C

California Bankruptcy Journal
2012

***827** CORPORATE FIDUCIARY LIABILITY TO CREDITORS AND INTERESTED/DIRECTOR TRANSACTIONS: TWO KEY DISTINCTIONS BETWEEN CALIFORNIA AND DELAWARE FIDUCIARY DUTY LAW THAT COME UNDER SCRUTINY DURING INSOLVENCY

Peter M. Gilhuly, Ted A. Dillman [FN1]

I. Introduction

In *Berg & Berg Enterprises, LLC v. Boyle*, [FN2] the California Court of Appeal held that the extracontractual duties owed by corporate directors to creditors of an *insolvent* corporation are limited to the trust fund doctrine, which prohibits "actions that divert, dissipate, or unduly risk corporate assets," including, among other things, self-dealing and preferential treatment of creditors. [FN3] The *Berg* decision came just a few years after the Delaware Supreme Court confirmed in *North American Catholic Educational Program Foundation, Inc. v. Gheewalla* [FN4] that under Delaware law, the creditors of an insolvent corporation have standing to bring derivative claims for breach of fiduciary duty on behalf of the company. [FN5]

It is common for California litigants and corporate advisors to look to Delaware corporate law for guidance. Yet, *Berg* and *Gheewalla* provide a useful reminder that there are important differences between California and Delaware law. This article examines two key distinctions between California and Delaware law that come under scrutiny when a company becomes insolvent: (i) the duties of directors of California corporations to creditors under the trust fund doctrine in light of *Berg* and other applicable law, as well as the extension of the trust fund doctrine beyond directors to controlling shareholders and officers; and (ii) the distinction between Delaware's "entire fairness" standard and California's "just ***828** and reasonable" requirement in the context of transactions between the corporation and interested directors.

II. The Trust Fund Doctrine

California's trust fund doctrine [FN6] imposes fewer restrictions upon directors' decisions than the full range of fiduciary duties owed to the corporation and its shareholders (and creditors under Delaware law once the company becomes insolvent). Specifically, the directors of a corporation are generally required to discharge their duties for the benefit of the corporation and its shareholder owners. In Delaware, this obligation extends to creditors of an insolvent corporation. In California, while directors are prohibited from self-dealing or preferring some creditors to others, [FN7] they do not owe general fiduciary duties to creditors, whether the company is solvent or insolvent. When coupled with the protections afforded to directors by the business judgment rule (which applies to business decisions implicating the trust fund doctrine), [FN8] the impact of the trust fund doctrine is largely limited to self-dealing or decisions in which the directors are not disinterested.

A. Creditors' ability to sue fiduciaries of insolvent corporations is limited

Under Delaware law, upon actual insolvency, creditors gain standing to bring derivative claims for breach of fiduciary duty. [FN9] While the directors must continue to seek to maximize the company's value, "the fact of insolvency places the creditors in the shoes normally occupied by the shareholders." [FN10] As such, ***829** "creditors of an *insolvent* corporation have standing to maintain derivative claims against directors on behalf of the corporation" as the "principal constituency injured by any fiduciary breaches that diminish the firm's value." [FN11] There is no indication that the scope of these fiduciary duties is more narrow than the long-existing fiduciary duties under Delaware law: the duties of care and loyalty and an obligation to act in good faith. [FN12]

The *Berg* decision substantially limits the extent to which creditors may bring suit in California. In marked contrast to Delaware law--where creditors may bring derivative suits--creditors may not sue the directors of an insolvent California company for breach of fiduciary duty. Rather, directors' duties to creditors are limited to those imposed by California's "trust fund doctrine." Under this doctrine, "all of the assets of a corporation, immediately on its becoming insolvent, become a trust fund for the benefit of all of its creditors." [FN13]

The plaintiff in *Berg* was the largest creditor of Pluris, Inc., a failed California corporation that had entered into an assignment for the benefit of creditors (a statutory alternative to bankruptcy akin to a Chapter 7 liquidation) [FN14] under California Code of Civil Procedure §§ 493.010 & 1802. [FN15] Berg's final amended complaint, brought as a derivative action on behalf of Berg and the other Pluris creditors, alleging that Pluris's individual directors violated their fiduciary duties to the company's creditors fiduciary duties that arose when Pluris became insolvent or was operating within the zone of insolvency. [FN16] Berg had proposed a plan to derive value from the company's $50 million of net operating losses ***830** through a reorganization under Chapter 11 of the Bankruptcy Code. Berg argued that the directors breached their fiduciary duties when they failed to make a reasonable investigation into Berg's proposed plan and instead chose to make the assignment. The trial court sustained the directors' demurrers to Berg's complaint, citing a failure to allege a viable claim for breach of fiduciary duty. Berg appealed, and the court of appeal affirmed, holding that:

