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IN WHOSE INTERESTS SHOULD A COMPANY BE RUN? FIDUCIARY DUTIES OF DIRECTORS DURING CORPORATE FAILURE IN INDIA: LOOKING TO THE WEST FOR ANSWERS

*Gautam Sundaresh**

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I. INTRODUCTION

A. *The Debate*

The debate regarding the nature and the beneficiaries of fiduciary duties owed by company directors finds its origins in 19th century jurisprudence. The debate is both complex and dynamic, with varying considerations being taken into account depending on the jurisdiction and the prevalent economic and commercial context. In addition, the position in each jurisdiction derives its color from historical and cultural factors that are indigenous to its corporate governance framework.

There has been a preponderance of corporate failures across jurisdictions over the last century, and substantial legal research is now dedicated to addressing the nuances of the occurrence and impact of insolvency. It was thus inevitable that the debate would extend to whose interests should be taken into account in the event of corporate insolvency. This debate primarily concerns the company's shareholders and its creditors. Although several other constituencies are affected by a company's functioning (as well as its financial deterioration), and should ideally be taken into account in such a debate, the focus across jurisdictions has been on the shareholders and creditors. This is due to the fact that creditors essentially encompass and represent the interests of several other stakeholders, constituting the "other side of the spectrum" to the shareholder-primacy focused approach.[1] When one is able to successfully move away from shareholder primacy, this opens up the possibility of looking at the interests of several others that were previously ignored.

The debate centers on the identification of the rightful beneficiaries of fiduciaries duties during the various stages of a corporation's financial health, namely: (i) solvency/financial stability; (ii) actual insolvency; and (iii) the zone/vicinity of insolvency (the "zone").[2] In each stage of the company's financial existence, there are those that advocate for maximization of shareholder wealth, and others who believe in a more inclusive approach, with other stakeholders and the company's creditors also being considered in decision making.[3] In some cases (such as in insolvency), however, proponents of the inclusive ap-

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1. *See* J. William Callison, *Why a Fiduciary Duty Shift to Creditors of Insolvent Business Entities is Incorrect as a Matter of Theory and Practice*, 1(2) J. BUS. & TECH. L.431 (2007).

2. Thus, the debate no longer functions as a binary of 'solvency' versus 'insolvency', and takes into account the need for a re-prioritization when the company has entered into a stage of financial decline.

3. REINIER KRAAKMAN ET AL., THE ANATOMY OF CORPORATE LAW: A COMPARATIVE AND FUNCTIONAL APPROACH 28 (2d ed. 2008); *See* Charles Handy, *What is a Company For?*, 1 CORPORATE GOVERNANCE 14, 14 (1993).

proach argue for duties being owed to the company's creditors and its other stakeholders, to the exclusion of its shareholders.[4]

The inherent conflict stems from the contrasting behavioral tendencies of the two primary constituencies, which is a direct consequence of the conflicting *inter-se* rights that the law confers upon them. As part of general corporate theory, there is heterogeneity between contractual rights accorded to shareholders *vis-à-vis* those accorded to creditors: shareholders being entitled to participation rights in the company in the form of dividends, and creditors only being entitled to receive repayment on their debts calculated against the time value of money.[5] Although the conflict exists right from the time of inception of a company (or from the time when it first has third-party debt on its books), the magnitude of the divergence in interests is greatly exacerbated as the financial health of the company deteriorates.[6] As long as the corporation displays signs of financial vitality, neither constituency has the incentive to pursue its interests to the disadvantage of the other, and the conflict remains in a latent state.[7] However, when it becomes evident that the corporation is showing signs of financial deterioration, the interests of creditors inevitably become at odds with those of the shareholders.[8] Arising from a fear of being unable to recover one's investment or debt, both constituencies are incentivized to focus on maximization of their returns in the short term, as opposed to the best interests of the company (and its other stakeholders).[9] The sources of conflict are four-fold: (i) the risk-level to be adopted in decision making; (ii) the contest to recover maximum investment; (iii) the decision to liquidate the firm versus keeping the firm as a going concern; and (iv) the decision to venture into new projects and to make fresh investments.[10]

As shareholder liability is limited to the value of investment in the company, shareholders usually favor risk-taking behavior in pursuit of the faintest possibility that the company may redeem itself.[11] Although shareholders have negligible claims in the insolvent liquidation of a company, they stand to gain

4. *See* Myron M. Sheinfeld and Judy Harris Pippitt, *Fiduciary Duties of Directors of a Corporation in the Vicinity of Insolvency and After Initiation of a Bankruptcy Case*, 60(1) THE BUSINESS LAWYER 79, 79–107 (2004).

5. *See generally* Charles P. Normandin, *The Changing Nature of Debt and Equity: A Legal Perspective*, available at https://pdfs.semanticscholar.org/7c99/d90e333475c57f9cd66cbd918f2056ebce6d.pdf.

6. Laura Lin, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 VAND. L. REV. 1485, 1488 (1993).

7. Justin Wood, *Director Duties and Creditor Protections in the Zone of Insolvency: A Comparison of the United States, Germany, and Japan*, 26(1) PENN STATE INT'L L. REV. 139, 139–68 (2007).

8. *See id.* at 1489.

9. *See id.* at 1486.

10. *See id.* at 1489.

11. *See* Henry T.C. Hu and Jay Lawrence Westbrook, *Abolition of the Corporate Duty to Creditors,* 107(6) COL. L. REV. 1321–403 (2007).

enormously in situations where risky actions result in increased profitability. The doctrine of limited liability thus results in a moral hazard, wherein shareholders are incentivized to make decisions that could adversely impact the corporation and its other stakeholders, with the possibility of any upside accruing only in their favor.[12]

On the other hand, creditors tend to be more risk-averse during the corporation's financial decline, their goal being to prevent any erosion of net asset value that would diminish the corporation's liquidation estate (from which their claims are satisfied in insolvent liquidation) or impact the assets over which they hold security interests.[13] As opposed to the gains that accrue to shareholders from smart and strategic investments, creditors do not stand to gain much from decisions that are 'high-risk, high-reward,' but also bear a downside risk.[14] Thus there is no incentive for creditors to pursue an efficacious turn-around for the company unless they also stand to gain in the process (for example, where creditors attain the status of residual claimants by way of an arrangement wherein they are to receive equity in a reorganized firm in exchange for their claims).[15] It is then only the shareholders, that reap the fruits of an upside gain in an insolvency scenario.[16] As a result, neither shareholders nor creditors have the incentive to opt for a "balanced approach" that would solely advance the interests of the deteriorating corporation.

Several thinkers have entered the debate, and opinions have largely been polarized. There are those that justify the "shareholder primacy approach." Most of this approach's foundational literature deals with duties of directors of a financially stable entity, when the debate had not yet progressed to encompass insolvency scenarios.

In this regard, the "natural entity theory" postulated by Millon[17] and others,[18] posits that corporations exist only by way of agglomeration of private initiatives of its shareholders as its residual claimants.[19] As the shareholders bear

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12. *See* Stephen M. Bainbridge, *Much Ado About Little? Directors' Fiduciary Duties in the Vicinity of Insolvency*, 1 J. BUS. & TECH. L. 335, 355 (2007), http://digitalcommons.law.umaryland.edu/jbtl/vol1/iss2/7.

13. Andrey Keay, *The Director's Duty to Take into Account the Interests of Company Creditors: When Is It Triggered*, 25 MELB. U. L. REV. 318, 315–39 (2001).

14. *See generally* Viral V. Acharya, Yakov Amihud & Lubomir Litov, *Creditor Rights and Corporate Risk-Taking*, 102(1) J. OF FIN. ECON. 150–66 (2011).

15. *See* Mark J. Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 COLUM. L. REV. 527, 542–43 (1983).

16. Cory Dean Kandestin, *Duty to Creditors in Near-Insolvent Firms: Eliminating the Near-Insolvency Distinction*, 60 VAND. L. REV. 1235 (2007); Lin, *supra* note 6.

17. David K. Millon, *Theories of the Corporation*, 1990 DUKE L. J. 201 (1990).

18. *See, e.g.,* Milton Friedman, *The Social Responsibility of Business is to Increase Its Profits*, N.Y. TIMES 32 (Sept. 13, 1970), https://www.nytimes.com/1970/09/13/archives/a-friedman-doctrine-the-social-responsibility-of-business-is-to.html.

19. *See* Michael Bradley, Cindy Schipani, Anant Sundaram & James P. Walsh, *The Purposes and Accountability of the Corporation in Contemporary Society: Corporate Governance at a Crossroads*, 62 LAW AND CONTEMP. PROBS. 9 (1999); Jonathan R. Macey & Geoffrey P. Miller,

a greater risk than the corporation's fixed claimants (its creditors), the corporation is beholden to the interests of the shareholders.[20] Berle also supported a shareholder primacy approach (as part of the famous Berle-Dodd debate).[21] Berle considered shareholder primacy as the only viable approach that promoted the concept of a free market economy (on account of its focus on profit maximization), and opined that other stakeholders were only so deserving if they were similarly situated in their contractual relationships with the corporation.[22] Berle remarked, "owner-shareholders ought to receive the profits of the corporation because they acquired ownership of the corporate venture and are the rightful benefactors of all corporate economic surplus to the exclusion of non-owners."[23] Some have also argued that a non-shareholder-focused approach would amount to spending "other people's money."[24] On the other hand, proponents[25] of Dodd's position[26] contest this understanding, and refute Berle's foundational premise that a corporation's allegiance lies primarily with its shareholders.

Dodd posited that, in the eyes of the public, corporations constitute economic institutions that play a role in social welfare (over and above just profit maximization), and that corporations owe their duties to other stakeholders as well (including their employees, customers, and creditors).[27] In response to Berle's position, some argued that a company is incapable of being "owned" and that owning shares does not equate to ownership of the company.[28] As a corollary, it was also argued that a corporation constitutes more than just a web of contracts and more than "a mere aggregation of individual units," being a juristic

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Corporate Stakeholders: A Contractual Perspective, 43 U. TORONTO L.J. 401 (1993); Jonathan R. Macey, *Fiduciary Duties as Residual Claims: Obligations to Nonshareholder Constituencies from a Theory of the Firm Perspective*, 84 CORNELL L. REV. 1266 (1999).

20. *See also* REINIER KRAAKMAN ET. AL, THE ANATOMY OF CORPORATE LAW 14–15 (2d ed. 2009).

21. Adolf A Berle, *For Whom Corporate Managers Are Trustees: A Note,* 45 HARV. L. REV. 1365 (1932).

22. *See* Stephen Bainbridge, *In Defense of the Shareholder Wealth Maximization Norm,* 50 WASH. & LEE L. REV. 1423 (1993); Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L. J. 42 (2001).

23. ADOLF A BERLE JR. AND GARDINER C MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (Harcourt, Brace & World, 1968).

24. Douglas Baird & Todd Henderson, *Other People's Money*, 60 STAN. L. REV. 1309 (2008).

25. Cynthia A. Williams, *Corporate Social Responsibility in an Era of Globalization*, 35 U.C. DAVIS L. REV. 705, 720 (2002).

26. Edwin Merrick Jr. Dodd, *For Whom Are Corporate Managers Trustees?* 45(7) HARV. L. REV. 1145 (1932).

27. *Id.*

28. Eugene Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 290 (1980); Ciaran O'Kelly, *History Begins: Shareholder Value, Accountability and the Virtuous State*, 60 N. IR. LEGAL. Q. 35, 38 (2009); John Parkinson, *Model of the Company and the Employment Relationship*, 41 BRIT. J. IND. REL. 481, 483 (2003).

person in itself.[29] While Berle finally conceded to Dodd in the debate, it seems that the legal community at large remained rather unmoved by this concession, and many countries across the world continue to adopt the shareholder primacy approach during a company's solvency.[30]

More recent theories in support of shareholder primacy include the belief that direct obligations towards other constituencies would result in inefficiencies in corporate governance[31] as well as redistribution that would unduly benefit creditors in excess of what they are owed under their contractual arrangements.[32] Further, it is contended that maximization of shareholder value results in a trickle-down effect that maximizes overall stakeholder value.[33] Some argue that the only reason for directors to consider creditors' interests is the motive to safeguard themselves against the resultant loss in goodwill in the credit market in situations where such interests are not taken into account.[34]

Authors supporting creditor protection argue that creditors should be owed duties in light of the inherent asymmetry of information and inequality of bargaining power that exists at the time of contracting, in addition to the unendurable costs of monitoring and ensuring compliance post the execution of contracts.[35] Some arguments are based on utilitarianism and principles of fairness, and are premised on the possibility of corporate failure resulting in creditors not being able to meet their own obligations, resulting in a ripple effect.[36] As a corollary, the concept of limited liability of shareholders is considered unfair, as it results in an undue burden of business risk falling on creditors.[37]

However, fiduciary duties are always routed to the relevant beneficiaries through the corporate enterprise itself (although the US deviated from this approach for a considerable time before correcting itself).[38] Thus, the primary duty of directors is ordinarily to the corporate enterprise itself; the corporation not being capable of enforcing fiduciary duties, which are only "enforceable" by the

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29. *See* THOMAS B. COURTNEY, THE LAW OF COMPANIES 168 (3d ed. 2012); Margaret Blair & Lynn Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 277 (1999).

30. Andrew Keay, *Tackling the Issue of the Corporate Objective: An Analysis of the United Kingdom's Enlightened Shareholder Value Approach*, 29 SYD. L. REV. 577 (2007).

31. *See* Harry J. Glasbeek, *More Direct Director Responsibility: Much Ado about . . . what?* 25 CAN. BUS. L. J. 416, 421 (1995).

32. *See* Andrew Keay, *Directors' Duties to Creditors: Contractarian Concerns Relating to Efficiency and Over-Protection of Creditors*, 66 MOD. L. REV. 665, 669 (2003).

33. Keith Davis, *The Case for and Against Business Assumption of Social Responsibilities*, 16 ACAD. OF MGMT. J. 312, 313–18 (1973).

34. *See* DAVID GODDARD, CORPORATE PERSONALITY IN THE 20TH CENTURY 27 (C.E.F. Rickett & R. Grantham eds. 1998).

35. Keay, *supra* note 30, at 578

36. *Id*.

37. Paul Halpern, Michael Trebilcock & Stuart Turnbull, *An Economic Analysis of Limited Liability in Corporation Law*, 30 U. TORONTO L. J. 117 (1980).

38. NACEPF v. Gheewalla, 930 A.2d 92, 101–02 (Del. 2007). *See also* Quadrant Structured Prods. v. Vertin, 115 A.3d 535, 545–47 (Del. Ch. 2015).

ultimate beneficiaries of the corporation. As seen below, however, which stakeholder becomes the rightful beneficiary at a particular point in time varies depending on the financial condition of the company and the level of risk borne by such stakeholder.

B. *Scope of Review*

This Comment looks at the debate as it has played out in the legal jurisprudence of the U.S. and the U.K.. The analysis of each considers the three financial stages of a corporation's existence that are specifically addressed in the debate today, i.e.: (i) solvency; (ii) insolvency; and (iii) the zone of insolvency. After setting out the current position, this Comment specifically address the various shortcomings and criticisms of the models adopted by each jurisdiction and offers observations on the s*tatus quo* and the implementation of these models. On this basis, this Comment goes on to propose a model to be adopted by India, the Indian legal jurisprudence in this respect still being in its evolutionary stages and lacking the depth and the level of analysis found in the West.

The common practice in India is to look to the U.K. and the U.S. for guidance in drafting statutes and resolving complex legal issues that arise thereafter.[39] Being a member of the Commonwealth, Indian courts benefit from decisions and legal developments in other common law jurisdictions. Indian courts often directly cite U.K. decisions in their judgments in order to fill gaps in the domestic framework. Drawing from either of these jurisdictions would result in benefits for India, owing to their rich, highly developed, and nuanced corporate and insolvency law jurisprudence.

The U.S. and the U.K. offer different models of corporate fiduciary duties. Each model has evolved by way of judicial interpretation. During the evolutionary process, nuanced features of each model have developed differently depending on the corresponding evolutionary trajectory of corporate governance and insolvency law principles. Several amendments have come about as a result of trial and error as well as repeated reprioritization warranted by changing economic and business scenarios. The respective models also derive their color from the character of the insolvency regimes themselves. The U.S. adopts a debtor-friendly regime, while the U.K. (and also recently, India) adopts a creditor-friendly approach. Thus, each model differs in several respects and offers different perspectives on how to approach the issue of fiduciary duties.

This Comment seeks to provide suggestions for the way forward for India by drawing from the experience of the U.S. and the U.K., and by laying out a model that would adopt the most efficient and suitable aspects of both approaches, while learning from the failures of both. It should also be noted that the U.S. analysis will focus primarily on the State of Delaware, Delaware courts

39. *See e.g.*, Navtej Singh Johar & Ors. v. Union of India & Ors., (Writ Petition (Criminal) No. 76 of 2016).

having delved into this issue in a substantial manner, and most large U.S. corporations being incorporated in Delaware.[40]

In addition to discussing fiduciary duties, this Comment also touches upon certain statutory provisions that create duties analogous to fiduciary duties, which operate to protect the interests of the relevant stakeholders in a similar manner during the various stages of a company's financial existence set out above.

C. *Fiduciary Duties*

Before entering into a substantive analysis and a comparison of the legal position in the above-mentioned jurisdictions, a brief introduction to fiduciary duties is warranted. Fiduciary duties are said to operate by "filling up the gaps" in the contractual underpinnings of a corporation's day-to-day functioning.[41] They are also meant to counter the inherent tendency of a corporation's management towards self-preservation.[42] Although courts have not set out any comprehensive definition of what constitutes a "fiduciary," in *Bristol and West Building Society v. Mathew*[43], it was said that, "[a] fiduciary is someone who undertakes to act for or on behalf of another in a particular manner in circumstances which give rise to a relationship of trust and confidence."[44] A fiduciary is said to be in violation of his or her duties not only where there has been purposeful intent to harm the economic interests of the beneficiaries, but also where he or she has not acted in a way that will subjectively advance their interests.[45]

Fiduciary duties apply to directors managing the affairs of a company as representatives of various stakeholder interests.[46] The primary fiduciary duties of U.S. directors are the duties of care and loyalty. The duty of care obligates U.S. directors to adopt a manner of functioning that "ordinarily careful and prudent men would use in similar circumstances".[47] The duty of loyalty, on the other hand, obligates such directors to make decisions that are aligned to the best interests of the corporation and its shareholders and disallows them from

40. *See* Robert M. Daines, *Does Delaware Law Improve Firm Value?*, 62 J. OF FIN. ECON. 525–58 (2001).

41. *See* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 92 (1991).

42. *See* Michael C. Jenson & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. & ECON. 305 (1976).

43. Bristol and West Building Society v. Mothew, [1996] EWCA (Civ) 533 (Eng.) (hereinafter "Bristol and West Building").

44. *See also* RESTATEMENT (SECOND) OF TORTS § 874 cmt. a (AM. LAW INST. 1977).

