Charter Exculpatory Provisions Preclude Bankruptcy Trustee from Suing on Breach of Duty of Care

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Among the powers conferred upon a bankruptcy trustee or chapter 11 debtor-in-possession ("DIP") is the ability to "stand in the shoes" of a debtor corporation and to prosecute any claims held by the debtor at the time it filed for bankruptcy protection. These claims are considered property of the debtor's estate.

Consistent with this authority, a trustee (or DIP) may pursue any of the corporate debtor's claims against its officers and directors for breach of fiduciary duty and other forms of misconduct. Certain questions, however, exist regarding the extent of the trustee's authority to bring claims on behalf of the corporate debtor. For example, is the trustee bound by the same constraints on the corporation's right to file suit against its directors and officers, such as the business judgment rule and certain director and officer exoneration provisions authorized under state corporate law? Similarly, are these claims property of the debtor's estate or do they belong exclusively to the debtor's creditors (in which case the trustee does not have the authority to assert them)?

These questions were the subject of a ruling recently handed down by the Second Circuit Court of Appeals in *Pereira v. Farace*. The court held that a bankruptcy trustee could not prosecute a corporate debtor's claims against its former directors for breach of the duty of care where the corporation's charter contained a provision shielding its directors from such liability.

Fiduciary Duties of Officers and Directors

State law uniformly subjects corporate fiduciaries to duties of loyalty and care. The former is premised upon the fundamental principle that a director stands in a special relationship of trust to the corporation and must act in furtherance of the best interests of the corporation rather than his own self-interest. The duty of care obligates a fiduciary to discharge his duties in good faith and to make informed decisions predicated upon a level of care that a similarly-situated person would reasonably believe appropriate under the circumstances. This rule generally protects directors from liability for detrimental corporation transactions so long as they are undertaken in good faith and with due care, and the relevant decisions are within the directors' authority.

In exercising the duty of care, fiduciaries generally enjoy the protection of the "business judgment rule" — a judicially created presumption that an officer or director has exercised due care in the furtherance of his duties. When directors are both disinterested and have been appropriately informed in the decision-making process, courts generally will refrain from substituting their own judgment for that of the directors, thereby deferring to the directors' "business judgment."

Additional protection for corporate fiduciaries also can be found in a corporation's by-laws or charter. A growing number of by-laws or charters take advantage of state law provisions that exonerate directors from monetary liability for any breach of the duty of care not involving bad faith, intentional misconduct, improper payment of dividends, improper stock purchase or redemption, as well as any breach of the duty of loyalty.

Fiduciary Duties in the Zone of Insolvency

Although it has long been universally understood that corporate management's fiduciary duties run to the corporation and its shareholders, the Delaware Chancery Court reconstructed the paradigm regarding the obligations of directors when the corporation enters the "zone of insolvency." In *Credit Lyonnais Bank Nederland, N.V. v. Pathé Communications Corp.*, the court stated that "[a]t least where a corporation is operating in the 'vicinity of insolvency,' a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise." The court recognized that once a corporation enters the "zone of insolvency," its directors must "consider the community of interests that the corporation represents" and choose a course of action that will maximize the corporation's value, which "may diverge from the choice that the stockholders . . . would make if given the opportunity to act." Many courts have interpreted this decision as imposing on corporate management fiduciary duties to creditors once the corporation enters the "zone of insolvency."

Bankruptcy Trustee's Standing to Assert Claims

The ability to commence litigation in a court of law is generally referred to as "standing." Standing is a threshold issue in which the court must determine whether the claimant has a right to be heard in that forum. In the bankruptcy context, standing is conferred upon the trustee by statute, which both empowers the trustee and limits his ability to commence litigation or otherwise assert claims of the corporate debtor to only those claims that the debtor could have prosecuted itself.

Along those lines, the trustee generally is not able to assert claims that belong exclusively to individual creditors, who generally have the right to assert a claim for breach of management's fiduciary duties once the corporation enters the zone of insolvency. Still, there are certain exceptions to the general rule that a trustee lacks standing to assert claims on behalf of individual creditors. For example, section 544(b) of the Bankruptcy Code authorizes the trustee to prosecute certain claims belonging to creditors under state law. This authority, however, is limited to actions to avoid fraudulent or preferential transfers.