> [U]nder the current state of California law, there is no broad, paramount fiduciary duty of due care or loyalty that directors of an insolvent corporation owe the corporation's creditors solely because of a state of insolvency .... [T]he scope of any extracontractual duty owed by corporate directors to the insolvent corporation's creditors is limited in California, consistent with the trust fund doctrine, to the *avoidance of actions that divert, dissipate, or unduly risk corporate assets that might otherwise be used to pay creditor claims.* This would include acts that involve self-dealing or the preferential treatment of creditors. [FN17]

The importance of the distinction, of course, depends upon what actions a court would find to violate this rule. In theory, a broad range of activities that would be disallowed under the general fiduciary duties of care and loyalty (if they extended to creditors) might also be found to "divert, dissipate, or unduly risk corporate assets." [FN18] However, in practice, California courts have typically found violations of the trust fund doctrine only in situations where there was (i) self-dealing by directors or (ii) preferential treatment of creditors--not exclusively based on other types of misconduct. The most frequently cited cases interpreting California's trust fund doctrine (which are referenced in the *Berg* decision) involve acts that fall into one or both of these categories. These include situations such as where directors or officers who were also creditors to the insolvent corporation obtained preferential treatment for their claims, where they improperly transferred the insolvent corporation's assets to themselves, or where they used corporate assets to guarantee personal debts. [FN19]

***831** While the *Berg* court's language suggests that any "preferential treatment of creditors" of an insolvent corporation is prohibited by the trust fund doctrine, almost all of the leading cases finding trust fund doctrine violations involve preferential payments to *insider* creditors. *Saracco Tank & Welding Co. v. Platz* [FN20] is the only one of these cases in which the court found a trust fund violation where the "preferred" creditors were not corporate insiders. In *Saracco*, the directors of a Nevada mining company transferred the assets of the company to a newly-formed California company, then directed payment toward only some of the old corporation's creditors--who were not corporate insiders--without giving notice to the unpaid plaintiff creditor. [FN21] The director-shareholders of the old company received stock of the new company, and the transfer of assets left the old company insolvent. [FN22] The plaintiff creditor was not given notice of the transfer of assets. [FN23] While the court found a trust fund violation resulting from preferential payments to third-party creditors, the case clearly involved acts by the directors that the court regarded as culpable and self-interested. It was plainly not a situation in which disinterested directors made a business decision to pay certain creditors ahead of others (which would presumably be protected by the business judgment rule).

The ability of directors to selectively pay third-party creditors makes practical sense. It is frequently necessary to prioritize payments as a company nears or reaches insolvency--for example, by making payments to creditors (such as key vendors and licensors) that are crucial to continuing business operations of the enterprise. The business judgment rule presumption (discussed below) may help to protect corporate fiduciaries in these situations because there is no recognized exception to the rule for preferential payments to non-insiders absent some other bad act. Moreover, several non-California cases analyzing their state's version of the trust fund doctrine have found that certain non-insider creditors may be paid--while others are not--without violating the trust fund doctrine. [FN24]

***832** Delaware's extension of fiduciary duties to creditors is consistent with the view that the scope of trust fund duties is significantly narrower than those imposed by the fiduciary duties of care and loyalty. In *In re JTS Corp.*, the court noted that Delaware's "insolvency exception," which created fiduciary duties to creditors, arose because "there is a need to consider the fiduciary duties of directors beyond the narrow confines of the trust fund doctrine." [FN25] The court stated that the trust fund doctrine was of little utility in protecting creditors' rights where the insolvent corporation continued to operate rather than simply distributed assets. [FN26] However, it is possible that, in some situations, actions that are "fair" with respect to fiduciary duties to creditors may result in director liability if the trust fund doctrine is strictly applied. For example, the *In re JTS Corp.* court noted that where an insider creditor received payment ahead of unsecured creditors, a trust fund violation would occur even though all unsecured creditors were eventually paid in full. [FN27] Even though the ultimate result was fair to all creditors, the payment to the insider was still "preferential" because the insider was paid first (which, at the moment it occurred, dissipated assets that could have otherwise been used to pay creditors).

The implication of these cases is that the trust fund doctrine does not require the directors to run the company for the benefit of creditors--their duties continue to run to the company and its shareholders. Directors' duties to creditors are limited to avoiding a limited set of prohibited acts, which, in light of the business judgment rule, are practically limited to those involving self-dealing.