45. Pitt v. Holt, [2013] 2 AC 108, at 73 [Pitt].

46. Multinational Gas & Petrochemical Co. v. Multinational Gas & Petrochemical Services Ltd., [1983] Ch 258.

47. *In re* Walt Disney Co. Derivative Litig., 907 A.2d 693, 749 (Del. Ch. 2005).

acting in pursuance of their self-interest.[48] It requires that directors retain an undivided and selfless loyalty to the corporation.[49] Justice Cardozo described the duty of loyalty as constituting "something stricter than the morals of the marketplace."[50] The duty requires that directors *inter alia* refrain from competing with the corporation, usurping corporate opportunities[51] or assets, and benefitting from non-public information.[52]

In the U.K., the fiduciary duty of loyalty is encapsulated under Sections 172 through 179 of the Companies Act, 2006 ("Companies Act"), which is discussed in greater detail as part of the U.K. analysis below. The duty to exercise "reasonable care and skill" is not a fiduciary duty recognized under U.K. law (as expressly stated under Section 178(2) of the Companies Act).[53] The common law remedy for breach of duty of care is in the nature of damages instead, thereby necessitating an assessment of causation, remoteness, and measure.[54] A breach of this duty may also result in disqualification of a director under the Company Directors Disqualification Act, 1986 ("Disqualification Act").[55] Under the Indian framework, both the duty of loyalty and the duty of reasonable care find their place in the Indian Companies Act statutory framework.[56]

While fiduciary duties owed to shareholders contemplate actions that maximize the value of the firm and the possible dividend that would accrue to its shareholders, fiduciary duties to creditors are more expansive and include *inter alia* avoiding transactions that diminish, divert, or expose the company's assets to risk as well as avoiding preferential and fraudulent transactions.[57] A violation of fiduciary duties would result in the personal liability of directors. Although most directors are covered by liability insurance, some courts have held that a portion of claim amounts or settlements must come from directors themselves.[58]

Although the scope of fiduciary duties is rather wide, several jurisdictions create an exception to their applicability in situations where the impugned deci-

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48. *See* Norlin Corp. v. Rooney, Pace Inc., 744 F.2d 255, 264 (2d. Cir. 1984); Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361–62 (Del. 1993).

49. Guth v. Loft Inc., 5 A.2d 503, 510 (Del. Ch. 1939) [hereinafter "Guth"].

50. *See* Meinhard v. Salmon, 164 N.E. 545, 546 (N.Y. 1928).

51. *See* Liston v. Gottsegen, 348 F.3d 294, 303 (1st Cir. 2003).

52. John A. Pearce II & Ilya A. Lipin, *The Duties of Directors and Officers within the Fuzzy Zone of Insolvency*, 19 AM. BANKR. INST. L. REV. 361, 365 (2011).

53. This is one of the causes for problems when the breach constitutes an overlap of both types of duties, however.

54. *See Bristol & West Building, supra* note 43, at 711.

55. Section 6 read with Schedule 1 of the Company Directors Disqualification Act, 1986.

56. Companies Act, No. 18 of 2013, India Code (2013), §§ 166, 184.

57. *See generally* Pearce II & Lipin, *supra* note 52 (discussing fiduciary duties owed to creditors in a variety of situations).

58. Shawn Young, *Ex-WorldCom Directors Reach Pact*, WALL ST. J. A6, Mar. 21, 2006; Rebecca Smith & Jonathan Weil, *Ex-Enron Directors Reach Settlement*, WALL ST. J. C3, Jan. 10, 2005.

sion/action has been taken by directors in "good faith" and what they believed was in the best interest of the beneficiaries and the corporation.[59] In the U.S., this exception finds its place in the legal framework under the nomenclature of the "business judgment rule." Under the business judgment rule, directors are accorded immunity against all losses arising due to errors of judgment, so long as the impugned decisions are attributable to an objective commercial purpose.[60] Once applied, this rule shifts the burden of proof from the directors onto the party challenging the impugned decision.[61]

As described by the Delaware Supreme Court, the business judgment rule exists to protect and promote the "full and free exercise of the managerial power"[62] available to directors. In determining whether to apply the rule, courts consider several mitigating factors, including: (i) whether the concerned director has made reasonable efforts to apprise himself or herself of the relevant facts;[63] (ii) whether the director was under the belief that the impugned action was in furtherance of the interests of the corporation and its relevant stakeholders;[64] (iii) the pro-activeness of the director in addressing the issues resulting in the loss caused to the company;[65] (iv) reliance on professional services[66] (unless it can be said that the director had access to additional material that would call into question the legitimacy of the opinion given by the professional);[67] and (v) state-specific carve-outs, etc.[68]

There are certain situations which preclude application of the rule. One example is where the director has a personal interest. In such situations, a higher standard applies: the "entire" or "intrinsic" fairness of the decision to the interests of the corporation.[69] The U.K. has not adopted a legislated business judgment rule (nor has India), but relies upon similar protections to directors under

59. Carlos Andres Laguado Girlado, *Factors Governing the Application of the Business Judgment Rule: An Empirical Study of the US, UK, Australia and the EU,* 111 VNIVERSITAS, 115, 125–46 (2006); Chia Yaru, *The Business of Judging Directors' Business Judgments in Singapore Courts*, 28 SINGAPORE ACADEMY OF LAW JOURNAL 428 (2016).

60. Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914, 872 (Del. 2003) [hereinafter "Omnicare"].

61. *See* Hugh McCullough & Marshall Huebner, *The Fiduciary Duties of Directors of Troubled U.S. Companies: Emerging Clarity*, INT. COMP. LEGAL GUIDES (Davis Polk & Hardwell), https://www.davispolk.com/files/files/Publication/e94983bd-b8c3-4826-bc90-013897c46700/Preview/PublicationAttachment/c3b06dbd-937d-46b5-b685-5f8bf8f41242/huebner.fiduciaryduties.article.jul09.pdf.

62. Smith v. Van Gorkom, 488 A.2d 848, 872 (Del. 1985).

63. *Id*; *see also* Grobow v. Perot*,* 526 A.2d 914, 925–26 (Del. Ch. 1987).

64. Parnes v. Bally Entm't Corp., 722 A.2d 1243, 1246 (Del. 1999).

65. Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1280 (Del. 1989).

66. *See* Munford, Inc. v. Valuation Res. Co., 98 F.3d 604, 611 (11th Cir. 1996).

67. *See* Brandt v. Hicks, Muse & Co. (*In re* Healtcho International), 208 B.R. 288, 306–07 (Bankr. D. Mass. 1997).].

68. *See* Gabriel Rauterberg & Eric Talley, *Contracting out of the Fiduciary Duty of Loyalty: An Empirical Analysis of Corporate Opportunity Waivers*, 117(5) COLUM. L. REV. 1075 (2017).

69. *See* McCullough & Huebner, *supra* note 61.

common law. In *Howard Smith Ltd. v. Ampol Petroleum*[70] and the line of cases that followed, it was held that:

> [i]t would be wrong for the court to substitute its opinion for that of the management, or indeed to question the correctness of the management's decision, on such a question, if bona fide arrived at. There is no appeal on merits from management decisions to courts of law; nor will courts of law assume to act as a kind of supervisory board over decisions within powers of management honestly arrived at.[71]

Apart from the duties mentioned above, the U.K., by way of the landmark decision in *Pitt v. Holt* in 2012, included the additional duty for directors to consider relevant matters (and disregard irrelevant matters) when exercising decision making powers.[72]

II. THE UNITED STATES

A. *Duties in Financial Stability*

In the U.S., directors' fiduciary duties are predicated on primacy of the shareholders (apart from the corporation itself).[73] *Dodge v. Ford Motor Co.*[74] illustrates this concept:

> [A] business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the non-distribution of profits among stockholders in order to devote them to other purposes.

Courts in the U.S. have reiterated this position over time,[75] including the Delaware Chancery Court in the landmark decision of *Katz v. Oak Industries Co*.[76] Thus, in the U.S., the directors of a solvent corporation do not ordinarily owe any duties to bondholders or creditors[77] because "the relationship between a corporation and the holders of its debt securities, even convertible debt securi-

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70. Howard Smith Ltd. v. Ampol Petroleum [1974] AC 821 PC (UK).

71. *Id.* at 832.

72. Pitt v. Holt [2013] UKSC 26, [2013] 2 AC 108.

73. *See* United States v. Jolly, 102 F.3d 46, 48 (2d Cir. 1996); Newby v. Enron Corp, 188 F. Supp. 2d 684, 704 (S.D. Tex. 2002); Guth v. Loft Inc., 5 A.2d 503 (Del. Ch. 1939); Unocal Corp v. Mesa Petroleum, 493 A.2d 946, 955 (Del. 1985).

74. Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919).

75. *See* Revlon Inc. v. Macandrews & Forbes Holdings, Inc. 506 A.2d 173 (Del. 1986); Polk v. Good, 507 A.2d 531, 536 (Del. 1986); Rosenblatt v. Getty Oil Co., 493 A.2d 929, 944 (Del. 1985); In re Abbott Labs, Derivative Shareholders Litigation, 325 F.3d 795, 808 (7th Cir. 2003); *In re* Doctors Hosp. of Hyde Park Inc., 506 A.2d 173, 179 (Del. 1986); Simons v. Cogan, 549 A.2d 300, 304 (Del. 1988); Lorenz v. CSX Corp., 1 F.3d 1406, 1417 (3d. Cir. 1933).

76. Katz v. Oak Industries Inc., 508 A.2d 873 (Del. Ch. 1986).

77. *See* Metropolitan Life Ins. Co. v. RJR Nabisco, Inc. 716 F. Supp. 1504, 1524–25 (S.D.N.Y 1989).

ties, is contractual in nature."[78] Further, even any extra-contractual rights that accrue to creditors are said to arise only from an "implied covenant of good faith" that is said to be found in all contracts.[79] In *Katz*,[80] it was held that such an implied covenant would only be breached when the impugned act is prohibited by the express terms of the indenture. In a later case,[81] it was clarified that this implied covenant could not, in any event, be extended to protect against acts in a manner that would be inconsistent with the other terms of the contractual agreement. Creditors' only recourse against directors of financially stable companies is by way of suits alleging fraud, and resorting to remedies available under state statutes and federal securities law. Unlike shareholders, they cannot rely on the "special and rare" obligations imposed on fiduciaries.[82] Thus, directors constantly face the risk of suits by shareholders for granting creditors greater rights than they are entitled to and have to be constantly wary of overstepping in this regard.[83]

It did not take long for U.S. courts to realize that such an analysis would not be equally applicable in insolvency scenarios. In insolvency, the shareholder primacy approach no longer seemed relevant, as shareholders were no longer the primary risk bearers of the corporation, this role shifting to the creditors instead.[84] It was found that the *Katz*[85] justification of protection to creditors continuing by way of contractual covenants also lost its relevance in insolvency, wherein creditors would find it increasingly difficult to enforce their contractual rights.[86] This is coupled with the fact that insolvent corporations are also afforded additional protection against actions by creditors. The analysis pertaining to fiduciary duties owed by directors in insolvency and in the 'vicinity of insolvency' is set out below.

B. *Duties in Insolvency*

As set out above, U.S. courts started recognizing the problem with according primacy to shareholders in insolvency during the early 1980s. Courts became increasingly aware of the fact that interests of shareholders become subordinate to the rights of creditors in insolvency and that shareholders stand last

78. *Katz*, 508 A.2d at 879 (Del. Ch. 1986); United States v. Jolly, 102 F.3d 46, 48 (2d Cir. 1996).

79. Bainbridge, *supra* note 12, at 345.

80. *Katz*, 508 A.2d at 880 (Del. Ch. 1986).

81. Metropolitan Life Ins. Co. v. RJR Nabisco, Inc. 716 F. Supp. 1504, 1517 (S.D.N.Y 1989).

82. *Id.* at 1524.

83. *See*, *e.g.*, Broad v. Rockwell Int'l Corp., 642 F.2d 929, 958 (5th Cir. 1981).

84. EASTERBROOK AND FISCHEL, *supra* note 41.

85. *Katz*, 508 A.2d at 873 (Del. Ch. 1986).

86. *See* Dale B. Tauke, *Should Bonds Have More Fun? A Reexamination of the Debate over Corporate Bondholder Rights*, COLUM. BUS. L. REV. 1, 26–28 (1989).

in line during liquidation.[87] In light of this, courts concluded that, upon insolvency, directors owed their fiduciary duties: (i) to the firm's creditors instead,[88] or (ii) in priority to creditors over shareholders.[89] In addition, courts felt that it was necessary to accord certain protections to preserve the asset value of the company in favor of creditors, who are solely reliant on the assets of the corporation for recovering their claim amounts.[90] Thus, the rules of the game changed drastically in favor of creditors, who were until then largely unprotected. As a result, creditors were now allowed to bring direct claims against the directors for breach of fiduciary duties in insolvency. While blanket rights were accorded at first,[91] they were subsequently watered down to provide only for those situations where there was a "marked degree of animus towards a particular creditor."[92]

This was all to change with the 2007 Delaware Supreme Court decision in *North American Catholic Educational Programming Foundation Inc. v. Gheewalla*.[93] In *Gheewalla*, the Court expressly did away with the rights of creditors to initiate direct claims against directors for breach of fiduciary duties in insolvency.[94] It held that:

> [I]t is well established that the directors owe their fiduciary obligations to the corporation and its shareholders. While shareholders rely on directors acting as fiduciaries to protect their interests, creditors are afforded protection through contractual agreements, fraud and fraudulent conveyance law, implied covenants of good faith and fair dealing, bankruptcy law, general commercial law and other sources of creditor rights. Delaware courts have traditionally been reluctant to expand fiduciary duties. Accordingly, 'the general rule is that directors do not owe creditors duties beyond the relevant contractual terms.[95]

Thus, the *Gheewalla* decision reverted to a *Katz* type understanding in its justification for holding that directors do not directly owe fiduciary obligations

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87. Unsecured Creditors Comm. of STN Enterprises Inc. v. Noyes*,* 779 F.2d 901, 904 (2d Cir. 1985); *In re* Sec. Asset Capital Corp., 396 B.R. 35, 42 (Bankr. D. Minn. 2008).

88. *See* FDIC v. Sea Pines Co., 692 F.2d 973, 976–77 (4th Cir. 1982); Henderson v. Buchanan *(In re* Western World Funding, Inc.*)*, 52 B.R. 743, 753–62 (Bankr. D. Nev. 1985); Carrieri v. Jobs.com, Inc., 393 F.3d 508, 534 (5th Cir. 2004); Arnold v. Knapp, 84 S.E. 895, 899 (W.Va. 1915); Geyer v. Ingersoll Publications Comp., 621 A.2d 784 (Del. Ch. 1992).

89. Bank Leumi-Le-Israel, B.M. v. Sunbelt Indus., Inc.*,* 485 F. Supp. 556, 559 (S.D. Ga. 1980).

90. *See* Richard M. Cieri and Michael J. Riela, *Protecting Directors and Officers of Corporations That Are Insolvent or in the Zone or Vicinity of Insolvency: Important Considerations, Practical Solutions*, 2 DEPAUL BUS. & COM. L.J. 295 (2004); Steven L. Schwarcz, *Rethinking a Corporation's Obligation to Creditors*, 17 CARDOZO L. REV. 647, 666 (1995).

91. Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp*,* 1991 WL 277613 109 (Del. Ch. 1991).

92. Production Resources Group v. NCT Group*,* 863 A.2d 772, 798 (Del. Ch. 2004).

93. 930 A.2d 92, 99 (Del. 2007).

94. North American Catholic Educational Programming Foundation Inc. v. Gheewalla*,* 930 A.2d 92, 101 (Del. 2007).

95. *Id.*

to creditors as a constituency. Its rationale was that creditors are protected by pre-existing contractual covenants. Recognizing the dilemma that directors might face by extending such direct duties to creditors, the court held that:

> [R]ecognizing that directors of an insolvent corporation owe direct fiduciary duties to creditors, would create uncertainty for directors who have a fiduciary duty to exercise their business judgment in the best interest of the insolvent corporation. To recognize a new right for creditors to bring direct claims against those directors would create a conflict between those directors' duty to maximize the value of the insolvent corporation for the breach of all those having an interest in it, and the newly recognized direct fiduciary duty to individual creditors.[96]

As an extension of this principle, the court ruled that although creditors no longer had the right to initiate direct claims against directors in insolvency, they still retained the right to bring derivative claims (on behalf of the corporation) against its directors. In this regard, the court held:

> [T]he corporation's insolvency makes the creditors the principal constituency injured by any fiduciary breaches that diminish the firm's value. Therefore, equitable considerations give creditors standing to pursue derivative claims against the directors of an insolvent corporation. Individual creditors of an insolvent corporation have the same incentive to pursue valid derivative claims on its behalf that shareholders have when the corporation is solvent.[97]

Thus, the court's rationale in barring direct claims was founded in the understanding that creditors are to take the place of shareholders upon insolvency, and thus their standing to proceed against the company should be the same as that of shareholders', *i.e.*, bringing suits against directors only on behalf of the corporation itself. As seen from the paragraphs quoted above, the court in *Gheewala*[98] reaffirmed the fundamental principle that duties are never to be owed to the company's stakeholders directly, the primary duty of directors always being towards the enterprise itself. As a result, stakeholders are only entitled to initiate derivative actions against the directors where their decisions have had an adverse impact on the company, and where they are in a vulnerable position as risk bearers, demonstrated by the fact that fiduciary duties are owed to them at the relevant point in time. This would empower creditors to prevent corporations from taking risky business decisions in insolvency that would directly affect their interests due to their implied recognition as the primary risk bearers of the corporation in insolvency.

There is a presumption under Delaware law in favor of directors fulfilling their duties of care and loyalty even during insolvency.[99] In other words, the business judgment rule continues to be applicable in insolvency. In this regard,

96. *Id.* at 23.

97. NACEPF v. Gheewalla, 930 A.2d 92, 101–02 (Del. 2007).

98. *Id.*

99. *See In re* Ultimate Escapes Holdings, LLC, Case No. 12-50849 (Bankr. D. Del. Nov. 12, 2014).

the court in *Gheewalla*[100] clarified that in endeavoring to increase the likelihood that creditors get a greater recovery, the directors do not become guarantors of success.[101] This is demonstrable by the fact that the statutory framework provides for the management of the company to continue to vest with directors post insolvency and that directors continue to take important decisions, including those regarding whether to commence a court-supervised reorganization post insolvency.[102]

Thus, fiduciary obligations to creditors act as gap-fillers where the statutory requirements of fraudulent conveyance or voidable preference laws are not met and encompass a large number of actions that would adversely affect the interests of creditors.[103] Further, this opens up an additional avenue for creditors to go up against directors who have not personally benefitted from the impugned transactions, but who have played a role in approving the transaction, or did not actively object.[104] As an empirical matter, however, cases in which directors have been found to have breached their fiduciary duties to creditors have mostly been observed to have been initiated where corporations involved have been either closely held[105] or under common control and ownership.[106][107]

C. *Duties in the Vicinity/Zone of Insolvency*

A company is said to be in the zone of insolvency during the "indeterminate period that exists between its solvency and insolvency."[108] From a corporate governance perspective, the determination of whom directors owe their allegiance to in the zone could lead to very different outcomes for the corporation. This would affect not only the day-to-day operations of a company in a state of financial decline but would even influence how important decisions regarding the turn-around of the firm are taken. The entire "vicinity debate" was first addressed in the landmark decision of the Delaware Chancery Court in *Credit Lyonnais*.[109] In *Credit Lyonnais*,[110] it was held that "[a]t least where a corpora-

100. *Id.*

101. *Id.*

102. McCullough and Huebner, *supra* note 61, at 7.

103. Lin, *supra* note 6, at 1508.

104. Rosebud Corp. v. Boggio, 561 P.2d 367, 372(Colo. App. 1977).

105. *See, e.g.*, Pepper v. Litton, 308 U.S. 295 (1939); Burroughs v. Fields, 546 F.2d 215 (7th Cir. 1976); South Falls Corp. v. Rochelle, 329 F.2d 611 (5th Cir. 1964).

