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Berg & Berg Enterprises, LLC v. Boyle: Outside the Zone - Directors Owe No Special Fiduciary Duties to Creditors of Insolvent or Quasi-Insolvent California Corporations

On October 29, 2009, the California Court of Appeal, Sixth Appellate District (the “Court”), issued a decision in *Berg & Berg Enterprises, LLC v. Boyle*, materially limiting the scope of director duties to creditors of an insolvent or financially distressed California corporation. Dealing with this issue for the first time in California, the Court rejected the precedent established by Delaware courts and declined to impose any special board fiduciary duties to creditors.

Background

In *Berg & Berg Enterprises, LLC v. Boyle*,¹ Berg & Berg Enterprises, LLC (“Berg”), the largest creditor of the failed Pluris, Inc., a California corporation (“Pluris”), filed an initial complaint against the directors of Pluris after Pluris had experienced financial difficulties in 2002 and entered into an assignment for the benefit of its creditors.² After a series of amended pleadings, Berg ultimately alleged that the Pluris directors had breached their fiduciary duty to act for the benefit of Pluris’ creditors given that Pluris had entered the “zone of insolvency.”

Berg alleged that in 2001, a Berg-related entity was involved in a dispute with Pluris regarding a lease repudiated by Pluris. Berg agreed to settle the dispute in February 2002 when Pluris, which was experiencing financial distress, informed Berg that it was attempting to secure outside financing to continue operations and that

settlement of such dispute was a condition to obtaining such financing. At this time, Berg allegedly informed Pluris that if its financing efforts failed, Berg wanted to explore ways in which Berg could derive value from approximately \$50 million in net operating losses that Pluris had accumulated.

Ultimately, Pluris was unable to secure outside financing sufficient to continue operations and made an assignment for the benefit of its creditors. Berg’s claim, in essence, was that Pluris’ directors had a fiduciary duty to Pluris’ creditors due to the insolvent or near-insolvent state of Pluris, and that the directors breached their duty to Berg and other creditors by failing to follow or consider Berg’s plan to derive value from Pluris’ net operating losses through a Chapter 11 reorganization or other alternatives.

The trial court dismissed Berg’s complaint without leave to amend, reasoning that the complaint failed to state a viable claim for breach of fiduciary duty against the directors. After appeal, the Court upheld the trial court’s dismissal of the action.

¹ 2009 DJDAR 15513 (2009).

² An assignment for the benefit of creditors is a statutory procedure provided for under California law that is an alternative to liquidation in bankruptcy.

Director Duty to Creditors

Under established California law, the fiduciary duties of care and loyalty imposed on the directors of a California corporation are owed only to the corporation and its shareholders and not to a corporation's creditors.³ Berg's claim was based on the theory that directors of an insolvent corporation, or one operating in the "zone of insolvency," should owe a fiduciary duty to the creditors of the corporation. The Delaware courts have developed this approach, beginning with the *Credit Lyonnais*⁴ case, where the Delaware Chancery Court noted that the scope of directors' duties when a corporation was in the vicinity of insolvency required the consideration of the whole "corporate enterprise," including the interest of creditors, as opposed to only the residual equity holders.

In *Berg*, however, the Court held that in California "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."⁵ Instead, the Court held that the duty of directors to an insolvent corporation's creditors was limited "to the avoidance of actions that divert, dissipate, or unduly risk corporate assets that might otherwise be used to pay creditor claims."⁶ The Court's holding applied the "trust fund doctrine" adopted by California courts in accordance with *Pepper v. Litton*, a landmark Supreme Court case. In *Pepper*, the U.S. Supreme Court held that "all of the assets of a corporation, immediately upon becoming insolvent, become a trust fund for the benefit of all creditors."⁷ The Court found that Berg's claims that the corporation should have explored ways to use its net operating losses instead of making an assignment for the

benefit of its creditors simply did not properly state a claim for breach of fiduciary duty, because under the trust fund doctrine, the failure to theoretically maximize the value of these net operating losses did not rise to self-dealing, preferential payments or undue risk.