B. The business judgment rule protects corporate fiduciaries' decisions

As with decisions relating to the duty of care owed to shareholders, a corporate fiduciary's decisions are protected from creditor trust fund violation claims by the business judgment rule. The business judgment rule "establishes a presumption that directors' decisions are based on sound business judgment," and ***833** has two components. [FN28] The first, which is codified in California Corporations Code § 309, protects directors from personal liability for management decisions so long as the directors were personally disinterested and they acted in good faith following reasonable inquiry. [FN29] The second, established by case law, "insulates from court intervention those management decisions." [FN30] The business judgment rule establishes a rebuttable "presumption that in making a business decision the director of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company." [FN31]

To be protected by the business judgment rule, however, directors must have been disinterested and independent, acted in good faith, and been reasonably diligent in informing themselves of the facts. [FN32] As such, a plaintiff seeking to overcome the rule's presumption must allege facts "which, if proven, would establish fraud, bad faith, overreaching or an unreasonable failure to investigate material facts," or circumstances that "inherently raise an inference of conflict of interest." [FN33] Once the plaintiff has pleaded such facts, the burden shifts to the directors to show that they did in fact exercise "good faith and reasonable investigation." [FN34] If the defendant directors are able to demonstrate that they exercised their good faith business judgment, a court will not interfere with the decision. [FN35] If, on the other hand, directors cannot demonstrate good faith and reasonable investigation of the facts, they may be found liable for negligence relating to their decisions (although the burden of proving each element of negligence remains with the plaintiff). [FN36]

It is probably *because* of the strength of the business judgment rule that the trust fund violation cases cited in *Berg* involved preferential treatment of insider-creditors and clear evidence that the directors were not disinterested in the ***834** challenged transaction. These circumstances shift the burden of showing good faith to the defendants and, absent a showing that the directors fulfilled their duties, allows the court to examine the substantive merits of their decision (after the fact and with the benefit of hindsight).

C. Extension of the trust fund doctrine to officers and controlling shareholders

Trust fund duties apply not just to directors of the corporation, but also to officers. The court in *CarrAmerica Realty Corp. v. nVidia Corp.* recognized, and the *Berg* court reiterated, that the trust fund doctrine "generally pertains to cases where the directors *or officers* of an insolvent corporation have diverted assets." [FN37]

The seminal United States Supreme Court case on the trust fund doctrine, *Pepper v. Litton*, held that controlling shareholders owe duties that are "designed for the protection of the entire community of interests in the corporation--creditors as well as stockholders." [FN38] Following this authority, a line of cases holds that controlling shareholders and parent companies are fiduciaries and owe trust fund duties to creditors. In *Commons v. Schine*, the court stated that "the corporate controller-dominator is treated in the same manner as a director of an insolvent corporation and thus occupies a fiduciary relationship to its creditors .... As a fiduciary, he has violated his duty to the beneficiaries of the trust." [FN39] Similarly, in *Title Ins. & Trust Co. v. California Dev. Co.*, the court applied the trust fund doctrine to a company that controlled the insolvent company. [FN40] The court stated that the controlling company "occupies in this case a situation analogous to that of a director .... It exercised a power far wider than that which a single director usually has." [FN41]

*835 D. It is unclear whether a direct or derivative action is required for a trust fund claim

It is not entirely clear under *Berg* whether a plaintiff alleging violation of the trust fund doctrine should bring a direct or derivative claim. Berg had originally brought a direct claim, which was subsequently amended to a derivative action on behalf of all the creditors of the company after the lower court determined that the alleged injury was not particular to Berg and therefore a direct claim was not appropriate. [FN42] While the Court of Appeal decision seems to indicate that a derivative action on behalf of the insolvent corporation would be proper, several prior trust fund doctrine cases involved direct actions by creditors. [FN43] In general, a derivative action is appropriate when “the gravamen of the complaint is injury to the corporation ... or if it seeks to recover assets for the corporation or to prevent the dissipation of its assets.” [FN44] A trust fund violation claim, which prohibits dissipation of corporate assets, seems to be the type of claim that is appropriately brought as a derivative action. However, the *Berg* court did not directly address this issue. By contrast, in Delaware, *Gheewalla* clearly disallows direct claims by creditors for breach of fiduciary duty even in actual insolvency and permits only derivative actions. [FN45]

III. When Trust fund Duties to Creditors Arise

A. No duty is owed in the “zone of insolvency”

The plaintiff in Berg claimed that the company's individual directors owed the company's creditors fiduciary duties when the company “was either insolvent or operating within the zone of insolvency.” [FN46] On appeal, the court noted that the idea that directors may owe creditors fiduciary duties prior to actual insolvency, while in the “zone” or “vicinity” of insolvency, was introduced by California litigants drawing on emerging Delaware case law. [FN47] Delaware courts have for ***836** some time held that directors of insolvent corporations have fiduciary obligations to creditors as well as stockholders. [FN48] In *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.* (1991), [FN49] the Delaware Court of Chancery espoused the view for the first time that these duties might precede actual insolvency. The *Credit Lyonnais* court observed that “in the vicinity of insolvency, circumstances may arise when the right ... course to follow for the corporation may diverge from the choice that the stockholders ... would make if given the opportunity to act.” [FN50] The holding was intended to “provide a shield to directors from stockholders who claimed that the directors had a duty to undertake extreme risk” rather than pay creditors' bills. [FN51] However, many (creditors) interpreted the ruling to provide creditors with a right to enforce duties owed to them before insolvency. [FN52] In 2007, the Delaware Supreme Court refuted this interpretation in *Gheewalla*, holding that “[w]hen a solvent corporation is navigating in the zone of insolvency, the focus of Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation ... for the benefit of its shareholder owners.” [FN53]