106. *See, e.g.*, Clarkson Co. Ltd. v. Shaheen, 660 F.2d 506 (2d Cir. 1951); Automatic Canteen Co. of Am. V. Wharton, 358 F.2d 587 (2d Cir. 1966); *In re* Holly Hill Medical Ctr., Inc., 53 (Bankr. M.D. Fla. 1985).

107. Lin, *supra* note 6, at 1518.

108. Gloria Chon, *Will the Courts Protect the Boards? Defending the Board of a Michigan Corporation in the "Zone of Insolvency"*, 53 WAYNE L. REV 1085, 1087 (2007).

109. *See* Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp.,1991 WL 277613 109 (Del. Ch. 1991); *see also In re* Healthco International, 208 B.R. 288 (Bankr. D. Mass. 1997).

tion is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes it duty to the corporate enterprise." Here, it was held that the obligation of directors in the zone of insolvency was to "the community of interests that sustained the corporation, to exercise judgment in an informed, good faith effort to maximize the corporation's long-term wealth creating capacity."[111] Different courts interpreted this holding differently. Some courts remained fixated with the notion that it is only the corporate enterprise that is owed duties and that no duties are owed to creditors directly.[112] Others read the decision much more expansively as introducing primary duties to creditors in the zone.[113] Such an interpretation was based on the understanding that creditors are owed duties as part of the "community of interests" that was referred to by the court.[114] Thus, this interpretation constituted a "doctrinal innovation" that starkly differed from the pre-existing legal position in Delaware.[115] This obligated directors to account for the legitimate claims of all the company's constituents/ stakeholders in their endeavor to maximize value.

There are several possible justifications for the court having expanded directors' obligations to include creditors in the vicinity of insolvency. These include the "trust fund doctrine"[116] (*i.e.*, that directors of corporations in financial difficulty act as trustees for its corporate assets, with the creditors as the beneficiaries of the trust), and the "at risk doctrine" (*i.e.*, creditors are deserving of such duties, all downside risks being borne by them at such time). At the same time, the holding in *Credit Lyonnais*[117] resulted in several unwanted and unfavorable outcomes. Although the ruling (even in its wider interpretation) was meant to act as a "shield" for directors, in that they could be granted immunity for actions taken for the benefit of the "community of interests" of the corporation, it ended up being used by creditors as a "sword" in order to scrutinize actions taken by directors in the zone of insolvency, and to bring direct claims

110. Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., 1991 WL 277613 109 (Del. Ch. 1991).

111. *Id.* at 34.

112. Weaver v. Kellogg, 216 B.R. 563, 582–84 (S.D. Tex. 1997); Comm. of Unsecured Creditors of Buckhead America Corp. v. Reliance Capital Grp., Inc.(*In re* Buckhead America Crop.),178 B.R. 956, 968–69 (D. Del. 1994); Omnicare, Inc. v. NCS Healthcare, Inc., 818 A.2d 914 (Del. 2003); Angelo, Gordon & Co. v. Allied Riser Commc'ns Corp., 805 A.2d 221 (Del. Ch. 2002).

113. *See Weaver,* 216 B.R. at 582; *see also In Re* Kingston Square Associates*,* 214 B.R., 713, 735 (Bankr. S.D.N.Y 1997).

114. *See* Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., 1991 WL 277613 109 (Del. Ch. 1991). *See* also Asaro LLC v. Ams. Mining Corp., 396 B.R. 278, 395, 415 (S.D. Tex. 2008).

115. BAINBRIDGE, *supra* note 9.

116. *See* Wood v. Dummer*,* 30 F. Cas. 435, 436 (1st Cir. 1824).

117. *Credit Lyonnais Bank*, 1991 WL 277613 at 109.

against directors for such actions.[118] Directors were thus left vulnerable and open to attack by creditors when the firm entered a state of financial deterioration and had to completely alter their functioning and management of the company. The issue was exacerbated by the fact that the boundary of the zone of insolvency itself remained marred by ambiguity.

The Delaware Court of Chancery stepped in to clarify the issue in *Production Resources*,[119] and rejected the idea that *Credit Lyonnais*[120] had created "a new body of creditors' rights law."[121] The court held that creditors were not to be afforded duties in the zone of insolvency, as they were already protected by contractual covenants, and that enforcing such duties would "fill gaps that do not exist."[122] The court clarified that even upon entering the zone, directors would only continue to owe their fiduciary duties to the corporation, and that creditors did not have the right to initiate direct claims against the corporation.[123] The court thus did away with the new movement towards creditors' rights that had been initiated by *Credit Lyonnais*,[124] and specifically clarified that the judgment was only meant to operate as a "shield" for directors.[125]

The Chancery Court reaffirmed this stance again in *Trenwick America*,[126] wherein the court held that there could be no logical reason to extend such protections to creditors in addition to the contractual covenants by which they are already protected.[127] Despite that, the court in *Production Resources*[128] did hold that directors may (but are not obligated to) consider the rights of non-shareholder constituencies in the vicinity of insolvency in certain situations.[129] For this, however, the directors would have to display a "marked degree of animus towards a particular creditor," and it would have to be demonstrated that the best interests of the corporation were at stake in respect of the decision.[130] While these cases did away with creditors' rights to bring direct actions against directors, creditors nevertheless retained their rights to bring derivative suits.[131]

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118. Brian E. Geer, *Fiduciary Duties When the Corporation is in the Zone of Insolvency*, 25 AM. BANKR. INST. J. 26, 56 (2006).

119. Production Resources Group v. NCT Group, 863 A.2d 772, 792 (Del. Ch. 2004).

120. *Credit Lyonnais Bank*, 1991 WL 277613 at 109.

121. Production Resources Group v. NCT Group, 863 A.2d 772, 787–88 (Del. Ch. 2004).

122. *Id.* at 29.

123. *Id.* at 792.

124. *Credit Lyonnais Bank*, 1991 WL 277613 at 109.

125. Production Resources Group v. NCT Group, 863 A.2d 772, 788 (Del. Ch. 2004).

126. Trenwick AmericaLitigation Trust v. Ernst & Young, L.L.P., 906 A.2d 168, 218 (Del. Ch. 2006).

127. *Id.* at ¶ 198.

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

129. *Id.* at 787–88.

130. *Id.* at 798.

131. *Id.* at 776.

While *Gheewalla*[132] overruled *Production Resources*[133] to the extent that it permitted creditors to bring direct claims against a corporation during actual insolvency (as stated in the previous section), it re-affirmed its holding to the extent that it disallowed direct claims by creditors in the vicinity of insolvency:

> [t]he need for providing directors with definitive guidance compels us to hold that no direct claim for breach of fiduciary duties may be asserted by the creditors of a solvent corporation that is operating in the zone of insolvency. When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising business judgment.[134]

Thus, the court clarified the following with respect to a corporation operating in the zone: (i) the company's creditors lack standing to bring direct claims against it;[135] (ii) the company's shareholders remain its residual claimants and thereby the primary focus of directors and their fiduciary duties; and (iii) directors continue to be afforded the protection of the business judgment rule for decisions made in the zone.[136] The court held that any benefit of allowing creditors to initiate direct claims against the company's directors would be greatly outweighed by the "disruption of the established corporate governance mechanism."[137]

However, unlike the case in actual insolvency, the court did not expressly hold that creditors were afforded the right to bring derivative claims against the corporation in the zone. This results in a situation where creditors could be said to be ineligible to prosecute directors for a breach of fiduciary duties in the zone, whether directly or indirectly. Such an interpretation of *Gheewalla* was upheld in *Torch Liquidating Trust ex rel. Bridge Assocs., LLC v. Stockstill,* regarding a Louisiana state court decision.[138]

On a separate note, certain state courts have taken a divergent view to that in *Gheewala* that creditors of a company in the zone retain their standing to bring direct claims against its directors.[139] Such decisions are not technically *per incuriam* owing to the fact that *Credit Lyonnais* remains to be expressly overruled by a decision of the Supreme Court or by way of federal legislation. In addition to the ruling on the continuing applicability of the business judg-

132. North American Catholic Educational Programming Foundation Inc. v. Gheewalla*,* 930 A.2d 92, 101 (Del. 2007).

133. *Production Resources Group,* 863 A.2d at 79.

134. *North American Catholic*, 2006 WL 2588971 at 12.

135. *Id.*

136. *See id.*

137. *Gheewalla,* 930 A.2d at ¶12.

138. 561 F.3d 377, 386 (5th Cir. 2009).

139. *See, e.g.*, Jetpay Merch. Servs., L.L.C. v. Miller, No. 3:07-CV-0950-G, 2007 WL 2701636, at *7-8 (N.D. Tex. Sept. 17, 2007).

ment rule in the zone,[140] the court also clarified that "deepening insolvency"[141] could not constitute a cause of action for any of the company's stakeholders *ipso facto*.[142] This position was also reaffirmed in *Trenwick,*[143] wherein it was held:

> Delaware law does not recognize this catchy term as a cause of action, because catchy though the term may be, it does not express a coherent concept. Even when a firm is insolvent, its directors may, in the appropriate exercise of their business judgment, take action that might, if it does not pan out, result in the firm being painted in a deeper hue of red. The fact that the residual claimants of the firm at that time are creditors does not mean that the directors cannot choose to continue the firm's operations in the hope that they can expand the inadequate pie such that the firm's creditors get a greater recovery. By doing so, the directors do not become a guarantor of success. Put simply, under Delaware law, "deepening insolvency" is no more of a cause of action when a firm is insolvent than a cause of action for "shallowing profitability" would be when a firm is solvent.[144]

Therefore, even in situations where the firm's finances are depleting, directors may take actions that end up painting the corporation in a "deeper hue of red."[145]

The decision in *Gheewalla*[146] aims to tackle several dilemmas that previously plagued the minds of directors managing corporate enterprises. First, it was a rather arduous task for any director to determine, at all times, whether his or her company was headed towards insolvency, owing to the multiple tests in place to determine the occurrence of insolvency under U.S. law.[147] In this regard, directors remained unsure of which date a judge might finally deem to have been the commencement of the onset of insolvency.[148] The revised approach does away

140. Earlier cases favoring application of the rule have included Angelo Gordon & Co. L.P. v. Allied Riser Comm. Corp*,* 805 A.2d 221, 229 (Del. Ch. 2002); and Comm. Of Creditors of Xonics Med. Sys., Inc v. Haverty (In Re Xonics, Inc.*),* 99 B.R. 870 (Bankr. N.D. Ill. 1989). On the other hand, cases which have held the rule not to apply (on the basis that directors and officers are "trustees" of the creditors of the corporation) have included Geren v. Quantum Chem. Corp., , 832 F. Supp. 728 (S.D.N.Y. 1993*)*; and Jewel Recovery L.P. v. Gordon*,* 196 B.R. 348, 351 (N.D. Tex. 1996).

141. This had earlier been identified as a trigger for directors to be held liable. *See* Stephen M. Packman, *Directors and Officers in the Zone of Insolvency: Take actions with caution to avoid personal exposure*, 193 N.J. L.J. 450 (2008).

142. North American Catholic Educational Programming Foundation Inc. v. Gheewalla*,* 930 A.2d 92, 99 (Del. 2007); *See also* Trenwick America Litigation Trust v. Ernst & Young, L.L.P.*,* 906 A.2d 168, 200 (Del. Ch. 2006).

143. Trenwick America Litigation Trust v. Ernst & Young, L.L.P., 906 A.2d 168, 168 (Del. Ch. 2006).

144. *Id.* at 174.

145. *Id.*

146. *See Gheewalla,* 930 A.2d at 101.

147. *In Re* Healthco Int'l, 208 B.R. 288, 303 (Bankr. D. Mass.1997) (holding that a corporation was in the "zone", when its financial condition was such that the conveyance would run the risk of leaving the corporation with unreasonably small capital).

148. McCullough & Huebner, *supra* note 61.

with the "triggering" inquiry to an extent, as directors continue to owe their duties to the corporation and its shareholders up until the triggering of actual insolvency of the enterprise. However, the issue subsists to the extent that there continues to be ambiguity surrounding the question of whether creditors have the right to initiate derivative claims in the zone, as discussed below.[149] Second, and as an extension of the first point, directors can rest easy and no longer have to be apprehensive about which constituency might ultimately initiate actions against them and no longer remain conflicted regarding where to focus their energies.[150] In the past, directors were subject to actions initiated by shareholders while looking out for creditor interests[151] and vice versa.[152] Third, transactions are rarely neatly classified into the "high-risk, high-reward" binary in a manner that would enable directors to decide whether to favor creditors or shareholders by simply relying on the difference in their risk appetites.[153] As discussed in the section below however, these concerns have not yet been fully allayed.

Post-*Gheewalla*, courts of other states also reached similar conclusions with respect to the duties owed by directors in the zone. For instance, a California court, in *Berg & Berg Enterprises LLC v. Boyle*,[154] held that directors owe no direct fiduciary duty to creditors simply by virtue of the fact that the company was in the zone.[155] This holding again was based on the logic that such a duty would be in conflict with duties owed by directors to the stockholders and the corporation under state legislation and common law, and that duties towards creditors would only be triggered off upon actual insolvency.

D. *Criticisms and Observations*

The legal position in the U.S. with respect to directors' fiduciary duties is not without problems. These pertain both to the theoretical framework that has evolved over time as well as the implementation of the model in practice. This section deals specifically with the criticisms of the U.S. model pertaining to fiduciary duties owed in: (i) the vicinity of insolvency; and (ii) actual insolvency. As the approach adopted by the U.S. in financial stability is largely aligned with the U.K. approach, and owing to the fact that this Comment deals extensively with the criticisms of the same under the U.K. section, I do not specifically address the U.S. position on duties in financial stability in this section.

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149. Kandestin, *supra* note 16, 1244.

150. *See* McCullough & Huebner, *supra* note 61.

151. *See* In re Buckhead America Corp*.,* 178 B.R. 956, at 960 (D. Del. 1994).

152. Gheewalla*,* 930 A.2d at ¶ 20.

153. McCullough & Huebner, *supra* note 61, at 8.

154. Berg & Berg Enter., LLC v. Boyle, 178 Cal. App. 4th 1020 (Cal. Ct. App. 2009).

155. Some state courts have continued to abide by the earlier position, i.e. fiduciary duties are owed to creditors in the zone of insolvency. *See 3 Point Holdings LLC v. Gulf South Solutions, LLC,* Civil Action No. 06-10902, 2008 WL 695379 (E.D. La. Mar. 13, 2008).

1. Vicinity of Insolvency

A major criticism regarding the model applicable to U.S. companies in the zone is that there is no bright-line test to determine what constitutes the "zone." Former Justice of the Delaware Supreme Court Norman Veasey strongly criticized the confusion this lack of clarity causes in the minds of directors when the company is in a state of financial decline.[156] In fact, the Delaware Chancery Court in *Production Resources* itself commented that there existed no "magic dividing line" to identify the zone of insolvency.[157]

This causes immense problems, including the possibility of a company being deemed to be in the zone despite being in perfectly good financial health. As noted by Frederick Tung, "all firms are always in the zone of insolvency because managers can always find a sizeable enough bet that puts all the firm's equity at risk."[158] This would be especially true if one were to apply a test similar to the one laid down in *Brandt v. Micks* to determine whether a company has breached the zone (*i.e.*, where a transaction would run the risk of leaving the corporation with "unreasonably small capital").[159] The confusion in this respect is severely compounded due to the fact that *Gheewalla* did not expressly rule on whether creditors have a right to bring derivative claims in the zone (although it specifically ruled on the permissibility to do so in actual insolvency).[160] Resolution of this question is absolutely fundamental to bring clarity to directors of financially unstable companies.

If creditors are permitted to bring derivative claims in the zone, directors would be subjected to the onerous task of catering to the interests of both shareholders and creditors simultaneously—the "two-masters conundrum"[161]—because *Gheewala* expressly ruled that fiduciary duties continue to be owed to the shareholders in the zone.[162] As a result, a mistaken belief that the company is solvent when it is in fact in the zone could lead to grave consequences for directors.[163] It is also uncertain whether directors will be entitled to the benefits of directors and officers liability insurance in such situations because such policies commonly contain "insured-versus-insured" exclusions.[164] By adopting

156. E. Norman Veasey & Christine T. Di Guglielmo, *What Happened in Delaware Corporate Law and Governance From 1992-2004? A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399, 1429–32 (2005).

157. *Production Resources,* 863 A.2d at 787 n.52.

158. Frederick Tung, *Gap Filling in the Zone of Insolvency*, 1 J. BUS. & TECH. L. 607, 623 (2007).

159. *In re* Healthco International*,* 208 B.R. 288, 302 (Bankr. D. Mass. 1997).

160. Anna Manasco Dionne*, Living on the Edge, Fiduciary Duties, Business Judgment and Expensive Uncertainty in the Zone of Insolvency*, 13 STAN J. L. BUS & FIN. 188, 188 (2007).

161. Veasey & Di Guglielmo, *supra* note 156.

162. Dionne, *supra* note 160.

163. Royce de R. Barondes, *Fiduciary Duties of Officers and Directors of Distressed Corporations*, 7 GEO. MASON L. REV., 45, 66–71(1998).

164. Bernard Black Brian Cheffins & Michael Klausner, *Outside Director Liability*, 58 STAN. L. REV. 1055, 1119 (2006).

such an interpretation, the legal position effectively reverts to the "middle-path" approach brought about in *Production Resources* and would mean that creditors are continued to be owed fiduciary duties (having the right to initiate derivative claims for any breach).

At the same time, the middle-path approach also incentivizes directors to pursue self-interest in the garb of furthering the company's cause.[165] Further, owing to the inherent conflict that exists between the two competing constituencies who stand to gain at the cost of the other, it is unlikely that any claim made against directors will ever be truly "derivative" and not in pursuit of the claimant's own self-interest.[166]

Whether creditors deserve to be accorded the protection of fiduciary duties in the zone can also be debated at a policy level without getting into the intricacies of the implementation of such a model. This boils down to the question of whether creditors deserve such additional protection over and above the vast array of contractual rights that they are given as a matter of practice, as discussed in *Production Resources* and *Gheewalla*.

