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California Appellate Court's Decision Limits a Creditor's Ability to Bring a Breach of Fiduciary Duty Claim Against Directors of Insolvent Corporations

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On February 3, 2010, the California Supreme Court denied review of a significant decision by the California Court of Appeal, Sixth Appellate District, that limits a breach of fiduciary duty action brought by creditors against directors of an insolvent corporation under California law. *Berg & Berg Enterprises, LLC v. Boyle, et al.*, 178 Cal. App. 4th 1020 (2009). California has now joined Delaware in holding that directors do not owe creditors a fiduciary duty, even when the corporation is operating in the so-called "zone of insolvency."

The *Berg* case arose under the following circumstances: Berg & Berg Enterprises, LLC ("Berg"), the largest creditor of the failed Pluris, Inc. ("Pluris"), filed an initial complaint against the directors of Pluris after Pluris had experienced financial difficulties and entered into an assignment for the benefit of its creditors under California Code of Civil Procedure sections 493.010 and 1802. The thrust of Berg's claim, as finally pleaded, was that the individual directors owed a fiduciary duty to Berg and other Pluris creditors to act for the benefit of Pluris creditors during a time period when Pluris either became insolvent or entered into a "zone of insolvency." The directors allegedly breached that duty by electing to make the assignment for the benefit of creditors, thereby extinguishing Berg's proposed plan to use the corporation's alleged $50 million of net operating losses through a chapter 11 bankruptcy reorganization. According to Berg, a reorganization would have benefitted the Pluris creditors by deriving value from the losses. Berg alleged that the directors had failed to conduct a reasonable investigation into its proposed plan before proceeding with the assignment, and had they investigated, the directors would have seen that pursuing Berg's bankruptcy plan was the only viable way to protect, and thereby satisfy, their fiduciary duty to Pluris' creditors.

The trial court dismissed Berg's complaint without leave to amend for

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failure to state a viable claim for breach of fiduciary duty against the directors. The California Court of Appeal upheld the trial court's dismissal of the action.

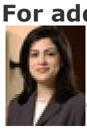
Under California law, corporate directors owe a fiduciary duty only to the corporation and its shareholders and not to a corporation's creditors. Relying on an unpublished 1991 Delaware decision, Berg's claim was based on the theory that directors of an insolvent corporation, or one operating in the "zone of insolvency," should owe a fiduciary duty to the creditors of the corporation.

The *Berg* Court rejected that theory and 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. . . . " Rather, the duty owed by corporate directors to an insolvent corporation's creditors arises under the "trust fund doctrine" and is limited "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 an action that involves self-dealing or the preferential treatment of creditors." Moreover, the duty arises only when the corporation is insolvent, rather than the difficult-to-define "zone of insolvency." Even assuming that Pluris was actually insolvent at the time the assignment for the benefit of creditors was made, and that Berg or Pluris' creditors had successfully carried forward the net operating losses against future income, the Court held that the facts pled by Berg failed to show that there was any diversion, dissipation, or undue risk of corporate assets that would trigger the limited duties to creditors under the trust fund doctrine.

In addition, even if Berg had pled a cognizable claim for breach of fiduciary duty, the Court held that the business judgment rule would shield the Pluris directors from liability if the decision to make the assignment for the benefit of creditors was made in good faith and without the presence of a conflict of interest.

Ultimately, the *Berg* decision severely limits the ability of a creditor to bring a breach of fiduciary duty claim against directors in the event of a corporate insolvency. Creditors will be forced to rely on the limited relief afforded by the trust fund doctrine to bring an action against directors but only when there are facts establishing that the directors improperly diverted, dissipated, or unduly risked corporate assets.

For additional information on this issue, contact: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