The *Berg* court likewise repudiated the notion that directors owe duties to creditors--beyond those owed under contract and the imputed duty of good faith and fair dealing--prior to actual insolvency. After concluding that duties to creditors are limited to those imposed by California's trust fund doctrine, the court went on to state that:

> [B]ecause all the California cases applying the trust fund doctrine appear to have dealt with actually insolvent entities, and because the existence of a zone or vicinity of insolvency is even less objectively determinable than actual insolvency, we hold that there is no fiduciary duty ***837** prescribed under California law that is owed to creditors by directors of a corporation solely by virtue of its operating in the “zone” or “vicinity” of insolvency. [FN54]

The court noted that Berg's claim had not pleaded facts establishing that Pluris was actually insolvent at the time of the alleged dereliction of duty.

B. Determining the point of actual insolvency may be difficult

The focus on "actual insolvency," rather than *near* insolvency, is significant from a litigation standpoint, but will not typically impact most boardroom decisions due to the "practical problems" inherent in 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." [FN55] Thus, *Berg's* more important holding is its limitation on the scope of duties owed to creditors--not the exact moment at which they arise.

For purposes of establishing duties to creditors, a California corporation may be found to be insolvent under either of two tests: (i) the "balance sheet test," similar to the Bankruptcy Code's definition of insolvency, [FN56] and (ii) the "ability-to-pay test" found in California Corporations Code § 501. [FN57] Delaware courts apply essentially the same criteria. [FN58] Under California Corporations Code § 501, a corporation is insolvent if, currently or as the result of a prohibited ***838** distribution, it is "likely unable to meet its liabilities ... as they mature," [FN59] which is similar to the fraudulent conveyance standard under the Bankruptcy Code. [FN60]

Both tests are subject to inherent shortcomings caused by the practical difficulty in determining, at any given time, whether a firm has crossed into insolvency, particularly in light of the contingent and often undetermined or unasserted liabilities that face almost all companies. [FN61] The result is that even though many corporate fiduciaries will be aware when the company is foundering--and can make a business judgment that the company is insolvent--the moment at which a company becomes insolvent cannot practically be determined with any degree of certainty at the time it occurs (but rather is determined after the fact).

IV. Voiding Transactions with Directors

California also employs a different standard than Delaware related to transactions between the company and a director or an entity in which a director has a material financial interest. While this distinction is longer-established than the divergence regarding duties to creditors highlighted in *Berg*, this is another (under-recognized) difference between the two states' corporate laws that comes under scrutiny when a company nears or reaches insolvency. [FN62]

Under Delaware law, a transaction may not be voided merely because a director has a financial interest in the outcome if it is (i) approved by a majority of disinterested directors in good faith and on an informed basis; (ii) approved by a majority of the stockholders entitled to vote, in good faith and on an informed basis; or (iii) the transaction is "fair" to the corporation. [FN63] To determine what is "fair," Delaware courts apply the "entire fairness" standard, [FN64] which requires the ***839** defendant directors to show that the price and dealing were fair. [FN65] Fair price looks at the financial considerations of the transaction; fair process examines "questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosures to directors, and how the approvals of the directors and shareholders were obtained." [FN66] The inquiry into "entire fairness" is holistic, and a fair price may partially compensate for deficiencies in the process in rendering the transaction entirely fair. [FN67] However, it is likely that satisfying only one prong of the test is insufficient to find entire fairness. [FN68] In addition, a transaction with an interested director can be "cleansed" if it is approved by a disinterested committee of the board (under Delaware law, a board committee can consist of a single director). [FN69]

Like Delaware law, California Corporations Code § 310 protects an interested-director transaction from being avoided where the transaction has been approved by a majority of disinterested shareholders after full disclosure of the relevant facts. [FN70] Unlike in Delaware, however, a transaction is not cleansed if approved by a disinterested board or committee--the transaction still must be "just and reasonable to the corporation." [FN71] Notwithstanding this requirement, approval by a majority of the members of the disinterested board or committee is valuable because it "effectively raises a presumption of fairness to the corporation," placing the burden of proving unfairness on the plaintiff. [FN72]