On the one hand, it has been argued that by adding fiduciary duties to the mix, creditors stand to gain a windfall that they never bargained for,[167] now having *ex post* access to tools that were not available to them to begin with.[168] Next, as stated by Kandestin, directors have not yet adopted the role of creditors' trustees in the zone, and the trust fund doctrine cannot be extended to the zone in this manner.[169] Further, the threat that shareholders may become risk-prone and gamble away the corporation's money may not constitute sufficient cause to move away from a shareholder-centric approach prior to insolvency; this being said to be a privilege that accrues to shareholders as an integral feature of their contracts (as owners of the corporation).[170] According creditors the benefit of fiduciary duties at this stage may incentivize them to refrain from contracting ex ante, but to simply take advantage of the enforcement tools made available to them in financial distress (of the corporation).[171] Creditors would also be in a position to sue merely on the basis that the board's strategies for the corporation turned out to be unsuccessful, finding themselves in an "irresistible" position.[172]

On the other hand, it is disputable whether all creditors are adequately covered or protected by contractual covenants. It is also problematic to ignore the

165. *See* Mark J. Roe, *The Shareholder Wealth Maximization Norm and Industrial Organization*, 149 U. PA. L. REV. 2063, 2065 (2001); Bainbridge, *supra* note 12.

166. *See* Lin, *supra* note 6.

167. Bainbridge, *supra* note 12.

168. *See* Dionne, *supra* note 160.

169. *See* Kandestin, *supra* note 16.

170. Bainbridge, *supra* note 12.

171. Tung, *supra* note 158, at 626.

172. Roger A. Lane, *Direct Creditor Claims for Breach of Fiduciary Duty: Is they is, or is they ain't? A Practitioner's Notes From the Field*, 1 J. BUS. & TECH. L. 483, 485 (2007).

tendency of shareholders towards short-termism in the zone, the incentive of shareholders to make risky decisions being the greatest at this point of time. As a corollary, the trust fund doctrine should be applied at this stage. Thus, even if an additional benefit was to accrue to creditors over and above their contractual rights, the level of risk borne by creditors in the zone would outweigh any concerns of misuse of such rights.

On a separate note, it should be noted that the justification adopted by the court in *Production Resources* and *Gheewalla* to refuse extension of duties to creditors in the zone is based on a false assumption that all types of creditors are equally placed and can rely on existing contractual protections. This sort of analysis is prejudicial to creditors who do not have the bargaining power to negotiate such arrangements, as well as involuntary creditors (individuals or corporations, whose claim against the corporation arises by way of a court awarded judgment for damages, for instance).[173]

2. Actual Insolvency

Unlike the case with respect to the zone, the legislative framework in the U.S. does provide for certain trigger-based tests to determine the commencement of actual insolvency. The problem in this regard is one of plenty.[174] Owing to the multiplicity of tests that exist under U.S. law to determine the commencement of insolvency, there is not enough clarity to appropriately guide directors regarding the nature and the beneficiaries of their fiduciary duties. To make matters worse, courts have held that they are empowered to determine whether a company was truly insolvent at the time the impugned actions were taken, "notwithstanding contrary presentations made in the company's audited financial statements or made to its board of directors."[175]

All of this also adds to the uncertainty in the minds of potential litigants (being the aggrieved members of the relevant constituency of the company), who stay wary of incurring unnecessary expenditure in situations where it is unclear whether they are the rightful beneficiaries of the directors' duties.[176] This may also have the opposite effect, where large and cash-rich creditors bring frivolous lawsuits and benefit from the ambiguity of the test just to pressurize directors

173. Janis Sarra, Wise People, *Fiduciary Obligation and Reviewable Transactions, Director's Liability to Creditors*, in SARA JANIS, ANNUAL REVIEW OF INSOLVENCY LAW (Toronto: Carswell, 2011).

174. Both the cash flow test and the balance sheet test have been applied in different contexts under US law. As discussed later in the paper, some US courts have also deemed the company to be insolvent when a particular transaction leaves the company with an "unreasonably small amount of capital".

175. Official C. Comm. of Unsecured Creditors v. Mellon Bank, N.A. (In re R.M.L., Inc.), 187, B.R. 455, ¶ 80 (Bankr. M.D. Pa. 1995).

176. Pearce II and Lipin, *supra* note 52.

and enhance their chances of recovery.[177] The possibility of such a moral hazard has been mitigated to an extent by a recent decision of the Delaware Chancery Court in *Quadrant Structured Products Co. Ltd. v. Vertin.*[178] *Vertin* held that under a derivative action initiated by a creditor, the creditor does not lose standing to proceed with the action in the eventuality that the corporation becomes solvent during the pendency of the lawsuit.

3. "Much Ado About Little?"(Scope of the Business Judgment Rule)

Stephen Bainbridge argues that the significance of the availability of fiduciary duties in favor of any of the company's constituencies is largely negated by the applicability of the business judgment rule which would preclude judicial review of the impugned action irrespective of whether it is the shareholders or the creditors that approach the court.[179] He thus contends that the issue regarding the applicability of fiduciary duties is really "much ado about little".[180]

Others have been highly skeptical of the efficacy of the business judgment rule for several reasons. First, the rule does not serve as a disincentive to creditors from bringing suits when they are not technically owed duties. As a result, directors may implicitly continue to account for creditors' interests in the face of the threat of protracted litigation and the costs that accompany it.[181] The fact that creditors have not been dissuaded by the rule and have continued to bring claims against directors is supported by empirical data.[182] Second (and unrelated to the issue of fiduciary duties), directors cannot resort to the rule for transactions that are deemed to be a "fraudulent conveyance," as all the bankruptcy trustee is required to demonstrate is that the corporation was insolvent at the time of the transfer and that what the transferee received exceeded what it would have received in a Chapter 7 liquidation; intent is not a mitigating factor in such situations.[183]

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177. *See* Donald J. Detweiler & Sandra G.M. Selzer, *Scope of Directors' Fiduciary Duties of Creditors: New Delaware Decision Sets Bright-Line Limit*, 26 AM. BANKR. INST. J. 1 (2007). *See also* Lane, *supra* note 172, at 485 and Dionne, *supra* note 160.

178. No. 6990-VCL, 2015 BL 128889 (Del. Ch. May 4, 2015).

179. *See* Bainbridge, *supra* note 12, at 338.

180. *Id. at 368.*

181. *See* Dionne, *supra* note 160; 122261 Fondren, LLC v. Riverbank Realty GP, LLC, No. H-09-4074, 2010 WL 1741071, 2 (S.D. Tex. Apr. 29, 2010).

182. *See* Mark N. Berman, *Not so Fast! Delaware Court Reigns in Creditor Suits Against DS & OS*, AM. BANKR. INST. J. 22, 22 (2005), available at https://www.abi.org/abi-journal/not-so-fast-delaware-court-reigns-in-creditor-suits-against-ds-os.

183. 11 U.S.C. § 527(b) (2003).

III. UNITED KINGDOM

A. *Duties in Financial Stability*

As in the U.S., the U.K. maintains that directors owe fiduciary duties to the company for the benefit of its shareholders during financial stability. This is in consonance with U.K.'s "economic and proprietary approach"[184] to company law, as also adopted in the U.S., Australia, and Canada, amongst other countries.[185] In the U.K., the shareholder primacy model for solvent enterprises was accorded judicial backing from the 1930s[186] and attained statutory sanctity by way of the Companies Act, in 2006.[187]

Prior to this, under common law directors only owed fiduciary duties to the company.[188] [189] In *Re Smith and Fawcett Ltd.*,[190] Lord Greene MR declared that directors are to act in a manner which is bona fide in what they consider to be the best interests of the company, and not what the court may consider to be so.[191] This was later interpreted in a manner that resulted in the interests of the company being interchangeable with the interests of the members themselves (reflecting the change in stance). There were also cases prior to *Re Smith & Fawcett Ltd.*[192] that expressly advocated for shareholder primacy, including the famous decision in *Dodge v. Ford*.[193] Thus, the balancing exercise to be conducted by directors was simply between the short term interests of current members as against the long term interests of future members.[194] This position was clarified and reaffirmed in *Greenhalgh*, in which the court held that directors are to act in a manner that promoted the interests of members as a general body, and need not focus on the company as a separate legal entity.[195] Thus, in the advancement of shareholders' interests, directors are expected to focus on

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184. Richard Williams, *Enlightened Shareholder Value in UK Company Law*, 35 U.N.S.W. L.J. 360, 363 (2012).

185. *Id.*

186. *See* Re Lee Behrens & Co. Ltd., [1932] 2 Ch 46, 49.

187. Companies Act 2006, c. 46, § 172(1 (Eng.)).

188. *See* John Quinn, The Corporate Objective: Reinterpreting Directors' Duties (2016) (unpublished Ph.D. dissertation, Dublin City University).

189. *See* Percival v. Wright [1902] 2 Ch 421 at 424 (Eng.).

190. Re Smith & Fawcett Ltd., [1942] Ch. 304, 306 (H.C.).

191. *Id.* at 306; *see also* Percival, [1902] 2 Ch. 421 at 424.

192. Re Smith & Fawcett Ltd., [1942] Ch. 304 at 306.

193. *See also* Hutton v. West Cork Railway, [1883] 23 Ch. D 654 [Hutton].

194. *See* PAUL L. DAVIES, GOWER AND DAVIES: THE PRINCIPLES OF MODERN COMPANY LAW 16–23 (8th ed. Sweet and Maxwell, 2008); BRENDA M HANNIGAN, COMPANY LAW (2d edn. Oxford University Press, 2009); Lord Wedderburn, *The Legal Development of Corporate Responsibility*, *in* K. HOPT AND G. EUBNER, CORPORATE GOVERNANCE AND DIRECTORS' LIABILITIES 5 (Berlin, 1985).

195. Greenhalgh v. Arderne Cinemas Ltd., [1951] Ch. 286 [Greenhalgh]; *see also* Park v. Daily News, Ltd., [1962] Ch. 927 [Park].

shareholder value.[196] At the same time, the common law on this point did not attain the requisite clarity and seemed to expound the duty in terms of what it was not rather than what it was.[197] This resulted in the need for greater clarity on the issue, thereby necessitating a statutory incorporation of the duty.

Prior to the concept of shareholder primacy being crystallized under the Companies Act, the Company Law Review Steering Group ("CLRSG") had emphasized its importance for the U.K.. The CLRSG reaffirmed the shareholder primacy approach, albeit with certain "concessions" in favor of other constituencies.[198] Thus came about the "enlightened shareholder value" ("ESV") concept which took its shape in the form of Section 172(1) of the Companies Act.

As part of its endeavor, the CLRSG undertook a broad spectrum review of the developments in U.K. company law right until the early 2000s. During the deliberation process on the scope of fiduciary duties owed by directors in solvency, there was polarization between two schools of thought – *i.e.*, the pluralist approach versus the ESV approach.[199] The pluralist approach advocated that directors be required to serve a range of interests that were wider than, and not subordinate to shareholder interests.[200] On the other hand, the ESV approach favored the retention of shareholder primacy, albeit with slight modifications that recognized certain other interests (but only to the extent that these furthered shareholder interests).[201] The other constituencies and interests recognized under ESV included employees, customers, suppliers, the company's overall reputation, and its impact on the community and environment.[202]

The debate concluded with the rejection of the pluralist approach and the adoption of the ESV approach.[203] The principle was thereafter incorporated in the Company Law Reform Bill that was introduced in Parliament in November 2005, and finally incorporated in the Companies Act (which came into effect on November 8, 2006). Therefore, U.K. law eschewed a purist shareholder-centric approach in favor of one that was relatively more inclusive and progressive.[204]

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196. Re Smith & Fawcett Ltd., [1942] Ch. 304 at 306. It should be noted, however, that certain cases seem to take a divergent view*, see generally* Lonhro v. Shell Petroleum, [1980] 1 WLR 627 (Eng.).

197. Williams, *supra* note 184, at 363.

198. COMPANY LAW REVIEW STEERING GROUP, MODERN COMPANY LAW FOR A COMPETITIVE ECONOMY: DEVELOPING THE FRAMEWORK*,* 2000, DTI 10, ¶ 2.11 (UK); *see also* COMPANY LAW REVIEW STEERING GROUP, MODERN COMPANY LAW FOR A COMPETITIVE ECONOMY: THE STRATEGIC FRAMEWORK 1999, DTI, ¶ 37 (UK).

199. *Id.* at ¶ 5.1.10.

200. *Id.* at ¶ 37.

201. *See* Mihir Naniwadekar & Umakanth Varottil, *The Stakeholder Approach Towards Directors' Duties Under Indian Company Law: A Comparative Analysis* 2(NUS Law, Working Paper No. 2016/006, 2016, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2822109.); Keay, *supra* note 30.

202. COMPANY LAW REVIEW STEERING GROUP (2000), *supra* note 198 at ¶ 13, 41.

203. COMPANY LAW REVIEW STEERING GROUP (2000), *supra* note 198 at ¶ 2.11.

204. John Armour, et al., *Shareholder Primacy and the Trajectory of UK Corporate Governance*, 41 BRIT. J. OF INDUS. REL. 531 (2003); s*ee also* Keay, *supra* note 30.

At the same time, Section 170(1) of the Companies Act states that "the general duties specified in sections 171 to 177 are owed by a director of a company to the company."[205] The Companies Act thus provides that any duties owed by directors to the company's stakeholders are subordinate to the interests of the company itself, and also clarifies that any actions initiated by stakeholders can only be derivative in nature, with a demonstrated harm to the company needed to be proved.[206]

Section 172(1) of the Companies Act reads as follows:

> *"Duty to promote the success of the company*
>
> (1) A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to—
>
> (a) the likely consequences of any decision in the long term,
> (b) the interests of the company's employees,
> (c) the need to foster the company's business relationships with suppliers, customers and others,
> (d) the impact of the company's operations on the community and the environment,
> (e) the desirability of the company maintaining a reputation for high standards of business conduct, and
> (f) the need to act fairly as between members of the company."

Prima facie, the ESV approach seems rather pluralist in character by accounting for various non-shareholder constituencies.[207] Even the CLSRG attempted to propagate this image, characterizing ESV as maximizing "overall competitiveness and wealth and welfare for all."[208] However, this is an incorrect reading of Section 172(1) which provides for non-member stakeholders to be taken into consideration only in furtherance of the interests of the company's members themselves.[209] Therefore, material interests of other constituencies are not permitted to be taken into account (in the process of "having regard to" such interests) without the ultimate benefit of the decision accruing to the shareholders.[210]

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205. Companies Act 2006, c. 46, 170(1) (Eng.).

206. Andrew Keay, *The Duty to Promote the Success of the Company: Is It Fit for Purpose?* 13 (University of Leeds, Centre for Business Law and Practice, Working Paper, August 2010), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1662411.

207. *See* Roman Tomasic, *Company Law Modernisation and Corporate Governance in the UK – Some Recent Issues and Debates,* VICTORIA L. SCH. J. 43 (2011); Luca Cerioni, *The Success of the Company in Section 172(1) of UK Company Act 2006: Towards and 'Enlightened Directors' Primacy?,* 4 ORIGINAL L. REV. 37 (2008).

208. COMPANY LAW REVIEW STEERING GROUP, MODERN COMPANY LAW FOR A COMPETITIVE ECONOMY: DEVELOPING THE FRAMEWORK, 2000, Chapter 2 ¶ 2.21 (UK).

209. *See* Naniwadekar & Varottil, *supra* note 201; Keay, *supra* note 30.

210. *See also* Keay, *supra* note 30; House of Commons, Standing Committee D, Fifteenth Sitting, 11 July 2006, Cols. 591–93, https://publications.parliament.uk/pa/cm200506/cmstand/cmscclaw.htm.

In any case, by virtue of directors' duties being owed to the company (as specified under Section 170(1)), other constituencies are precluded from enforcing their rights under Section 172(1). Thus, only the shareholders are afforded the right to bring derivative claims against a company (under Section 260(1) of the Companies Act).[211] It can thus hardly be said that the ESV approach is one that is pluralistic or that promotes the theory of "dual consideration."[212]

As described above, Section 172(1) provides an illustrative list of considerations that directors are to "have regard to" while discharging their duties for the benefit of the "members as a whole."[213] In fact, this is why the approach is considered "enlightened."[214] The considerations set out under Section 172(1) are not meant to be an exhaustive list but simply to provide directors with "a list of exhortations to 'good' conduct."[215] The duties to "have regard to" include *inter alia* taking into consideration the likely consequences of any long term decisions, the interests of the company's employees, fostering the company's business relationship and reputation, and the impact of its operations on the community and environment.[216] Thus, it is theoretically possible that courts may approve of directors acting in furtherance of the interests of the company's members, by focusing on employee welfare rather than solely on profit making.[217] Similarly, since duties are owed for the benefit of "members as a whole", it may be justifiable for directors to take decisions that promote the success of the company to the detriment of certain select shareholders.[218] This however is unlikely, as courts have been seen to take a rather conservative approach and have not been willing to dilute shareholder primacy even to the slightest extent.[219]

Although creditors find no specific mention in Section 172(1) (other than in the form of "suppliers"[220]), it is arguable that creditors would fall under subsection (3) of Section 172(1), *i.e.*, "others," by way of operation of the doctrine of *ejusdem generis*.[221] This however is rather unlikely because creditors' interests are specifically provided for under Section 172(3) of the Companies Act.

211. Parker Hood, *Directors Duties under the Companies Act 2006: Clarity or Confusion?* 13 J. CORP. L. STUD. 47 (2013); Williams, *supra* note 184.

212. Collins C. Ajibo, *A Critique of Enlightened Shareholder Value: Revisiting the Shareholder Primacy Theory*, 2(1) BIRKBECK L. REV. 37, 37–58 (2014).

213. Companies Act 2006, c. 46, § 172(1) (Eng.).

214. *See also* Keay, *supra* note 30.

215. Williams, *supra* note 184, at 397–408.

216. Companies Act 2006, c. 46, § 172(1) (Eng.).

217. *See* John Lowry, *The Duty of Loyalty of Company Directors: Bridging the Accountability Gap through Efficient Disclosure*, 68(3) CAMBRIDGE L. J. 607 (2009) (Eng.).

218. *See* Mutual Life Insurance Co. of New York v. Rank Organisation Ltd., [1985] BCLC 11; Re Pantone 485 Ltd., [2002] 1 BCLC 266 [Pantone].

219. *See* Marios Koutsias, *Shareholder Supremacy in a Nexus of Contracts: A Nexus of Problems,* 38(4) BUS. L. REV. 136–46 (2017).

220. Companies Act 2006, c.46, § 172(1)(c) (Eng.).

221. Ajibo, *supra* note 212, at 55.

The only rights that the Companies Act expressly provides to creditors of solvent companies is the right of disclosure. This is by way of a "business review" that is mandated under Section 417(2) of the Companies Act (now referred to as a strategic report).[222] As part of this business review, directors are expected to give a comprehensive and objective analysis of the company's performance by adoption of key performance indicators.

