preserve the limited equity left in a company and its availability to creditors. As has been shown above, the longer a company puts off insolvency, the lower chance that creditors will recover their investments. Unlike Germany, however, this requirement should only be enforced through the threat of disqualification. Through this approach, nations will be in a better position to avoid harming business development and entrepreneurship by avoiding draconian punishments. Corporate directors will be less likely to flee a troubled company at the first sign of trouble because of criminal liability.

Third, allowing courts to disqualify board members who have proven unfit to manage their troubled company has numerous advantages. Instead of applying more draconian rules making directors and officers personally liable for insolvency losses, the disqualification option allows courts to effectively impose punishment on corporate leaders while avoiding harsh rules that may affect the willingness of individuals to manage. Disqualification will serve to protect the general public from unworthy directors and officers by not permitting them to manage other companies for set period of time.

The benefits to these suggestions are clear. With rules that are easy to measure across jurisdictions, companies will be able to plan corporate strategy with accurate information. When a company foresees troubled times, the directors and officers in the company's leadership can plan accordingly. These rules will encourage more talented and experienced managers to play a part in a company's decisions and not be reluctant to participate due to the risks associated with failure. Thus, an international legal standard is desirable. Consistent and clear rules will allow directors and officers to make confident decisions that will benefit creditors and shareholders alike.