***840** If neither of these cleansing mechanisms is utilized, the transaction is voidable unless the party seeking enforcement of the transaction can show that it was "just and reasonable to the corporation" at the time it was approved. [FN73] There is no precise distinction between California's "just and reasonable" standard and Delaware's "entire fairness" requirement, and case law applying the "just and reasonable" standard is sparse. However, cases examining this standard establish that "[t]he essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain." [FN74] While some courts may look to both fair dealing and fair value, [FN75] at least one case found that a corporate president and director's salary and benefits were "just and reasonable" where the dealing was arguably improper. [FN76] In that case, *Sammis v. Stafford*, the court determined that the compensation was reasonable and refused to void the transaction, even though the process was deficient (the compensation agreements were initially only approved by the defendant as a one-man board of directors, and subsequently ratified by a larger, but interested, board). [FN77]

V. Conclusion

The *Berg* decision is a useful reminder that California corporate law diverges from Delaware in important respects. California directors must continue to operate the company for the benefit of its shareholder owners, albeit in a manner that does not conflict with their responsibilities to creditors under the trust fund doctrine. Under the trust fund doctrine, directors may not "divert, dissipate or unduly risk" assets that could be used to pay creditors. However, when coupled with (and likely as a result of) the business judgment rule, the initially ***841** broad appearance of the trust fund doctrine is largely limited to: (i) self-dealing, and (ii) (potentially) preferring certain creditors over others, although when paying third-party creditors, courts appear to require some other act or motive they find culpable before they will find a trust fund violation. Such differences in law are significant, as one can easily imagine cases where the interest of shareholders and creditors will diverge--for example, whether to try to revive the business or sell its assets to pay creditors.

Similarly, corporate advisors in California must be mindful of the different standards that apply to interested-director transactions. In Delaware, an interested-director transaction may be cleansed by an informed vote of disinterested board members (including by a single director). On the other hand, California requires that a transaction also be "just and reasonable," and does not enable a single director to cleanse a transaction. The "just and reasonable" standard--although not as thoroughly interpreted by case law as the entire fairness standard--appears to differ from Delaware's "entire fairness" standard in that it does not expressly permit the "balancing" that is part of the Delaware analysis.

[FN1]. Peter M. Gilhuly is a corporate restructuring and bankruptcy partner in Latham & Watkins' Los Angeles office where he is responsible for managing the firm's West Coast insolvency practice. Ted A. Dillman is a finance associate in Latham & Watkins' Los Angeles office, specializing in corporate restructuring and bankruptcy. The authors would like to thank Matthew K. Larssen for his contribution to this article.

[FN2]. Berg & Berg Enters., LLC v. Boyle, 178 Cal. App. 4th 1020, 100 Cal. Rptr. 3d 875 (2009), *rev. denied*, 2010 Cal. LEXIS 1461 (Feb. 3, 2010).

[FN3]. *Id.* at 894.

[FN4]. N. Am. Catholic Educ. Program Found., Inc. v. Gheewalla, 930 A.2d 92 (Del. 2007).

[FN5]. *Id.*

[FN6]. The law of a corporation's state of incorporation generally governs internal affairs issues and director liability. *See* CAL. CORP. CODE § 2116; Rest. 2d Conflict of Laws § 309 (1969).

[FN7]. Despite language in *Berg* that suggests a violation of the trust fund doctrine may result from preferring non-insider third-party creditors to other creditors, the law in this area is well defined. *See* discussion *infra* Part II.A.

[FN8]. *See* discussion *infra* Part II.B.

[FN9]. *See* Geyer v. Ingersoll Pubs. Co., 621 A.2d 784, 789 (Del. Ch. 1992); Adlerstein v. Wertheimer, No. CIV.A. 19101, 2002 WL 205684, at *11 (Del. Ch. Jan. 25, 2002).

[FN10]. Prod. Res. Grp., LLC v. NCT Grp., Inc., 863 A.2d 772, 791 (Del. Ch. 2004); *see also* Schoon v. Smith, 953 A.2d 196, 208 n.46 (Del. 2008) ("*Gheewalla* confers standing upon creditors to bring a derivative action where the corporation is insolvent, but only because the shareholders of an insolvent corporation no longer have an economic interest in the corporate entity--only its creditors have that interest. Only for that reason and in that context does *Gheewalla* permit creditors to stand in the shoes of the shareholders. Because *Gheewalla* merely substitutes creditors for shareholders in that limited setting, it does not represent an extension or enlargement of the scope of the equitable standing doctrine."); Burtch v. Huston (*In re* USDigital, Inc.), 433 B.R. 22, 42 (Bankr. D. Del. 2011).

[FN11]. *Gheewalla*, 930 A.2d at 102.

[FN12]. *See Schoon*, 953 A.2d at 208 n.46; *USDigital*, 433 B.R. at 42; Stone *ex. rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362, 370 (Del. 2006); *see also In re* JTS Corp., 305 B.R. 529 (Bankr. N.D. Cal. 2003) ("This new fiduciary relationship is certainly one of loyalty, trust and confidence."); LaSalle Nat'l Bank v. Perelman, 82 F. Supp. 2d 279, 292 (D. Del. 2000) ("The fiduciary duties that a debtor owes the estate are comparable to the duties that the officers and directors of a solvent corporation owe their stockholders outside bankruptcy.").