Section 172(1) specifies that directors are to act in a good faith manner that "promote[s] the success of the company for the benefit of its members as a whole."[223] The exact scope and meaning of this phrase, however, is not clear from a plain reading of the provision. Section 170(1) should be read with Section 170(4) of the Companies Act, which provides that "general duties shall be interpreted and applied in the same way as common law rules or equitable principles, and regard shall be had to the corresponding common law rules and equitable principles in interpreting and applying the general duties."[224] A joint reading of the two provisions would clarify that the duty being referred to under Section 172(1) is nothing but the common law duty to promote the interests of the company for the benefit of its current and future shareholders.[225]

Moreover, it is possible that the provision also provides for a "business judgement" type immunity that requires only that courts be satisfied that directors acted in "good faith" in promoting the success of the company for the members as a whole.[226] In this regard, directors may take into account the considerations listed under Section 172(1)(a)–(f) in any permutation or combination as they please, as long as the interests of the shareholders are promoted.[227] The Explanatory Notes to the Company Law Reform Bill also provide that a decision as to what constitutes (and what does not) the promotion of the success of the company for the benefit of its members as a whole, is one that is left to the discretion of directors, in good faith.[228]

However, it is unlikely that courts will treat Section 172(1) as constituting a comprehensive business judgment rule since it finds its basis in common law. The CLRSG states that:

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222. Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013, c.46, § 417(2).

223. Companies Act 2006, c. 46, § 172(1) (Eng.).

224. Companies Act 2006, c.46, § 172(4) (Eng.).

225. Ajibo, *supra* note 212, at 55.

226. Andrew Keay, *Section 172(1) of the Companies Act 2006: An Interpretation and Assessment*, 28(4), COMPANY LAWYER 5 (2007).

227. Note 309 of the Explanatory Notes to the Company Law Reform Bill (dated May 24, 2006), available at https://publications.parliament.uk/pa/cm200506/cmbills/190/en/06190x-e.htm#index_link_29.

228. Guidance on Key Clauses to the Company Law for a Competitive Economy: Developing the Framework (Department of Trade and Industry 2000) at ¶ 63; *see also* Davy KC Wu, *Managerial Behaviour, Company Law and the Problem of Enlightened Shareholder Value*, COMPANY LAWYER 2 (2010).

> [C]ourts have shown a proper reluctance to enter into the merits of commercial decisions; there are major difficulties in drafting such a provision which would add complexity and is likely to be inflexible and unfair, being too harsh in some cases and allowing too much leeway in others. The principle as drafted leaves room for the courts to develop this approach. We also propose to retain in slightly more generous form the existing provision enabling the courts to relieve directors of liability. We therefore oppose a legislative business judgment rule.[229]

Further, notwithstanding the flexibility afforded to directors within the four corners of Section 172(1), the provision still constitutes a shift away from the earlier position laid out in *Re Smith & Fawcett Ltd.*[230]

That said, creditors' interests are not completely ignored while a company is financially solvent. Creditors are indirectly afforded certain protections under the Disqualification Act. The Disqualification Act provides that the State may apply for the disqualification of a director, if such director acts in a manner that makes him "unfit to be concerned in the management of the company."[231] The legislation came into effect pursuant to the report of the Cork Committee on Insolvency Law Reform,[232] which aimed to institute an effective regime for tackling rampant "abuses of limited liability."[233]

The standard for determining "unfitness" under the statute has been left ambiguous, and the court is guided instead by an illustrative list of conduct set out in Schedule 1 of the Disqualification Act. Importantly, the welfare of creditors is featured amongst the several other matters that find mention under Schedule 1 (including the protection of shareholders and other constituencies).[234] Thus, while not providing a direct remedy to creditors, the legislation penalizes directors for their actions that violate creditors' rights.[235] Although this remedy seems rather promising for creditors and other non-shareholder constituencies, there is a catch, i.e. that applications for disqualification (under Section 8) may only be made by the State and not by the parties themselves. Furthermore, it is uncertain whether the introduction of the ESV principle under the new Companies Act will alter or take away the benefit afforded under the Disqualification Act. This has not been the case thus far, and there has been no visible impact of the introduction of the principle on previously decided cases under the Disquali-

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229. COMPANY LAW REVIEW STEERING GROUP, GUIDANCE ON KEY CLAUSES TO THE COMPANY LAW FOR A COMPETITIVE ECONOMY: DEVELOPING THE FRAMEWORK, Department of Trade and Industry 2000, ¶ 3.69 (UK).

230. *See* Re Smith & Fawcett Ltd., [1942] Ch. 304 (that directors are completely free to adopt any methodology whatsoever in the promotion of the interests of the company).

231. Company Directors Disqualification Act 1986, c.8(2).

232. *See* INSOLVENCY LAW AND PRACTICE: REPORT OF THE REVIEW COMMITTEE, 1982, Cmnd 8558, (UK).

233. *Id.* at ¶ 1808, 1813.

234. *See, e.g.*, Company Directors Disqualification Act Schedule 1, ¶ 7, (1986).

235. Donna W. Mckenzie-Skene, *Directors Duties to Creditors of a Financially Distressed Company, A Perspective from Across the Pond*, 1 J. BUS. & TECH. L. 499, 526 (2007).

fication Act, or on the considerations adopted by the State (or the official receiver under Section 6) in resorting to such proceedings.[236]

It is also interesting to note that the provision on "transactions defrauding creditors"[237] under the Insolvency Act, 1986 ("Insolvency Act") applies even in solvency (there being no look-back period provided in this respect). To demonstrate a violation under this section, however, it is necessary to prove that the impugned transaction was entered into at undervalue, and that it was entered into for the purpose of putting assets beyond the reach of a creditor.[238] The task of proving such a violation, therefore, is particularly onerous.[239]

B. *Duties in Insolvency*

Much like the U.S., creditors are deemed to be the company's primary risk bearers upon the commencement of actual insolvency in the U.K..[240] Thus, the focus of directors' fiduciary duties is towards creditors in insolvency.[241] The move away from a shareholder-focused approach is facilitated by Section 172(3), which operates as an exception to the rule under Section 172(1) (and is also applicable in the zone of insolvency, as discussed hereinafter). This provision makes the ESV rule "subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company."[242] By virtue of this provision, creditors' interests are said to override those of shareholders despite shareholders rights being generally prioritized under Section 172(1). This principle also finds mention in the Explanatory Notes to the Companies Act.[243] As a result, a deemed suspension of the operation of Section 172(1) is triggered in insolvency (as also in the zone).[244]

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236. *See* THE INSOLVENCY SERVICE ANNUAL REPORT AND ACCOUNTS 2010-11, HC, 31–32 (UK,), http://www.official-documents.gov.uk/document/hc1012/hc13/1388/1388.pdf; Williams, *supra* note 184, at 362–63.

237. Insolvency Act 1986, § 424 (UK).

238. Insolvency Act 1986, § 423 (UK) (the likelihood of the transaction having been entered into for this purpose could be either actual or potential.).

239. *See* Andrew Keay, *The Duty of Directors to Take Account of Creditors' Interests: Has it Any Role to Play?*, J. BUS. L. 379 (2002).

240. Armour, *supra* note 204, at 555; Oliver Hart and John Moore, *Default and Renegotiation: A Dynamic Model of Debt*, 113 THE Q. J. OF ECON. 1 (1998).

241. Andrew Keay, *Another Way of Skinning the Cat : Enforcing Directors' Duties to Creditors,* 17 INSOLVENCY INTELLIGENCE 1, 5–7 (2004); Liquidator of West Mercia Safetywear Ltd. v. Dodd, [1988] 4 BCC 30 (EWCA) at 33 (Eng.); *In Re* Pantone 485 Ltd., [2002] 1 BCLC 266 (Ch) at ¶ 69 (Eng.); Gwyer Assoc. Ltd. v. London Wharf (Limehouse) Ltd., [2003] BCC 855 (Ch) at 909 (Eng.); *In Re* Frenderick Inns Ltd., [1994] 1 ILRM 387, ¶ 47; Company Law Reform Bill 2005, HL Bill [34] cl. 156(4) (Eng.).

242. Companies Act 2006, c.46, § 172(3) (UK) (emphasis added).

243. Companies Act 2006, c. 46, Explanatory Notes ¶ 331 (Eng.).

244. Keay, *supra* note 239.

In addition, shareholders are no longer permitted to ratify actions taken by directors.[245]

Section 172(3) is deliberately worded in an open-ended manner and provides no specifics regarding the scope or the trigger for duties shifting towards creditors. The provision instead defers to existing common law and provides scope for its further development. The provision also implicitly operates to save the pre-existing statutory rights of creditors, such as those pertaining to wrongful trading or preferential transactions.[246] The principle that directors owe fiduciary duties to creditors in insolvency constitutes a "rule of law" for purposes of Section 172(3) as it has been applied and reaffirmed by English courts.[247] The common law on this point finds its origins in the dictum of Justice Mason's opinion in the Australian High Court decision of *Walker v. Wimborne.*[248] *Walker* held that "in discharging their duty to the company, directors are required to take into account the interests of its shareholders and its creditors. Any failure by the directors to take the creditors' interests into account will have adverse consequences for the company and for the creditors themselves.*"*[249] This approach was reaffirmed in subsequent common law decisions including the famous decision of the Supreme Court of New South Wales in *Kinsela* which influenced the decision to incorporate the approach under U.K. law.[250] [251]

In the U.K., recognition of the principle was first accorded in the case of *Lornho Ltd. v. Shell Petroleum Co. Ltd.*[252] in 1980, and subsequently in *Re Horsley & Weight Ltd.*[253] However, in a later decision (*Multinational Gas*[254]), Lord Justice Dillon did not recognize the existence of the duty, and stated that fiduciary duties are owed only to the company and not its creditors, whether current or future.[255] Fortunately, this decision was subsequently distinguished

245. Keay, *supra* note 241; Liquidator of West Mercia Safetywear Ltd. v. Dodd, [1988] 4 BCC 30 (EWCA) (Eng.); *Miller v. Bain,* [2002] 1 BCLC 266; DD Prentice, *Creditors Interests and Directors Duties*, 10 OJLS 275 (1990).

246. COMPANY LAW REVIEW STEERING GROUP, MODERN COMPANY LAW FOR A COMPETITIVE ECONOMY: DEVELOPING THE FRAMEWORK (2000).

247. *See* Liquidator of West Mercia Safetywear Ltd. v. Dodd, [1988] 4 BCC 30 (EWCA) at 33 (Eng.); *In Re* Pantone 485 Ltd., [2002] 1 BCLC 266 (Ch) at ¶ 69 (Eng.); Gwyer v. London Wharf (Limehouse) Ltd., [2002] EWHC 2748 [Gwyer Associates]; Re MDA Investment Management Ltd., [2003] EWHC 227 (Ch.): Re Cityspan Ltd., [2007] EWHC 751; Re Fredericks Inn Ltd., [1994] ILRM 387.

248. Walker v. Wimborne (1976) 137 CLR 1 (Austl.).

249. *Id.* at ¶ 13.

250. *See* Nicholson v. Permakraft *(NZ) Ltd.,* [1985] 1 NZLR 242 (CA) [hereinafter Permakraft]; *see also* Kinsela v. Russell Kinsela Pty. Ltd., (1986) 4 NSWLR 722 (Austl.).

251. *Kinsela,* 4 N.S.W.L.R. at 722.

252. [1980] 1 WLR 627 (UKHL) (UK)].

253. *In re* Horsley & Weight Ltd. [1982] Ch. 442 (Eng.).

254. Multinational Gas & Petrochemical Co. v. Multinational Gas & Petrochemical Services Ltd., [1983] Ch. 258.

255. *Id*. at 585.

in *West Mercia Safetywear*[256] on the basis that the company in question in *Multinational Gas*[257] was "amply solvent," and it was clarified that the rule in *Kinsela*[258] applies in insolvency scenarios.[259] Interestingly, in *West Mercia*, Lord Justice Dillon found that the director breached his fiduciary duty because he "ought to have known" that the company was insolvent at the time of his giving a preferential payment to a related company.[260]

The issue of whether duties to creditors are owed by directors directly or indirectly has also seen considerable debate in the U.K. under common law (prior to the commencement of the Companies Act). In *Walker*, the duty was expressed to be one that is owed to the company and not directly to its creditors. In *Winkworth v. Edward Bardon Development*,[261] however, Lord Templeman stated that the "duty is owed by the directors to the company and to the creditors of the company to ensure that the affairs of the company are properly administered and that its property is not dissipated or exploited for the benefit of the directors themselves to the prejudice of the creditors,"[262] thus implying a direct duty owed to the company's creditors (this interpretation was deemed incorrect by the High Court of Australia in *Spies v. Queen*[263], however).[264] The *Winkworth* approach was conclusively reversed in *Yukong Lines of Korea v. Rendsberg Investment Corp of Liberia*,[265] wherein Justice Toulson held that a director "does not owe a direct fiduciary duty. . .[to] an individual creditor, nor is an individual creditor entitled to sue for breach of the fiduciary duty owed by the director to the company."[266]

The debate ended in favor of the *Yukong* approach by virtue of the incorporation of Section 170(1) of the Companies Act, which states that "[t]he general duties specified in sections 171 to 177 are owed by a director of the company *to the company*."[267] A company-centric approach would prevent the multiplicity of claims by individual creditors, as creditors would only be permitted to initiate

256. Liquidator of West Mercia Safetywear Ltd. v. Dodd, [1988] 4 BCC 30 (EWCA) at 33 (Eng.).

257. Multinational Gas & Petrochemical Co. v. Multinational Gas & Petrochemical Services Ltd., [1983] Ch 258.

258. Kinsela v. Russell Kinsela Pty. Ltd., (1986) 4 NSWLR 722 (Austl.).

259. Liquidator of West Mercia Safetywear Ltd. v. Dodd, [1988] 4 BCC 30 (EWCA) at 253 (Eng.).

260. Liquidator of West Mercia Safetywear Ltd. v. Dodd, [1988] 4 BCC 30 (EWCA) (Eng.).

261. *See* Winkworth v. Baron Dev. Co. Ltd.,[1986] 1 W.L.R. 1512 (HL) [hereinafter Winkworth].

262. *Id*; *see also* Lornho Ltd. v. Shell Petroleum Co. Ltd, [1980] 1 WLR 627 (UKHL) (UK)].

263. (2000) 201 CLR 603 (Gaudron, McHugh, Gummow, and Hayne, J.J.).

264. VANESSA FINCH, CORPORATE INSOLVENCY LAW: PERSPECTIVES AND PRINCIPLES 500 (2d ed. Cambridge University Press, 2002).

265. [1988] BCC 870 (QBD) (Comm) (Eng.).

266. *Id.* at 884.

267. Companies Act 2006, c.46, § 170(1) (emphasis added); *see also* GHLM Trading Ltd. v. Maroo, [2012] EWHC 61 (Ch), 168 [UK].

derivative claims by demonstrating a harm to the company instead.[268] This would also negate the possibility of double recovery by creditors, and would ensure the sanctity of the *pari passu* principle and the liquidation waterfall mechanism.[269]

Another important debate that has taken place in the U.K. is whether directors, while owing their duties to creditors in insolvency, are permitted to take into account the interests of other constituencies as well. The Court of Appeal in *Brady v. Brady*[270] seemed to answer this question in the negative, Justice Nourse, stating that "where the company is insolvent, or even doubtfully solvent, the interests of the company are in reality the interests of existing creditors." A similar opinion was given by Justice Street, in *Kinsela*[271] (a decision of the Supreme Court of New South Wales), which was approved without any further elucidation by Lord Dillon in *West Mercia Safetywear v. Dodd*[272] *West Mercia*, however, was subsequently cited for the proposition that shareholders' interests are to be taken into account by directors in addition to those of creditors in insolvency.[273] In *Re Pantone,* however, a position similar to the one in *Brady* was reinstated once again (*i.e.*, a focus on creditors in insolvency to the exclusion of shareholders).[274] *Re Pantone* relied on the decision in *Re Horsley v. Weight Ltd* to uphold the validity of the principle.[275] As some have pointed out, the decision in *Horsley* does not in fact support such a proposition. As a result, *Brady* is effectively the only judicial decision that seems to be on solid grounding in terms of precedential value, and the debate on this issue seems to not yet have reached a conclusive outcome.[276]

The legal framework in the U.K. also provides for certain alternative mechanisms for third parties (including creditors) to assert rights against directors of insolvent corporations. One such mechanism is provided under Section 212 of the Insolvency Act, which proscribes "misfeasance" by officers (including directors) of a company and the breach of any fiduciary duties owed by such officers to its creditors.[277] An application under Section 212 can be made by the liquidator or any creditor of the insolvent company. If the charge under Section

268. *See* C.A. Riley, *Directors' Duties and the Interests of Creditors*, 10 COMPANY L. 87 (1989).

269. D D.D. Prentice, *Directors, Creditors and Shareholders*, *in* COMMERCIAL ASPECTS OF TRUSTS AND FIDUCIARY OBLIGATIONS 276 (Ewan McKendrick ed.,Oxford Press 1992).

270. Brady v. Brady (1987) 3 B.C.C. 535, 552 (UK) [hereinafter Brady].

271. Kinsela v. Russell Kinsela Pty. Ltd., (1986) 4 NSWLR 722 (Austl.).

272. Liquidator of West Mercia Safetywear Ltd. v. Dodd, [1988] 4 BCC 30 (EWCA) at 241 (Eng.).

273. *See* Gwyer v. London Wharf (Limehouse) Ltd., [2002] EWHC 2748; Clydebank Football Club Ltd. v. Steedman, (2000) CSOH 250 (Scot.).

274. *In Re* Pantone 485 Ltd., [2002] 1 BCLC 266 (Ch) (Eng.)9.

275. *In re* Horsley & Weight Ltd. [1982] Ch. 442 (Eng.) at 1055–56.

276. *See* CORPORATE AND COMMERCIAL LAW: MODERN DEVELOPMENTS 173 (David Feldman & Frank Meisel eds., 1996).

277. Insolvency Act 1986, § 212 (Eng.).

212 is proved, the court may order the officer or director to repay such money, or contribute such amounts to the assets of the company as it deems fit in relation to the breach or misfeasance.[278] This mechanism may even be available to creditors while the company is still solvent or in the zone of insolvency, the scope of the provision not being restricted to acts carried out by officers only post-insolvency (it only providing that such breaches are to be discovered "during the course of winding up of a company"). There has been general apprehension among creditors in adopting this route, however, owing to the fact that all contributions and recovery under this provision accrues to the company itself, and not directly to them.

Another mechanism favoring creditors in order to ensure the compliance of fiduciary duties in insolvency is the "disqualification route," *i.e.*, under the Disqualification Act. Similar to Section 8 of the Act, which affords an opportunity to the State to apply for disqualification of directors due to "unfit" management of a solvent company, Section 6 of the Disqualification Act provides for disqualification in insolvency. The criteria for the determination of "unfitness" under Section 6 is separately provided for under Schedule 2 of the Disqualification Act, which expressly covers creditors' interests.[279] In *Re Sevenoaks Stationers (Retail) Ltd.*,[280] it was stated that "[i]t is beyond dispute that the purpose of section 6 is to protect the public, and in particular potential creditors of companies from losing money through companies becoming insolvent when the directors of those companies are people unfit to be concerned in the management of a company."[281] Further, it was held that directors can be liable for disqualification in situations where they permit or cause a company to trade, and where they have knowledge that no reasonable prospect exists for the company's creditors to be paid.[282] Therefore, the remedy under this route is available even where the remedy for wrongful trading is not (as described in the next section). However, as is the case with Section 8, the locus to bring applications under Section 6 of the Act is not afforded to creditors. It is instead the official receiver of the company who can bring such actions. Despite this shortcoming, the Disqualification Act can been seen to have been effectively used to protect creditors' interests in several instances.[283]

278. Insolvency Act 1986, § 212 (Eng.).

279. Disqualification Act, Schedule 2 (Eng.).

280. [*Re* Sevenoaks Stationers (Retail) Ltd.,[1991] 3 Eng. Rep. 578, 583 (UK) [hereinafter Sevenoaks].