Moreover, the Court recognized the difficult circumstances directors would be put in if any incremental duties arose when a corporation was in the "zone of insolvency."⁸ The Court rejected the Delaware approach⁹ and held that "no fiduciary duty...is owed to creditors by directors of a corporation solely by virtue of its operating in the 'zone' or 'vicinity' of insolvency."¹⁰

The Court went on to note that, even if a fiduciary duty did exist, Berg's claim would be barred because the Prius board had complied with the requirements of Section 309 of the California Corporations Code. This Section codifies California's business judgment rule. The Court's dicta on this point was obviously unneeded if no fiduciary duty existed in the first place, but does indicate that California courts may read the business judgment rule in a more flexible manner than Delaware courts.

³ "A director shall perform the duties of a director...in good faith, in a manner such director believes to be in the best interests of the corporation and its shareholders..." California Corporations Code Section 309(a).

⁴ *Credit Lyonnais Bank Nederland N.V. v. Pathe Communications Corp.*, 1991 Del. Ch. Lexis 215 (1991).

⁵ *Id.* at *108, fn. 55.

⁶ *Berg, supra*, at *21.

⁷ *Pepper v. Litton* 308 U.S. 295, 306 (1939).

⁸ "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." *Berg, supra*, at *20.

⁹ In a recent case, *NACEPTF v. Gheewalla*, 930 A.2d 92, 103 (2007), the Delaware Chancery Court limited the applicability of the "zone of insolvency" theory of liability, holding that creditors may not bring direct claims (as opposed to derivative claims) against directors of an actually insolvent corporation or a corporation in the "zone of insolvency." The Court in *Berg*, however, appears to be under the impression that the "zone of insolvency" theory was entirely rejected by the court in *Gheewalla*. See *Berg, supra*, at *21, n. 22.

In addition, in contrast to the holding in *Gheewalla*, Berg had initially made a direct claim against the defendants, then, in response to a demurrer, changed the claim to a derivative claim. However, the Court did not provide a conclusive holding in *Berg* as to whether direct claims by creditors against directors would be permissible in an insolvency scenario.

¹⁰ *Berg, supra*, at *21.

Conclusion

The long-term effect of the *Berg* holding remains to be seen, but the Court clearly rejected the Delaware approach. In California, directors owe no fiduciary duties to creditors, nor does a board's duties "shift" when the corporation is in the amorphous Delaware "zone of insolvency." Instead, creditors can rely on the limited relief afforded by the trust fund doctrine only when directors improperly divert or unduly risk corporate assets that could be used to pay creditors, but otherwise must rely on contractual arrangements for protection, regardless of the solvency of the corporation. These standards, combined with the deference to director

decisions provided by the business judgment rule, severely limit the ability of any creditor in California to bring fiduciary duty claims (direct or derivative) against directors in the event of corporate insolvency. Given the *Berg* Court's application of the trust fund doctrine, one of whose components is dissipation, we should expect to see creditor cases in the future recast as corporate waste or dissipation claims.¹¹

¹¹ See *Gheewalla*, *supra*, n.127 (Court suggests that a direct claim by a creditor against directors for failure to "preserve" company assets should be recast as a derivative waste claim).

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

If you wish to receive more information on the topics covered in this memorandum, you may contact your regular Shearman & Sterling contact person or any of the following:

Steve L. Camahort
San Francisco
+1.415.616.1240
steve.camahort@shearman.com

Michael S. Dorf
San Francisco
+1.415.616.1246
mdorf@shearman.com

Mark K. Hyland
San Francisco
+1.415.616.1181
mhyland@shearman.com

Michael J. Kennedy
San Francisco
+1.415.616.1248
michael.kennedy@shearman.com

Steven E. Sherman
San Francisco
+1.415.616.1260
sesherman@shearman.com

John D. Wilson
San Francisco
+1.415.616.1215
jwilson@shearman.com

Christopher S. Han
San Francisco
+1.415.616.1188
christopher.han@shearman.com