[FN13]. *Berg*, 100 Cal. Rptr. 3d at 894 (quoting CarrAmerica Realty Corp. v. nVidia Corp., Nos. C 05-00428 JW, 5:05-cv-00427-JW, 5:05-cv-00429-JW, 5:06-cv-03856-JW, 5:06-cv-03238-JW, 2006 WL 2868979, at *16 (N.D. Cal. Sept. 29, 2006)).

[FN14]. References to the "Bankruptcy Code," as well as Chapter and Section references are to the United States Bankruptcy Code, codified at 11 U.S.C. § § 101 *et seq.* (as amended), unless context requires otherwise.

[FN15]. *Berg*, 178 Cal. App. 4th 1020, 100 Cal. Rptr. 3d at 875.

[FN16]. *Id.* at 1029, 100 Cal. Rptr. 3d at 884.

[FN17]. *Id.*

[FN18]. The *Berg* court's statement that acts prohibited under the trust fund doctrine "*include* acts that involve self-dealing or the preferential treatment of creditors," appears to be illustrative rather than to define the universe of prohibited acts. *See id.* However, the restriction appears to be more limited as a practical matter.

[FN19]. *In re* Wright Motor Co., 299 F. 106 (9th Cir. 1924); *In re* Jacks, 266 B.R. 728 (B.A.P. 9th Cir. 2001); Bonney v. Tilley, 109 Cal. 346, 42 P. 439 (1895); *see also* Saracco Tank & Welding Co. v. Platz, 65 Cal. App. 2d 306, 150 P.2d 918 (1944) (applying trust fund doctrine to directors who made payments to preferred creditors); Title Ins. & Trust Co. v. Cal. Dev. Co., 171 Cal. 173, 152 P. 542 (1915) (holding that company controlling insolvent corporation's debt payments is subject to trust fund doctrine); Commons v. Schine, 35 Cal. App. 3d 141, 110 Cal. Rptr. 606 (1973) (applying trust fund doctrine where defendant controlling shareholder made insolvent corporate partnership sell real estate and pay proceeds to defendant).

[FN20]. Saracco Tank & Welding Co. v. Platz, 65 Cal. App. 2d 306, 150 P.2d 918 (1944).

[FN21]. *Id.* at 316-17, 150 P.2d at 923-24.

[FN22]. *Id.* at 316, 150 P.2d 923.

[FN23]. *Id.* at 316-17, 150 P.2d 923-24.

[FN24]. *See, e.g.*, Asmussen v. Quaker City Corp., 156 A. 180, 183 (Del. Ch. 1931) (holding that such payments may be permitted since "equity will not treat the assets of an insolvent corporation as a trust fund for the benefit of creditors in the sense that one creditor has a right to be paid his debt pari passu with all other creditors similarly situated"); *In re* JTS Corp., 305 B.R. 529, 538-40 (Bankr. N.D. Cal. 2003) (surveying the status of Delaware trust fund doctrine); *see also* *Prod. Res. Grp., LLC*, 863 A.2d at 791-92.

[FN25]. *JTS Corp.*, 305 B.R. at 540.

[FN26]. *Id.* at 539.

[FN27]. *Id.* at 539-40 (discussing Odyssey Partners L.P. v. Fleming Cos., Inc., 735 A.2d 386 (Del. Ch. 1999)).

[FN28]. *Berg*, 178 Cal. App. 4th at 1045, 100 Cal. Rptr. 3d at 897.

[FN29]. *Id.*; Lee v. Interinsurance Exch., 50 Cal. App. 4th 694, 713-14, 57 Cal. Rptr. 2d 798, 810 (1996).

[FN30]. *Berg*, 178 Cal. App. 4th at 1045, 100 Cal. Rptr. 3d at 897; Gaillard v. Natomas Co., 208 Cal. App. 3d 1250, 1263, 256 Cal. Rptr. 702, 710 (1989).

[FN31]. Katz v. Chevron Corp., 22 Cal. App. 4th 1352, 1366, 27 Cal. Rptr. 2d 681, 689 (1994).

[FN32]. *See* *Gaillard*, 208 Cal. App. 3d at 1264, 256 Cal. Rptr. at 711; *Berg*, 178 Cal. App. 4th at 1044, 100 Cal. Rptr. 3d at 898.

[FN33]. *Berg*, 178 Cal. App. 4th at 1044, 100 Cal. Rptr. 3d at 898; *Lee*, 57 Cal. Rptr. 2d at 811.

[FN34]. *Lee*, 50 Cal. App. At 714, 57 Cal. Rptr. 2d at 811.