281. *Id.* at 176.

282. *Id.* at 283; Re Bath Glass Ltd., (1988) 4 B.C.L.C. 130 (Ch.) (Eng.); Brady v. Brady (1987) 3 B.C.C. 535 (UK); Liquidator of West Mercia Safetywear Ltd. v. Dodd, [1988] 4 BCC 30 (EWCA) (Eng.); Facia Footwear Ltd. (in administration) v. Hinchliffe, [1988] 1 B.C.L.C. 218; *In Re* Pantone 485 Ltd., [2002] 1 BCLC 266 (Ch) (Eng.); Gwyer v. London Wharf (Limehouse) Ltd., [2002] EWHC 2748; Re MDA Investment Management Ltd., [2003] EWHC 227 (Ch.).

283. Williams, *supra* note 184.

C. *Duties in the Vicinity/ Zone of Insolvency*

U.K. law recognizes that fiduciary duties may be owed to creditors prior to the commencement of insolvency itself.[284] This is due to the fact that U.K. law identifies creditors as the primary risk bearers of a company in financial distress, a position some say was first brought about in *Geyer v. Ingersoll Publications Co.*[285][286] That U.K. courts have granted such recognition to duties in the zone is significant, as all other statutory rights belonging to creditors (with certain minor exceptions) are triggered only in liquidation. The genesis for this approach lies in the principle embodied under Section 172(3) of the Companies Act (applying the rule of interpretation provided in Section 170(4) of the Companies Act).[287] Further, the Explanatory Notes to the Companies Act also expressly state that such a shift is to "occur as the company approaches insolvency."[288] Recognition to this principle was also accorded in the CLRSG's final report (although it was initially rejected in its trial draft).[289][290]

U.K. courts have established multiple tests to determine the point at which fiduciary duties shift to creditors pre-insolvency. These have included tests based on when the company is *inter alia* "nearing insolvency,"[291] on the "borderline of insolvency,"[292] on the "verge of insolvency,"[293] and in "doubtful insolvency."[294] Certain tests do not even make a specific reference to the company's impending insolvency, simply requiring that the company be in a "dangerous financial position." instead.[295] Even the decision in *Brady v.*

284. *See, e.g.,* GHLM Trading Ltd. v. Maroo, [2012] EWHC 61 (Ch), 168 [UK]; *see also* Liquidator of West Mercia Safetywear Ltd. v. Dodd, [1988] 4 BCC 30 (EWCA) at 552 (Eng.); DEREK FRENCH, STEPHEN MAYSON AND CHRISTOPHER RYAN, COMPANY LAW 485 (26th ed., Oxford Press 2010).

285. 621 A.2d 784, 787 (Del. Ch. 1992).

286. *See* Stephen McDonnell, *Geyer v. Ingersoll Publications Co: Insolvency Shifts Directors' Burden from Shareholders to Creditors*, 19 DEL. J. CORP. L. 177, 185 (1994); Mark Van der Weide*, Against Fiduciary Duties to Corporate Stakeholders*, 21 DEL. J. CORP. L. 27 (1996).

287. ANNOTATED COMPANIES LEGISLATION ¶ 10.172.06 (John Birds et al. eds., 2d ed. 2012); ANDREW HICKS AND SAY H. GOO, CASES AND MATERIALS ON COMPANY LAW 385 (6th ed., Oxford Press, 2008).

288. Companies Act 2006, c. 2, § 172, Explanatory Notes ¶ 332 (UK).

289. *Id.* at ¶ 3.12, 3.13 (UK).

290. COMPANY LAW REVIEW STEERING GROUP, MODERN COMPANY LAW FOR A COMPETITIVE ECONOMY: DEVELOPING THE FRAMEWORK, 2000, Ch. 3 ¶ 3.72, 3.73 (UK).

291. The Liquidator of Wendy Fair (Heritage) Ltd. v. Hobday [2006] EWHC (Ch) 5803 ¶ 66, All ER 238 (Eng.).

292. Eastford Ltd. v. Gillespie, Airdrie North Ltd., [2010] CSOH 132, at ¶ 22 (Scot.).

293. Gwyer v. London Wharf (Limehouse) Ltd., [2002] EWHC 2748.

294. *Id.*; *see also* Brady v. Brady (1987) 3 B.C.C. 535, 553 (UK); *In re* Horsley & Weight Ltd. [1982] Ch. 442 (Eng.).

295. Facia Footwear Ltd. (in administration) v. Hinchliffe, [1988] 1 B.C.L.C. 218, 228; *see also Williams v. Farrow,* [2008] EWHC (Ch) 3663 (Eng.); Linton v. Telnet Pty Ltd., [1999] NSWCA 33; Re MDA Investment Management Ltd., [2003] EWHC 227 (Ch.).

Brady[296] lays down a similar test, the company in that case having remained solvent even after the completion of the impugned transaction, and the court held that directors are to consider interests of creditors even in situations where a transaction could potentially affect the company's solvency.[297]

As mentioned in the previous section, fiduciary duties also arise in favor of creditors in the zone of insolvency under Section 212 of the Insolvency Act. Such duties also exist in the form of the *ex post* liability imposed by Section 214 of the Insolvency Act (dealing with wrongful trading).[298] The Section 214 duty also retains its applicability post the commencement of the Companies Act by way of the operation of the principles contained in Section 172(3), amounting to a specific "enactment" or "rule of law" requiring directors to consider the interests of the company's creditors.[299] Section 214 provides for personal liability for directors who knew or ought to have concluded prior to the commencement of winding up, that there was no reasonable prospect of the company avoiding insolvent liquidation;[300] and where such directors, despite having such knowledge, failed to take the requisite steps towards minimizing loss to the company's creditors.[301] Section 214 thus covers decisions taken by directors in disregard of creditors' interests subsequent to the company having reached the "brink of insolvency."[302] The provision provides for an objective test that does not proscribe ordinary and legitimate trading in the lead-up to the company's insolvency.[303] This can also be seen from the decision in *Continental Assurance Plc.*,[304] where the court refused to impose liability on the directors simply because they had permitted the company to continue trading in the zone of insolvency. Instead, the court held that a simplistic 'but for' test could not be applied in the context of Section 214; rather, there must be a nexus between the directors' actions and the loss sustained by the company.[305]

If the tests of Section 214 are met, the liquidator is empowered to make an application to the court seeking a direction that the company's directors be compelled to make such contributions to the assets of the company as the court may think proper, in order to compensate for the loss.[306] It is interesting to note

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296. Brady v. Brady (1987) 3 B.C.C. 535 (UK).

297. *See also* Katz v. McNally, [1996] BCC 933.

298. Insolvency Act 1986, 45 § 214 (UK).

299. Ajibo, *supra* note 212, at 43.

300. Insolvency Act 1986, 45 § 214(2) (UK).

301. Insolvency Act 1986, 45 § 214(3) (UK).

302. *See* Sean Gabb, *Directors' Duties at Common Law to Consider the Interests of Creditors* (2017), https://www.seangabb.co.uk/directors-duties-common-law-consider-interests-creditors-2017-sean-gabb/.

303. *See also* Keay, *supra* note 30.

304. Re Continental Assurance Co. of London Plc., [2007] 2 BCLC 287 [Continental Assurance].

305. *Id.* at ¶ 289.

306. Insolvency Act 1986, 45 § 214(1) (UK).

that Section 214(6) provides for a balance sheet test to determine whether the insolvent liquidation of the company was inevitable at the time the impugned transactions occurred. Section 214 was identified by the European Commission's High Level Group of Company Law Experts as constituting an apt model for creditor-regarding duties to be imposed pre-insolvency.[307] The provision contains its own inbuilt 'business judgment rule' under sub-section (3), which applies when directors have taken every step (that ought to have been taken) to minimize the loss accruing to the company's creditors. Another benefit of adopting the wrongful trading route is that courts cannot *post facto* relieve directors from liability, as they are capable of doing in respect of an ordinary breach of duty under Section 1157 of the Companies Act.[308] Further, liquidators are permitted to tag claims under Section 214 with any other claims against directors under the provisions dealing with other antecedent transactions, which allows for a certain level of flexibility.[309]

Although there exists an inherent possibility of bias in favor of creditors in conducting an *ex post* determination of the occurrence of a breach of directors' duties, U.K. courts have made certain efforts to mitigate this. In *Colin Gwyer Associates Ltd. v. London Wharf (Limehouse)*,[310] Queen's Counsel Lesmin Kosmin (sitting as deputy judge of the High Court at the time) held that directors should be guided in the determination of their duties towards creditors by the same test that is applicable to shareholders, as laid down in *Charterbridge*.[311][312] Thus, if it is established that a director, in approving a certain transaction, failed to take into account creditors' interests in insolvency or in the zone, the court must determine whether an intelligent and honest director, could have reasonably believed such a transaction to have been for the benefit of the company, considering the entirety of circumstances at play at the specific period of time the transaction occurred.[313] This test, although objective in nature, cannot be said to be foolproof, as it effectively relies on a "reasonable man's standard," and does not do away with the possibility of bias altogether.

The primary difference between the fiduciary duties arising out of Section 172(3) of the Companies Act and those under Section 214 of the Insolvency Act is the point at which these duties are triggered. The former type of duty is trig-

307. High Level Group of Company Law Experts, *A Modern Regulatory Framework for Company Law in Europe: A Consultative Document of the High Level Group of Company Law Experts*, Brussels, (2002), available at http://ec.europa.eu/internal_market/company/docs/modern/consult_en.pdf.

308. Companies Act, §1157 (Eng.).

309. Keay, *supra* note 239.

310. *See Generally* Gwyer v. London Wharf (Limehouse) Ltd., [2002] EWHC 2748.

311. Charterbridge Corp. Ltd. v. Lloyds Bank Ltd., [1970] Ch. 62

312. The test being whether an "intelligent and honest man" in the position of a director could have reasonably believed the action to be for the benefit of the company, taking into account the entirety of the circumstances at the point in time.

313. Charterbridge Corp. Ltd. v. Lloyds Bank Ltd., [1970] Ch. 62.

gered earlier than the duty under Section 214 as per the tests set out above. Duties under Section 172(3) may arise when insolvency is doubtful itself (although multiple parallel tests exist in this regard), whereas the duty under Section 214 arises only when there is no reasonable prospect of avoiding insolvent liquidation.[314] Further, recourse to Section 214 is available only after the commencement of liquidation (and can be taken only by the liquidator), whereas recourse to a Section 172(3) duty is available as soon as the company enters the zone.[315]

D. *Criticisms and Observations*

1. Financial Stability

The ESV principle has been lauded for its endorsement of a multi-stakeholder approach that brings about accountability of directors to stakeholders other than shareholders.[316] The extent that this protection extends beyond shareholders in reality, however, is disputable. At a fundamental level, creditors and other non-shareholder constituencies are not accorded locus to bring actions against the company's directors under the Companies Act (as is specifically provided to shareholders).[317] This effectively renders their rights available only in the abstract.[318] At the same time, the ambiguity surrounding the rights available under Section 172, and the efficacy of the provision itself, would disincentivize even those non self-interested shareholders, who wish to bring actions on behalf of aggrieved creditors.[319]

In light of this, it is clear that the U.K. has moved away from a model that adopts the dual consideration theory.[320] Some have argued that as Section 172 proscribes actions that affect shareholders' interests only in a negative manner, the law provides scope for directors to look to others' interests.[321] As mentioned above, however, it is evident that the law simply does not provide the incentive for directors to do so. Further, it is not clear what is meant by directors requiring to "have regard to" the principles set out under Section 172(1). While the Explanatory Notes to the Companies Act[322] state that, in "having regard to"

314. Keay, *supra* note 239.

315. *See* Insolvency Act 1986, 45 § 214(3) (UK).

316. Virginia Harper Ho, *Enlightened Shareholder Value, Corporate Governance Beyond the Shareholder-Stakeholder Divide,* 36 J. Corp. L. 61 (2010).

317. Section 260, Companies Act, 2006.

318. *See* L. Sealy, *Directors' Duties—An Unnecessary Gloss*, 47(2) CAMBRIDGE L.J. 175–77 (1988) (Eng.).

319. Williams, *supra* note 184.

320. JOHN EDWARD PARKINSON, CORPORATE POWER AND RESPONSIBILITY: ISSUES IN THE THEORY OF COMPANY LAW (1993); *See* Simon Deakin, *The Coming Transformation of Shareholder Value,* 13 CORP. GOVERNANCE: AN INT'L. REV. 11, 12 (2005).

321. *See, e.g.,* Williams, *supra* note 184 at 361–63.

322. Companies Act 2006, Explanatory Notes ¶ 328 (Eng.).

such factors, it will not be sufficient for directors to just pay lip service to them, there is nothing that really prevents directors from doing so.[323] As per the view of the Parliamentary Standing Committee, the determination of whether directors have had sufficient regard to the ESV principles itself is a "matter for the director's good faith judgment."[324]

The lack of clarity in this respect permits courts to interpret the provision on a case-by-case basis, resulting in perpetuation of uncertainty in the minds of directors regarding the scope of their duties.[325] Requiring directors to have regard to interests of other stakeholders that are in direct conflict with their primary duty towards shareholders, and providing no further clarity in this regard, distorts the overall duty in a manner which "amounts ultimately to no more than a vague obligation to be fair."[326] In fact, the Australian Parliamentary Joint Committee on Corporations and Financial Services had considered and expressly rejected the ESV approach after identifying its several flaws, instead favoring an "enlightened self-interest" model under which directors can consider the interests of other stakeholders to the extent that they are relevant to the long-term growth of the company.[327]

The requirement of publishing a business review can hardly qualify as a consolation for creditors, especially in light of the fact that the CLRSG, in its deliberations, was initially considering a full-fledged and comprehensive 'operating and financial review' ("OFR").[328] The introduction of an OFR was initially used to convince those advocating for a pluralist approach to concede to the ESV and was then done away with after the introduction of the ESV principle.[329] The OFR was focused on ensuring maximum information and disclosure to all stakeholders, while the business review is mostly shareholder-centric, and focuses on maximization of value to the business.[330] Unlike the OFR, under the business review, disclosures on stakeholder issues are no longer mandatory, and are only necessary to the extent that directors "deem them relevant for an understanding of the business."[331]

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323. Morey W. McDaniel, *Bondholders and Stockholders*, 13 J. CORP. L. 205, 309 (1988).

324. 11 July 2006, Parl Deb HL (2006) col. 591 (UK).

325. Andrew Keay, *Moving Towards Stakeholderism? Constituency Statutes, Enlightened Shareholder Value and More: Much Ado About Little?*, 22 EUR. BUS. L. REV. 1, 29 (2011).

326. L. S. Sealy, *Directors' "Wider" Responsibilities - Problems Conceptual, Practical and Procedural*, 13 MONASH U. L. REV. 164, 175 (1987).

327. *See* PARLIAMENTARY JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES, COMMONWEALTH OF AUSTRALIA, CORPORATE RESPONSIBILITY: MANAGING RISK AND CREATING VALUE (2006), https://www.aph.gov.au/Parliamentary_Business/Committees/Joint/Corporations_and_Financial_Services/Completed_inquiries/2004-07/corporate_responsibility/report/index.

328. COMPANY LAW REVIEW STEERING GROUP (2000), *supra* note 290 at ¶ 34.

329. *See, e.g.*, Quinn, *supra* note 188, at 62.

330. *Id*.

331. *Id*. at 74.

2. Vicinity of Insolvency

While the U.K. recognizes the need to re-orient directors' duties to focus on creditors in the zone, it has not developed any corresponding bright-line test to guide directors in their determination at the relevant points in time. Directors are left guessing when the shift is triggered from duties owed under Section 172(1) to those under Section 172(3). As has been elucidated in the previous section of this Comment, court decisions seem to have been very inconsistent and have adopted a vast array of tests in order to determine the point at which the shift is to occur. This produces apprehension in the minds of potential litigants regarding their chances of succeeding in an action brought against the directors, and thus indirectly accords impunity to directors even where there has been a clear breach. A possible solution, as Finch suggests, is that the trigger not result in a reorientation that is solely focused on creditors' interests, but should continue to adopt a multi-stakeholder approach (contrary to the holding in *Brady v. Brady,* discussed above), albeit according primacy to creditors' interests, and thereby according directors more flexibility in their decision making.[332] However, it is unclear how such an approach would reduce the current ambiguity, and may pose the additional risk of diluting even the rights that are currently afforded to creditors.

Several of the tests established by the courts would deem the company to be in the zone even where the possibility of the relevant action resulting in insolvency is remote. The issue was accurately identified in the recent case of *BTI 2014 LLC v. Sequana SA*,[333] wherein the mere inclusion of a large provision in the company's books with respect to an unknown liability was held inadequate to trigger the shift of duties to creditors:

> [i]t cannot be right that whenever a company has on its balance sheet a provision in respect of a long term liability which might turn out to be larger than the provision made, the creditors' interests duty applies for the whole period during which there is a risk that there will be insufficient assets to meet that liability. . .To hold that the creditors' interests duty arises in a situation where the directors make proper provision for a liability in the company's accounts but where there is a real risk that the provision will turn out to be inadequate would be a significant lowering of the threshold.[334]

Thus, the vicinity of insolvency analysis lacks an objective standard under U.K. law despite the fact that such a standard has always existed under Section 214 of the Insolvency Act and other similar provisions. The confusion with respect to duties owed in the zone is exacerbated due to the fact that the Companies Act[335] permits shareholders to ratify decisions taken by directors that are in breach of their duties, in a retrospective manner, which may directly conflict

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332. *See* FINCH, *supra* note 264, at 503.

333. BTI 2014 LLC v. Sequana & Ors [2016] EWHC 1686 (Ch) (Eng.). *See also* Dickinson v. NAL Realisations (Staffordshire) Ltd., [2017] EWHC 28 (Ch) (Eng.).

334. *Id.*

335. Companies Act 2006, § 239 (U.K.).

with duties owed to creditors in the vicinity of insolvency, where it is unclear when the company actually entered the zone.