State law determines whether a claim seeking recovery against corporate officers and directors is derivative (*i.e.*, the claim actually belongs to the corporation and, therefore, may be asserted by a bankruptcy trustee) or held directly by creditors (in which case the trustee lacks standing to assert it). In the context of claims against corporate fiduciaries, this important distinction was the subject of a decision rendered by the Delaware Chancery Court in *Production Resources Group, LLC v. NCT Group, Inc.*

In that case, a judgment creditor claimed that the company's directors breached their fiduciary duty of loyalty to the company, which was purportedly insolvent, by engaging in conscious wrongdoing. The court stated that although creditors have standing to bring this type of action, any recovery should go to the company itself, rather than creditors. The court reasoned that even where a company is insolvent, conduct by directors that deepens the company's insolvency and is actionable by creditors harms the company itself. Whether such claims are brought by a shareholder when the company is solvent or a creditor when it is not, the court concluded that any recovery "logically flows to the corporation and benefits the derivative plaintiffs indirectly to the extent of their claim on the firm's assets." Furthermore, the court explained that, under state law, provisions exonerating management from certain fiduciary infractions continue to protect directors once the corporation enters the zone of insolvency, regardless of whether those claims are asserted derivatively by stockholders or by creditors.

The ramifications of this approach on a bankruptcy trustee's standing to prosecute alleged fiduciary indiscretions were addressed by the Second Circuit Court of Appeals in *Pereira v. Farace*.

The Second Circuit's Ruling

The chapter 7 trustee of Trace International Holdings, Inc. ("Trace") filed a complaint against former Trace officers and directors claiming, among other things, breach of fiduciary duty arising from their roles in Trace's financial demise. The complaint alleged that because Trace had been insolvent since 1995, management owed fiduciary duties to Trace's creditors as well as its stockholders. The district court held that the defendants breached their fiduciary duties by allowing a number of improper transactions to occur that depleted Trace's assets and ultimately drove it into bankruptcy. Importantly, the court held that the exculpatory clause in Trace's articles of incorporation, which shielded the directors from liability to Trace for breach of the duty of care, was inapplicable because the trustee had brought the action on behalf of all of Trace's creditors, and not Trace itself. The court rejected the defendants' argument that the exculpatory clause applied only to claims asserted by individual creditors (as opposed to the aggregate body of Trace's creditors), which the trustee lacked standing to assert.

The defendants appealed the district court's decision to the Second Circuit. The Court of Appeals acknowledged that a bankruptcy trustee generally lacks standing to sue third parties on behalf of the estate's creditors and may assert only the claims held by the bankrupt corporation itself. It then stated that "[a]lthough corporate officers and directors owe fiduciary duties to creditors when a corporation is insolvent in fact, these duties do not expand the circumscribed rights of the trustee, who may only assert claims of the bankrupt corporation, not its creditors." Therefore, the Second Circuit ruled that because breach of fiduciary duty claims belong to the corporation, they are subject to the corporate charter's exculpatory provisions, even when asserted by a trustee in bankruptcy on behalf of the corporation.

Analysis

Pereira v. Farace reinforces the important principle that the powers of a bankruptcy trustee or DIP are subject to certain restrictions. Unless causes of action arise under provisions of the Bankruptcy Code that specifically confer standing upon a trustee to prosecute them in a bankruptcy case (*e.g.*, avoidance of fraudulent or preferential transfers), applicable non-bankruptcy law generally will govern the extent to which a trustee can pursue such claims on behalf of the estate (if at all).

The decision can be viewed as a welcome development by corporate fiduciaries. If its rationale is adopted by other courts, directors acting in good faith need not fear that the safe harbor protections established in *Production Resources* will be abridged or forfeited if a bankruptcy case is filed by or against the corporation.

Pereira v. Farace, 413 F.3d 330 (2d Cir. 2005).

Credit Lyonnais Bank Nederland v. Pathé Communications Corp., 1991 WL 277613 (Del. Ch. Dec. 30, 1991).

Production Resources Group, LLC v. NCT Group, Inc., 863 A.2d 772 (Del. Ch. 2004).