[FN35]. *Id.* at 715-16, 50 Cal. Rptr. 2d at 812-13.

[FN36]. Burt v. Irvine Co., 236 Cal. App. 2d 828, 851-52, 47 Cal. Rptr. 392, 407-08 (1965).

[FN37]. *Berg*, 178 Cal. App. 4th at 1040, 100 Cal. Rptr. 3d at 893 (quoting *CarrAmerica Realty Corp.*, 2006 WL 2868979, at *16-17) (emphasis added).

[FN38]. Pepper v. Litton, 308 U.S. 295, 307 (1939); *see also* Lynch v. Cook, 148 Cal. App. 3d 1072, 1082, 196 Cal. Rptr. 544 (1983), *overruled on other grounds by In re* Marriage of Arcenaux, 51 Cal. 3d 1130, 800 P.2d 1227 (1990); Efron v. Kolmanovitz, 226 Cal. App. 2d 546, 556, 38 Cal. Rptr. 148, 155 (1964).

[FN39]. *Commons*, 35 Cal. App. 3d at 141, 110 Cal. Rptr. at 608. It should be noted that although controlling shareholder-creditor fiduciary relationship was not expressly limited to the trust fund doctrine in Commons v. Schine, it seems improper to impute broader duties to controlling shareholders than are owed by directors.

[FN40]. *Title Ins.& Trust Co.*, 171 Cal. at 205-06, 152 P. at 556-57.

[FN41]. *Id.*

[FN42]. *Berg*, 178 Cal. App. 4th 1029, 100 Cal. Rptr. 3d at 883-84.

[FN43]. *See, e.g.*, *Saracco*, 65 Cal. App. 2d 306, 150 P.2d at 920; *Bonney*, 109 Cal. at 347-48, 42 P. at 439-40.

[FN44]. Grosset v. Wenaas, 42 Cal. 4th 1100, 72 Cal. Rptr. 3d 129, 135-36 (2008); *see also* Nighbert v. First Nat'l Bank, 26 Cal. App. 2d 624, 632, 79 P.2d 1105 (1938) ("It is the generally accepted rule that misfeasance or negligence on the part of the managing officers of a corporation, resulting in loss of its assets, as alleged herein, is an injury to the corporation for which it must sue.").

[FN45]. *Gheewalla*, 930 A.2d at 103.

[FN46]. *Berg*, 178 Cal. App. 4th 1029, 100 Cal. Rptr. 3d at 884 (internal quotations omitted).

[FN47]. *Id.* at 891.

[FN48]. *See, e.g.*, Simons v. Cogan, 542 A.2d 785, 788 (Del. Ch. 1987), *aff'd*, 549 A.2d 300 (Del. 1988); Geyer, 621 A.2d at 787; *Prod. Res. Grp.*, 863 A.2d at 791 (calling the proposition that directors owe fiduciary duties to creditors at the point of insolvency "uncontroversial").

[FN49]. Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., No. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991).

[FN50]. *Id.* at *34 n.55.

[FN51]. *Prod. Res. Grp.*, 863 A.2d at 788.

[FN52]. *See, e.g.*, *In re* Radnor Holdings Corp., 353 B.R. 820 (Bankr. D. Del. 2006); *In re* Buckhead Am. Corp., 178 B.R. 956, 968-69 (D. Del. 1994) (denying motion to dismiss Creditors Committee complaint alleging breach of fiduciary duty, and stating that even if corporation was not insolvent at the time of the transaction at issue, it was operating in the "zone of insolvency").

[FN53]. *Gheewalla*, 930 A.2d at 101.

[FN54]. *Berg*, 100 Cal. Rptr. 3d at 894. The *Berg* court discussed the dilemma in which directors would find themselves by virtue of owing fiduciary duties to creditors as well as shareholders prior to actual insolvency, noting the "practical difficulties and inefficiencies inherent in directors managing conflicting duties to disparate interests, thereby diluting the continuing and historic duty owed by directors to shareholders." *Id.* at 892 n.18.

[FN55]. *Id.* at 894.

[FN56]. The Bankruptcy Code defines "insolvent" as the "financial condition such that the sum of such entity's debts is greater than all such entity's property, at a fair valuation." 11 U.S.C. § 101(32)(A) (2006); *see In re* Kallmeyer, 242 B.R. 492, 496-97 (B.A.P. 9th Cir. 1999) (applying balance sheet test). A similar definition is found in California Civil Code section 3439.02(a), which states that "a debtor is insolvent if, at fair valuations, the sum of the debtor's debts is greater than all of the debtor's assets." CAL. CIV. CODE § 3439.02(a).