In addition to this, and as briefly stated earlier, although there exists a definitive "trigger point" for duties under Section 214 to come into effect, the criticism remains that such duties arise too late.[336] The point at which there is "no reasonable prospect that the company would avoid going into insolvent liquidation" clearly arises much after a company can be said to have entered the zone of insolvency.[337] Further, the cause of action under Section 214 itself arises only after the company has gone into insolvent liquidation and therefore provides inadequate protection from a creditor standpoint.[338] Some have argued that this problem is a by-product of the "duty of care" not being recognized as a fiduciary duty under U.K. law.[339] Not permitting creditors to make direct claims for breaches under Section 214 has been subject to widespread criticism because creditors find it difficult to persuade the liquidator to make applications under this provision unless there is a clear case of a breach.[340] Direct claims, however, were expressly permitted under the Companies Acts of 1929 and 1948.[341] Further, proving lack of good faith in hindsight has proven to be an uphill task,[342] especially as courts seem to be overly conscious of the hindsight bias that exists in favor of creditors, as mentioned above.[343]

The test under Section 214 also does not provide adequate guidance to directors on how to avoid liability for wrongful trading, other than simply stating that directors are to take "every step with a view to minimizing the potential loss to the company's creditors."[344] Further, the application of the balance sheet test to determine the commencement of insolvency is hit by the commercial reality that the value of a company's assets and liabilities undergo constant and inevitable fluctuation.[345] Therefore, a breach under this provision may only be easy to prove when the directors themselves own a substantial portion of the equity.[346] Further, there are three possible scenarios in which directors may es-

336. *See* Thomas Bachner, *Wrongful Trading – A New European Model for Creditor Protection?* 5 EUROPEAN BUS. ORG. L. REV. 293, 294 (2004).

337. PAUL DAVIES, INTRODUCTION TO COMPANY LAW, CLARENDON LAW SERIES 90 (2d ed., Oxford Unviersity Press – Clarendon Law Series, 2010).

338. Mckenzie-Skene, *supra* note 235.

339. *See* Keay, *supra* note 206, at 16, 33.

340. *Id.*

341. Companies Act, 1929, § 275(1) (U.K.); and Companies Act 1948, § 332(1) (U.K.).

342. *See Sherborne Associates Ltd.* (1994), B.C.C. 40 (QB) 55-56 (UK); *Welfab Engineers Ltd.* (1990), B.C.C. 600 (Ch) 603–04 (UK); *Continental Assurance Co.* (2007), B.C.L.C. 287 (Ch) 293–94 (UK).

343. *See* Keay, *supra* note 30; *see also* The Liquidator of Marini Ltd v. Dickensen, [2003] EWHC 334 (Ch); Secretary of State for Trade and Industry v. Gash, [1997] BCC 172 at 178.

344. Insolvency Act 1986, c. 45, § 214, sch. 3 (Eng.).

345. *See* Gabb, *supra* note 302.

346. RIZWAAN JAMEEL MOKAL, CORPORATE INSOLVENCY LAW, THEORY AND APPLICATION 266 (Oxford University Press, 2005).

cape the applicability of Section 214 altogether.[347] These are: (i) when the gamble taken by the directors pays off, i.e. the company does not end up in insolvent liquidation; (ii) where the company does turn insolvent, but is not actually put into insolvent liquidation, but is just struck off the register of companies at a later point; and (iii) where administration is resorted to instead of insolvent liquidation. In these situations, the duty of directors towards creditors remains un-triggered.

Another important issue with respect to the implementation of Section 214, is the amount of compensation that courts are willing to demand from directors who have breached their duties thereunder. In several instances, it has been observed that courts are only willing to demand from directors the value of the "diminution in the company's net asset position" during the look-back period provided under Section 214.[348] In fact, in some cases, courts have held that no compensation is payable because the additional liabilities in question did not result in a material increase in the net deficiency of the company.[349] Even Gabriel Moss has been highly critical of this position and has even gone to the extent of deeming it a "disgrace" to U.K. jurisprudence.[350] As he rightly pointed out, such a test would permit directors to circumvent the penalty by repaying existing creditors (i.e., those that had lent money prior to the cut-off date) while not repaying new creditors who had granted debt after the cut-off date.

Further, courts seem to be less stringent with directors who they believe cannot be imputed with full blameworthiness for the acts committed under Section 214.[351] U.K. law does not also account for several nuances in its wrongful trading regime, as are provided for under the framework of other jurisdictions, like Germany. German law, under its version of wrongful trading, provides *inter alia* for special protection and compensation for "new" creditors, i.e., those that become creditors after the date on which the duty is deemed to be triggered. In light of the above, it is not surprising that protections under Section 214 are not being utilized to their full potential, and that creditors remain rather disinterested in pursuing such actions.[352] Further complications were brought about by the decision in *Oasis Merchandising*,[353] which established that proceeds emanating from a successful Section 214 claim would not be caught by security interests, thereby increasing the apprehension in the minds of secured creditors to initiate such claims.

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347. *See* Paul Davies, *Directors' Creditor-Regarding Duties in Respect of Trading Decisions Taken in the Vicinity of Insolvency*, 7(1) EBOR (2006) at 301–37.

348. *Id.* at 325.

349. *See* Re Ralls Builders Ltd., Grant v. Ralls, [2016] EWHC 243 (Ch); *See also* Re Ralls Buildings Ltd. (No. 2), Grant v. Ralls, [2016] EWHC 1812 (Ch.).

350. Gabriel Moss, *No Compensation for Wrongful Trading – Where Did it All Go Wrong?*, 30(4) INSOLVENCY INTELLIGENCE 49 (2017).

351. *See* Davies, *supra* note 347.

352. *Id.*

353. *In re* Oasis Merch. Serv. Ltd., [1998] Ch 170 (AC).

3. Actual Insolvency

The framework for "actual insolvency" in the U.K. also suffers from a definitional problem. The primary tests adopted under the insolvency legislation are the "balance sheet" test and the "cash flow" test.[354] However, there is still ambiguity regarding the relevant test to apply in the determination of fiduciary duties owed by directors.[355] In reality, actual insolvency is largely irrelevant in determining whether creditors' interests should be taken into account; rather, these duties commence from the time the company enters the zone itself. However, the issue of a lack of an objective test still remains a concerning one, especially in situations where the company jumps directly from solvency to insolvency, thereby skipping the zone altogether. Objections have also been raised that insolvency can also be "untriggered" on the basis that companies constantly fluctuate between solvency and insolvency in their regular functioning.[356] U.K. courts have not provided for the continuity of any actions initiated by creditors in insolvency, as was done in the U.S. in the case of *Quadrant Structured Products Co. Ltd. v. Vertin*.[357]

Many have suggested an objective test for the determination of actual insolvency which applies a standard similar to the one under Section 214 of the Insolvency Act, and the one applied in *Permakraft* (i.e. an "ought to have known" standard). In fact, the CLRSG had also proposed an objective test,[358] and a draft provision was included in the Statement of Directors' Duties for purposes of further consultation.[359] The test recommended by the CLRSG was objective

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354. *See* Insolvency Act 1986, c. 45 §§ 123, 240(2) (Eng.).

355. Mckenzie-Skene, *supra* note 235, at 507.

356. Sealy, *supra* note 326, at 179.

357. *See generally* Quadrant Structured Products Co. Ltd. v. Vertin, No. 6990-VCL, 2015 BL 128889 (Del. Ch. May 4, 2015).

358. COMPANY LAW REVIEW STEERING GROUP, MODERN COMPANY LAW FOR A COMPETITIVE ECONOMY: FINAL REPORT, 2001, (U.K.).

359. The draft provision read:

> *"At a time when a director of a company knows, or would know but for a failure of his to exercise due care and skill, that it is more likely than not that the company will at some point be unable to pay its debts as they fall due –*
>
> *the duty under paragraph 2 does not apply to him; and (b) he must, in the exercise of his powers, take such steps (excluding anything which would breach his duty under paragraph 1 or 5) as he believes will achieve a reasonable balance between –*
>
> *reducing the risk that the company will be unable to pay its debts as they fall due; and*
>
> *promoting the success of the company for the benefit of its members as a whole.*
>
> *Notes:*
>
> *What is a reasonable balance between those things at any time must be decided in good faith by the director, but he must give more or less weight to the need to reduce the risk according as the risk is more or less severe.*
>
> *(2) In deciding in any case what would be most likely to promote the success of the company for the benefit of its members as a whole, the director must take account in good faith*

to the extent that it was triggered "where it is more likely than not that the company will at some point be unable to pay its debts as they fall due" but was subjective for purposes of establishing actual compliance with the test.[360] The draft proposal was not accepted by the Government, except to the extent that it expressly recognized the need for a statutory provision providing for directors' duties which came to life by way of Section 172.[361] In addition to this, the White Paper issued by the Government specifically stated that it had decided against including duties to creditors in the statutory statement and had instead left the position to continue to develop under common law.[362]

The ambiguity of the statutory regime under the Companies Act has resulted in enormous confusion, which could have easily been prevented with clarity at the time of drafting.[363] This criticism was shared by the Australian Joint Parliamentary Committee on Corporations and Financial Services in its 2006 report:

> [t]he Committee does not support the British approach, which appears to introduce great uncertainty into the legal expression of directors' duties. . .Subclause (3) requires directors to have regard to a menu of non-shareholder interests, but gives no guidance as to what form this 'regard' should take, and therefore gives no guidance to directors on what they must do in order to comply.[364]

The issue is magnified by insubstantial case law under Section 172(3) so far.[365]

Apart from the above, U.K. law, like that of the U.S., broadly views creditors as a homogenous group and does not consider the varying interests of, and the inherent conflict that exists between the different sub-classes of creditors.[366] Various authors have stressed the importance of formulations that would accord primacy to certain specific types of creditors (other than secured creditors), owing to the extent of their vulnerability (secured creditors having the protection of their security interests, on the other hand). For instance, Finch[367] argues that the duty should be primarily directed towards unsecured creditors, whereas

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of all the material factors that it is practicable, in the circumstances for him to identify. . ." [Emphasis supplied]

360. COMPANY LAW REVIEW STEERING GROUP, MODERN COMPANY LAW FOR A COMPETITIVE ECONOMY: FINAL REPORT, 2001, Annexure C ¶ 8 (U.K.).

361. TRADE & INDUSTRY COMMITTEE, THE WHITE PAPER ON MODERNISING COMPANY LAW, 2002-3, HC 439, at 7.

362. *Id.*

363. Mckenzie-Skene, *supra* note 235.

364. Parliamentary Joint Committee on Corporations and Financial Services (Australia), *Corporate Responsibility: Managing Risk and Creating Value* (2006), at ¶ 4.46 and accessible at http://www.aph.gov.au/senate/committee/corporations_ctee/completed_inquiries/2004-07/corporate_responsibility/report/index.htm.

365. Keay, *supra* note 206, at 12.

366. Mckenzie-Skene, *supra* note 235.

367. *See* Vanessa Finch, *Directors' Duties: Insolvency and the Unsecured Creditor*, *in* A. CLARKE (ed.) CURRENT ISSUES IN INSOLVENCY LAW 707 (London: Stevens, 1991).

Lispon[368] argues that it should be owed to all creditors that possess a low level of volition. A related problem is that a successful claim for a breach of duty would bear fruits for all of the company's creditors without any identity-based segregation, anything recoverable under such a claim being considered the company's property.[369]

IV. INDIA

A. *Duties in Financial Stability*

1. The Existing Position

The statutory provision that applies to directors' fiduciary duties in financial stability under the Indian framework is Section 166 (2) of the Companies Act, 2013 ("2013 Act"). The provision reads "[a] director of a company shall act in good faith in order to promote the objects of the company for the benefit of its members as a whole*, and in the best interests of the company, its employees, the shareholders, the community and for the protection of environment*." This provision should be read with Section 166 (7) of the 2013 Act, which provides that in case of contravention of any of the provisions under Section 166 (including sub-section (2)), directors are to be punished with a fine of not less than one lakh rupees but which may extend to five lakh rupees.[370]

Section 166(2) bears a slight resemblance to Section 172(1) of the U.K. Companies Act. However, the scope of Section 166(2) seems to be much wider than the U.K. provision and seems to adopt an approach that is truly pluralist. This is due to the fact that the provision does not create a hierarchy between shareholder interests and the interests of the other constituencies, but puts interests of all constituencies on par.[371] In other words, under Section 166(2), the protection of non-shareholder constituencies is not predicated on the furtherance of the interests of the members themselves.[372] Importantly, however, creditors do not find any mention under Section 166(2), and are conspicuous by their absence.

Although there was no corresponding statutory provision in place prior to the commencement of the 2013 Act that specifically dealt with directors' fiduciary duties, Indian law did recognize certain shareholder rights under a variety

368. *See* Jonathan C. Lipson, *Directors' Duties to Creditors: Power Imbalance and the Financially Distressed Corporation*, 50 UCLA L. REV. 1189, 1245–49 (2003).

369. Andrew Keay, *The Director's Duty to Take into Account the Interests of Company Creditors: When is it Triggered?*, 25 MELB. U. L. REV. 315 (2001).

370. Companies Act, 2013, No. 18, § 166(7), 2013 (India).

371. Naniwadekar & Varottil, *supra* note 201, at 2.

372. *Id*.

of statutory provisions and common law.[373] The move towards Section 166(2), began with proposals to amend the Companies Act, 1956 ("1956 Act"), which was a pre-cursor to the 2013 Act. The provision finds its origins in a recommendation made by the Irani Committee Report[374] in 2005, which was subsequently incorporated in the form of a clause in the Companies Bill, 2008, and retained in the same form in the Companies Bill, 2009 (Clause 147 in both Bills).[375] The draft provision until this stage however was a replica of the ESV provision in the U.K., and non-shareholder interests did not find exclusive mention other than for purposes of promoting shareholders' interests.[376] This was the case despite the Irani Committee Report having made a specific mention of the need to account for non-shareholder interests.

It was only in the Companies Bill, 2011, which was introduced after detailed deliberations by the Parliamentary Standing Committee on Finance,[377] that the Clause took a shape and form resembling Section 166(2) as it stands today. The Standing Committee, in turn, had acted on a recommendation given by the Institute of Company Secretaries of India.[378] Certain indirect rights did exist in favor of other stakeholders even prior to the commencement of the 2013 Act, under the broader umbrella of "public interest."[379] These, however, were inadequate to offer true protection to these stakeholders, public interest being a much higher and much vaguer threshold.

In its concluding remark,[380] the Standing Committee expressly clarified that the duty would only be owed to the corporate enterprise for the interest of the stakeholders, and not to any of its stakeholders directly. This position was not expressly mentioned in the 2013 Act, resulting in immense ambiguity in the actual implementation of the statutory model.

It seems that the adoption of a multi-stakeholder approach under Section 166(2) was a result of detailed deliberations on the specifics of such a model (and its pluralist character).[381] The provision should have resulted in much enthusiasm amongst non-shareholder constituencies. In reality, the rights available under the provision are illusory (even more so than under the ESV provi-

373. Umakanth Varottil, *The Evolution of Corporate Law in Post-Colonial India from Transplant to Autochthony*, AM. U. INT'L L. REV. 31, 253 (2016).

374. Ministry of Corporate Affairs (2005), *Report of the Expert Committee on Company Law*, available at http://reports.mca.gov.in/Reports/23-Irani%20committee%20report%20of%20the%20expert%20committee%20on%20Company%20law,2005.pdf.

375. Companies Bill, 2008, No. 57, Cl. 147, 2008 (India); Companies Bill 2009, No. 59, Cl. 147, 2008 (India).

376. *See* Naniwadekar & Varottil, *supra* note 201.

377. THE COMPANIES BILL, 2009, Twenty-first Report (Standing Committee on Finance 2009-10), http://www.prsindia.org/uploads/media/Companies%20Bill%202009.pdf.

378. *Id*.

379. *See*, e.g., The State Bank of India Act, No. 23 of 1955, INDIA CODE(1955), § 35A; *see also* Companies Act, No. 1 of 1956, INDIA CODE(1956).

380. *See* Naniwadekar & Varottil, *supra* note 201.

381. *Id.*

sion, the provision having seemed far more inclusive at first blush). In its implementation, Section 166(2) is actually not dissimilar from Section 172(1). Despite the evident textual disparity between the two provisions, Section 166(2) fails to offer a workable pluralist model.

At a fundamental level, the model fails because non-shareholder constituencies are not afforded any statutory remedies for the redress of breaches of duty under Section 166(2). Under the 2013 Act, only shareholders can initiate derivative actions and even class action suits against the company.[382][383] The statutory framework disallows class action suits to be brought even on behalf of other stakeholders.[384] This seems to be the position even for derivative claims; however, the statutory framework does not provide clarity on this point.[385]

Another significant issue is that the only identifiable stakeholder that finds mention under Section 166(2) (other than the company's shareholders), is its employees.[386] The other constituencies mentioned are rather vague (being the "community" and the "environment"), and it is hard to determine whether the company's other key constituencies would fall under the scope of the provision.[387] Although similar terms find mention under Section 172(1) of the U.K. Companies Act, they appear after the other relevant stakeholders have been specifically set out (i.e. employees, suppliers, customers etc.). Thus, rather than being progressive, these duties bear a strong resemblance to the "public interest" duties that existed under the previous regime.

Even greater confusion is caused by the fact that it is unclear under the statutory framework whether duties under Section 166(2) are owed directly to these constituencies (and not routed through the corporate enterprise). It has been argued that the mere omission to clarify this fact does not change the "well-established principle of company law"[388] that duties can be owed only to the company, and that Section 166(2) cannot be said to have done away with this position.[389] Another possible interpretation is that the first part of the provision requires directors to "act in good faith in order to promote the objects of the company for the benefit of its members as a whole," which constitutes a subjective test to act for the benefit of the company. The second part of the test re-

382. This duty arising from the common law position, and these rights being unavailable to other stakeholders under the UK regime as well. The right of shareholders to file derivative suits was expressly recognized in the recent Delhi High Court decision. *See* Rajeev Saumitra v. Neetu Singh & Ors., (2015) I.A. No. 17545/2015 in CS (OS) No. 2528/2015 (2016).

383. § 245 Companies Act, 2013, No. 18, Acts of Parliament, 2013 (India).

384. *See* Naniwadekar & Varottil, *supra* note 201.

385. *See* Vikramaditya Khanna & Umakanth Varottil, *The Rarity of Derivative Actions in India: Reasons and Consequences*, *in* DAN W PUCHNIAK, ET AL, THE DERIVATIVE ACTION IN ASIA: A COMPARATIVE AND FUNCTIONAL APPROACH 369, 396–97 (Dan W. Puchniak ed., Cambridge University Press 2012).

386. Companies Act, 2013, No. 18, §166(2), 2013 (India).

387. Naniwadekar & Varottil, *supra* note 201, at 14.

388. Naniwadekar & Varottil, *supra* note 201; Percival, *supra* note 189.

389. *Id.*

quires that such conduct be "in the best interests of the company, its employees, the shareholders, the community and for the protection of environment," which constitutes an objective test to act for the benefit of the non-shareholder constituencies.[390] The fact that the first part of the test is subjective would also imply the applicability of the business judgment rule to this extent. Even if this was meant to be the case, no further clarification has been given, whether in statute or otherwise.