[FN57]. *See Kallmeyer*, 242 B.R. at 496-97; *Berg*, 100 Cal. Rptr. 3d at 895 n.23; J.B. Heaton, *Solvency Tests*, 62 BUS. LAW. 983, 988 (2007). Bankruptcy courts have also utilized a third test, the "capital-adequacy" solvency test, which "essentially asks whether the firm is *unlikely* to become insolvent," i.e., whether insolvency is reasonably foreseeable. Heaton, *Solvency Tests*, at 995.

[FN58]. *See* U.S. Bank N.A. v. U.S. Timberlands Klamath Falls, LLC, 864 A.2d 930, 947-48 (Del. Ch. 2004).

[FN59]. CAL. CORP. CODE § 501.

[FN60]. *See* 11 U.S.C. § 548(a)(1)(B)(ii)(III).

[FN61]. A particular problem with the balance sheet test is the question of how to value the firm's assets, including whether to value them as if the company will continue as a going concern or be liquidated. The "ability-to-pay" test, meanwhile, suffers from the lack of certainty in most firms' cash flows and debt obligations. Heaton, *Solvency Tests*, *supra* note 57, at 989-91.

[FN62]. However, unlike the trust fund doctrine, this distinction applies at all times and is not dependent upon insolvency.

[FN63]. DEL. CODE ANN. tit. 8, § 144(a)(1)1(3). Even if the statutory safe harbors in the Delaware and California codes are satisfied, a transaction may still be attacked on other grounds, such as waste. *See* Harbor Fin. Partners v. Huizenga, 751 A.2d 879, 895 (Del. Ch. 1999); *Gaillard*, 256 Cal. Rptr. at 716.

[FN64]. *See, e.g.*, Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1279 n.27 (Del. 1989).

[FN65]. Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983).

[FN66]. *Id.*

[FN67]. *See* Valeant Pharms. Int'l v. Jerney, 921 A.2d 732, 748 (Del. Ch. 2007).

[FN68]. *See* R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS § 4.16 n.717 (3d ed. Supp. 2010); Rabkin v. Olin Corp., C.A., No. 7547 slip op. at 314 (Del. Ch. Apr. 17, 1990), *aff'd*, 586 A.2d 1202 (Del. 1990) ("Whether a party can prevail after trial upon one yet not the other aspect of entire fairness has yet to be decided.”).

[FN69]. *See* Lewis v. Fuqua, 502 A.2d 962, 967 (Del. Ch. 1985) (noting that where the special committee is comprised of a single member, that member is required, “like Caesar's wife, to be above reproach”); *see also Schoon*, 953 A.2d at 208.

[FN70]. CAL. CORP. CODE § 310(a)(1). CAL. CORP. CODE § 310(a) applies to transactions a director or an entities in which a director has a “material financial interest.” However, the terms “material financial interest” and “material” are not defined in the Corporations Code, except as described in § 310(a)(3) (providing that a common directorship does not constitute a material financial interest, and a director does not have a material financial interest in setting the compensation of another director), although courts may look to the securities laws for interpretive guidance. *See* HENRY W. BALLANTINE & GRAHAM L. STERLING, BALLANTINE & STERLING: CALIFORNIA CORPORATION LAWS § 103 (R. Bradbury Clark ed., Matthew Bender & Co. 4th ed. 2011).

[FN71]. CAL. CORP. CODE § 310(a)(2).

[FN72]. C. HUGH FRIEDMAN AND EVRIDIKI DALLAS, CALIFORNIA PRACTICE GUIDE: CORPORATIONS ¶ 6:296.3 (The Rutter Group 2011). It should also be noted that in California, a board committee must be comprised of at least two directors. CAL. CORP. CODE § 311. Moreover, to meet this requirement, California Corporations Code § 310 requires that the board approve the transaction by a “vote sufficient without counting the vote of the interested director.” CAL. CORP. CODE § 310(a)(2). As a result, if an interested director is counted for purposes of determining a quorum, a majority of the quorum (not just of disinterested members) must still approve the transaction. HAROLD MARSH, JR., ET AL., MARSH'S CALIFORNIA CORPORATION LAW § 11:07[B] p. 11165 & 66 (4th ed. Supp. 2011). In contrast, Delaware requires a simple majority vote of the disinterested members (which allows a single director to cleanse a transaction). DEL. CODE ANN. tit. 8, § 144(a)(1).

[FN73]. *Id.* § 310(a)(3).

[FN74]. Remillard Brick Co. v. Remillard-Dandini Co., 109 Cal. App. 2d 405, 241 P.2d 66, 75 (1952).

[FN75]. *See Marsh*, *supra* note 72, at § 11:07[D] p. 11-74; Tevis v. Beigel, 344 P.2d 360, 364-67 (1959).

[FN76]. Sammis v. Stafford, 48 Cal. App. 4th 1935, 56 Cal. Rptr. 2d 589, 595 (Ct. App. 1996).

[FN77]. *Id.*
31 Cal. Bankr. J. 827

END OF DOCUMENT