Professor Varottil and Mihir Naniwadekar argue that "other stakeholders" might find an indirect remedy against directors under the provisions dealing with "oppression and mismanagement" in the 2013 Act[391] (although these provisions were primarily meant for the protection of minority shareholders).[392] For instance, under Section 241(2), the Central Government is entitled to apply to the National Company Law Tribunal ("NCLT"), for appropriate orders, in case the company's affairs are being managed in a manner that is prejudicial to the public interest. Even the Indian Supreme Court, while dealing with an oppression and mismanagement case, held that "the action of the directors must be set aside if the same was done oppressively, capriciously, corruptly or in some other way mala fide."[393]

The ambiguity arising from Section 166(2) can only be addressed in one of two ways: (i) by suitable amendments to the statute or by issuance of clarifications by the courts, or (ii) by the application of established common law principles to fill up the gaps. Importantly, the question of whether common law is to apply *vis-à-vis* directors' fiduciary duties (which would run parallel to the duties under Section 166(2)) remains unanswered under the Indian statutory framework. This causes several complications. First, Section 166(2) is hardly comprehensive enough to provide the full scope of the duties to be owed by directors at such times. The provision only seems to provide for a personal, and not a proprietary remedy, resulting in a situation where no remedy would be available to stakeholders for a breach of duty that does not result in a corresponding personal gain to the directors.[394] Second, as discussed in the following sections, the non-applicability of common law would result in an absurd scenario, where duties under Section 166(2) would continue to apply to directors of a company that has turned insolvent or entered the zone and would thus improperly account for the requisite shift of duties that is meant to take place at such times. The issue of applicability of common law in this respect was discussed in a recent

390. *See* Sakshi Raje, *Fiduciary Duties of Directors*, LAW TIMES J. (May 04, 2017), available at http://lawtimesjournal.in/fiduciary-duties-directors/.

391. Companies Act of 2013, § 241.

392. Companies (Amendment) Act, 2013, Acts of Parliament, 2013 (India).

393. Harinagar Sugar Mills Ltd. v. Shyam Sunder Jhunjhunwala Ors., (1962) 2 SCR 339.

394. Umakanth Varottil, *Codification of Directors' Duties: Is Common Law Excluded?*, India Corp Law Blog (May 31, 2014), https://indiacorplaw.in/2014/05/codification-of-directors-duties-is.html.

case of the Delhi High Court.[395] Although only briefly touching upon the issue (by way of *obiter*), the Court seemed to imply the subsistence of common law duties. However, the position on this issue will remain unclear until there is a definitive ruling on it.

Similar to the U.K., the newly introduced Insolvency and Bankruptcy Code, 2016 ("IB Code") provides for a provision on "transaction[s] defrauding creditors," which seems to offer protections to creditors even in financial solvency, albeit in a retrospective manner.[396] The provision does not provide for any look-back period (and would by default also extend to the zone of insolvency) and proscribes those transactions that were: (i) entered into at undervalue; and (ii) entered into in order to keep assets of the corporate debtor beyond the reach of any person who is entitled to make a claim against it; or in order to adversely affect the interests of such person in relation to the claim.[397] The effect of a successful application under this provision is that the NCLT may restore the position as existed before the entering into of such a transaction. Similarly, Section 66(1) of the IB Code also proscribes (without there being any restrictions in terms of the time-period within which such transactions are to take place) the conducting of any business of the company with the intent to defraud its creditors or for any other fraudulent purpose, and courts have the discretion to order directors to make such contributions to the assets of the corporate debtor as they deem fit.[398] It is important to note that applications under both these provisions are only permitted to be made by the resolution professional appointed to take over the management of the company. It is yet to be seen how far these provisions go to protect the interests of creditors in practice.

2. The Way Forward

It is clear that Section 166(2) is a highly confused and complicated provision, and does not "do what it says." Despite expressly providing for fiduciary duties towards non-shareholder constituencies, the provision seems to exclusively promote the interests of the shareholders instead (as explained in the previous section). It is therefore imperative that the provision be amended or clarified to take a definitive stance on the issue and either: (i) only promote shareholders' interests and do away with the mention of the other constituencies altogether (or only include them as a means to further the interests of the members themselves, like the ESV in the U.K.), or (ii) continue to account for non-shareholder constituencies, but accord these constituencies the appropriate remedial rights to initiate actions against the directors for breach of their fiduciary duties.

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395. Rajeev Saumitra v. Neetu Singh & Ors., I.A. No. 17545/2015 in CS (OS) No. 2528/2015.

396. Insolvency and Bankruptcy Code, 2016, No. 31, § 49, 2016 (India).

397. *Id.*

398. Insolvency and Bankruptcy Code, 2016, No. 31, § 66(1), 2016 (India).

In case the first model is adopted, certain corresponding obligations (although not in the form of fiduciary duties) may be provided for in favor of the other stakeholders. In this regard, reliance may be placed on the Green Paper on Corporate Governance issued by the U.K. in 2016.[399] The Green Paper suggests that: (a) stakeholder advisory panels be created for directors to directly hear from their key stakeholders; (b) non-executive directors be designated to hear voices of key interest groups; (c) individual stakeholder representatives be appointed to company boards; and (d) reporting requirements related to stakeholder engagement be strengthened.[400] These features should all be built in and operate in a coordinated manner towards protecting the stakeholders' interests, and should not operate in isolation or in exclusion of one another.

In case the second model is adopted (i.e. a truly pluralist approach), it is also imperative that the provision specifically mention and account for the key stakeholders and do away with the current ambiguity. Although a pluralist approach in insolvency may qualify as being "very progressive" (and distinguishable from the shareholder primacy model in the U.S., U.K. and elsewhere), it is also important that such model account for the possible conflicts and issues that may arise as part of its implementation. If this model is adopted, India would no longer be able to place reliance on the existing jurisprudence in the West. Further, in case creditors are recognized as rightful beneficiaries in their own right, despite them having contractual protections in their favor, this model would have to be sophisticated enough to provide for duties to creditors only where absolutely necessary (and thus prevent the confusion arising under the "two-masters" conundrum).

Such a model may be along the lines of the "enlightened self-interest" model adopted in Australia, permitting directors to consider and act in the legitimate interests of non-shareholder constituencies to the extent that these interests are relevant to the company.[401] At the same time, such a model must consider and identify sub-classes within each class of stakeholders, and adopt a weighted approach, with more protection to more vulnerable sub-classes (for e.g. unsecured creditors, decree holder creditors etc.).

It is also imperative to clarify that the duty under Section 166(2) is only owed to the corporate enterprise, and that the beneficiaries of this duty are only permitted to bring derivative actions (on behalf of the company itself) against its directors.

399. DEPARTMENT FOR BUSINESS, ENERGY & INDUSTRIAL STRATEGY, GREEN PAPER 2016, (available at https://www.pwc.com/jg/en/events/beis-16-56-corporate-governance-reform-green-paper-final.pdf).

400. *Id.*

401. Robin Hollington, Tim Akkouh & Emily Gillett, *Companies Act 2006 (1)* 151 Solicitors J. 12 (2007).

B. *Duties in Insolvency*

1. The Existing Position

As mentioned above, there is currently no clarity under the Indian legal framework regarding a shift of fiduciary duties that is triggered upon the commencement of the company's insolvency. A possible reason for this is that Section 166(2) (as per its literal reading) is meant to cover all stakeholders, there being no necessity to occasion a "shift" as a result. However, in light of the analysis brought out in the U.S. and U.K. sections, it remains a significant issue that creditors are not recognized as the primary risk bearers in insolvency (and do not find express mention under Section 166(2) either). One explanation is that creditors' interests are covered during insolvency *de facto,* as the liquidator of a company is eligible to recover monies in the name of the company, which would then form part of the general pool of assets available to them (in priority) during liquidation.[402] Another is that the winding up regime under the Companies Act framework (i.e., the 1956 Act as amended by the 2013 Act) already provides for certain duties to creditors in insolvency. For instance, the 1956 Act obligated the company's liquidators to have regard to the resolution of its creditors when there is administration and distribution of the company's assets,[403] thereby overriding any directions given by the advisory committee.[404] Creditors and contributories are also empowered to inspect the books of the company.[405] These duties, however, can hardly be said to be adequate, or even appropriate, considering the nature of risk borne by creditors in insolvency.

Thus, there is a legal vacuum in respect of the duties owed to creditors in insolvency, and the issue fails to be addressed in a manner similar to the U.S. and the U.K.. As also mentioned in the previous section, there is a lack of clarity whether common law is to supplement the duties under Section 166(2), which would have specifically accounted for a shift of duties in insolvency (as is specifically provided with respect to the ESV duties under Section 170 (4) of the U.K. Companies Act).

There is one provision under the 2013 Act which seemingly accounts for creditors' interests from a fiduciary duty perspective in actual insolvency. This is Section 340, which is titled *Power of Tribunal to Assess Damages Against Delinquent Directors, etc.*[406] This provision permits applications in the course of the winding up of a company by the creditors (or the contributories or the company/official liquidator) in situations where a director has: (i) misapplied, or

402. Naniwadekar & Varottil, *supra* note 201; Percival, *supra* note 189; *Johnson v. Gore Wood & Co,* [2002] 2 AC 1; ROY GOODE, PRINCIPLES OF CORPORATE INSOLVENCY LAW 522–23 (4th. Sweet & Maxwell, 2011).

403. Companies Act, 1956, No. 1, §292(2), 1956 (India).

404. *Id.*

405. Companies Act, 1956, No. 1, §549, 1956 (India).

406. Companies Act, 2013, No. 18, §340, 2013 (India).

retained, or become liable or accountable for, any money or property of the company; or (b) been guilty of any misfeasance or breach of trust in relation to the company.[407] In such a scenario, the Tribunal may order that such a director repay or restore the money or property or any part thereof with interest at such rate as it deems just or proper in respect of the misapplication or breach of trust. Such an application must be made within five years of the winding up order, or of the date of the appointment of the company liquidator; or of the misapplication, retention, misfeasance or breach of trust, as the case may be, whichever is longer.[408] This provision is yet to be fully tested by courts, however.

2. The Way Forward

As mentioned above, the Indian legal framework completely ignores the significant shift in behavioral patterns and incentives that occurs amongst and *inter-se* the company's two primary constituencies upon its insolvency. There is also no clarity regarding the applicability of common law to fill the gaps in this regard. It is therefore important that India not only recognizes the existence of the issue but also creates a detailed model to bridge the gap, taking from (and learning from the mistakes of) the U.S. and the U.K.

Undoubtedly, such a model must recognize the company's creditors as its primary risk bearers in insolvency, and reject a shareholder primacy approach. In this regard, the statute may specifically provide for a shift of duties towards creditors, or may simply defer to common law in the manner done under Section 172(3) (read with Section 170(4)) of the U.K. Companies Act. The former approach is definitely preferable, in my opinion. Notwithstanding the route adopted, a decision would need to be made regarding the nature of claims that can be brought by creditors, i.e.: (i) whether creditors' interests are to be accounted for only as the residual claimants, with the directors' duties being owed to the corporate enterprise, and creditors only being eligible to bring derivative claims against the company (as was laid down in *Gheewalla* in the U.S., and which is the current statutory position in the U.K.); or (ii) to accord direct duties to creditors and the right to bring direct claims against the company.

Adopting the derivative approach makes more sense because of the complications associated with a model that recognizes direct claims. Adopting this approach will do away with the possibility of creditors initiating multiple concurrent and frivolous actions against the company at a time when the energies of directors should be focused on reviving the company and its operations. Creditors with secondary and subservient charges will thus also be precluded from bringing actions which would enable them to unfairly benefit in a manner where they gain over and above what is legitimately due to them under their respective security interests.

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407. *Id.*

408. *Id.*

At the same time however, this Comment proposes certain exceptions and modifications to the *Gheewala* approach. The direct incorporation of the model would not be beneficial. First, the rule should expressly provide for the possibility of a direct action on behalf of a specific creditor/ group of creditors towards whom the directors' conduct has been especially and deliberately egregious and mala fide (in other words, as held in *Production Resources,* there being a "marked degree of animus towards a particular creditor").[409] This should not result in the opening of the floodgates of litigation (as happened pursuant to the decision in *Production Resources* in the U.S.) and thus effectively alter the very nature of the model itself (i.e. away from the "derivative" approach). Thus, the standard and threshold of the grievance underlying the creditor's claim must be kept high enough for the claim to be resorted to only in "rare and special" circumstances. Second, this exception should be applied in a weighted manner, giving additional protection and recognition to vulnerable classes of creditors that do not have the comforts and protections of secured creditors.

It is imperative to supplement and clarify the nature of this duty with an appropriate and definitive trigger test to determine the commencement of insolvency. In this regard, the issue is even more complicated than in the U.S. and the U.K., which suffer from a problem of multiplicity of tests. In India, under the recently introduced IB Code, a corporate insolvency resolution process ("CIRP") can be initiated against a company (by any of the company's creditors, or by the company itself) that has defaulted on its debts to the tune of at least INR 1 lakh (approximately 1540 USD).[410] The initiation of the CIRP against such a company is subject to the confirmation of the existence of the default by the NCLT. After initiation of the CIRP, the company's management (including its board of directors) are replaced by an insolvency professional that takes over the management of the company during the CIRP.[411] Post-CIRP, the company will either no longer be insolvent and will restart operations as a financially stable entity, or will be liquidated. Thus, it becomes highly problematic to attribute an insolvency trigger for fiduciary duties arising out of the scheme of the IB Code.

Adopting the IB Code trigger to determine the commencement of insolvency is also not recommended due to the extremely low standard for determining the occurrence of a default (and thus insolvency). The threshold of a default under the IB Code is likely to be breached and remedied on a constant basis.[412] Even if insolvency is triggered only when an application for the initiation of a CIRP is admitted by the NCLT, this would be redundant from a fiduciary duty perspective because the directors are no longer in control of the management of

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409. Production Resources*, supra* note 82, at 43.

410. Insolvency and Bankruptcy Code, No. 31 of 2016, India Code, § 4(1).

411. *Id*. at §17(1).

412. A similar objection had been raised by Leonard Sealy in the UK context. *See supra* note 325.

the company after this point. Thus, although likely to cause confusion at first, it is recommended that a completely distinct and exclusive test be introduced for purposes of determining the commencement of insolvency from a shift in fiduciary duty perspective. In this regard, India may consider the test brought out in *Permakraft*, i.e., whether the occurrence of insolvency was "reasonably within the knowledge or ought to have been in the knowledge" of the relevant directors.[413] This needs to be supported by a formal and substantive trigger test, however.

The test that is finally adopted should be clearly distinguishable to the one applicable to the zone of insolvency, and there should be no possibility of conflation in this regard. In this respect, India may also consider the draft provision recommended by the CLRSG in the U.K. (although not specifically providing for a shift of duties towards creditors), which provided for a test which is triggered where "it is more likely than not that the company will at some point be unable to pay its debts as they fall due."[414] In the interim (until the point that such a test is adopted and implemented), it may be recommended that India incorporate a *Vertin*-like standard (as laid down by the Delaware Chancery Court) and protect the sanctity of derivative claims initiated by creditors even if the company turns solvent during the pendency of the lawsuit.[415] Further, any such duty must only be applied in conjunction with the business judgment rule which should be expressly extended to apply post the commencement of insolvency.

C. *Duties in the Vicinity/ Zone of Insolvency*

1. The Existing Position

As is the case in actual insolvency, the Indian courts and legislature have not expressly accounted for a shift in fiduciary duties on the company having breached the zone of insolvency. There is also no definitive ruling or clarification on whether common law can be read in to provide the requisite clarity. This issue needs to be addressed promptly to bring India in line with the global standards, to duly account for the polarization of interests or incentives amongst a company's primary constituencies when it is in a state of financial deterioration, and to accord protection to the true and rightful claimants in such a scenario.

India however applies a "wrongful trading" standard that is akin to the one under Section 214 of the U.K. Insolvency Act. This is mentioned in Section 66(2) of the IB Code:

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413. Nicholson v. Permakraft, [1985] 1 NZLR 242, at 250 (N.Z.).

414. COMPANY LAW REVIEW STEERING GROUP, MODERN COMPANY LAW FOR A COMPETITIVE ECONOMY: FINAL REPORT, 2001, (U.K.).

415. Quadrant Structured Prods. Co. v. Vetrin, 115 A.3d 535 (Del. Ch. 2015).

> (2) On an application made by a resolution professional during the corporate insolvency resolution process, the Adjudicating Authority may by an order direct that a director or partner of the corporate debtor, as the case may be, shall be liable to make such contribution to the assets of the corporate debtor as it may deem fit, if—
>
> (a) before the insolvency commencement date, such director or partner knew or ought to have known that the there was no reasonable prospect of avoiding the commencement of a corporate insolvency resolution process in respect of such corporate debtor; and
>
> (b) such director or partner did not exercise due diligence in minimising the potential loss to the creditors of the corporate debtor.
>
> Explanation.—For the purposes of this section a director or partner of the corporate debtor, as the case may be, shall be deemed to have exercised due diligence if such diligence was reasonably expected of a person carrying out the same functions as are carried out by such director or partner, as the case may be, in relation to the corporate debtor.[416]

This provision clearly contemplates director's duties towards the company's creditors prior to the commencement of insolvency (where there was knowledge of, or there ought to have been knowledge of the company's impending insolvency). Much like the wrongful trading provision in the U.K., Section 66(2) provides that an application can only be made by the resolution professional (like the U.K. statutory framework, which only permits the liquidator to make such an application) and also makes directors liable to make contributions to the assets of the company if such application is successful. Similar is the case with Section 214 by employing an objective "knew or ought to have known" test, enabling the NCLT to adopt a more scientific approach to determine the breach of the duty, and precluding an inconsistent case-by-case approach like the one for creditors in the zone under common law.

Section 66(2) of the IB Code adopts a much higher standard than the U.K. provision however, in that it is pegged against the reasonable apprehension of the commencement of a CIRP, as opposed to insolvent liquidation (under the U.K. provision).[417] This could theoretically create several issues, as discussed in detail in the section below. Section 66(2) remains to be tested, as the IB Code is relatively new. Only time will tell whether the provision will truly protect creditors' interests in the zone of insolvency.

Further, as mentioned earlier, creditors may also be afforded the protection under Sections 49 and 66(1) of the IB Code in the zone of insolvency.

2. The Way Forward

It is crucial that India recognizes the existence of the zone of insolvency and its interplay with directors' fiduciary duties. Whether it does this by way of a

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416. Insolvency and Bankruptcy Code, No. 31 of 2016, India Code, § 66(2).

417. *Id.*

statutory amendment or by deferring to common law is something that must be left to the wisdom of the legislature. The question then is whether India should follow the approach adopted in the U.S. or that of the U.K.. The U.S. approach would involve steering clear of creditors' interests pre-insolvency, as was held in *Gheewala* and would require a continued focus on the interests of the corporate enterprise from the perspective of shareholder rights. The U.K. approach, on the other hand, by deferring to common law on this point, provides for a shift towards creditors' interests as the company enters the zone.

This Comment disagrees with the US approach at a fundamental level, as shareholders cannot be said to be the primary risk bearers of a company in the zone of insolvency. Shareholders' behavior is bound to change at the slightest hint that the insolvency of the company is imminent. A direct analogy to such behavior can be found when one looks at trading patterns in the stock market, shareholders being known to liquidate their stockholding at the very hint of bad news. It is then inapposite to contend that shareholders can be trusted to have the best interests of the company in mind, even when it has reached a financially precarious state. Protections in favor of creditors have no bearing on the incentive structure or the risk matrix in the zone and contractual protections cannot be assumed to be the norm especially given the preponderance of unprotected and vulnerable creditors in today's business scenario. This Comment disagrees with Kandestin[418] and others,[419] who are of the opinion that directors cannot, or should not, play the role of trustees/fiduciaries of creditors prior to insolvency. As proposed by Grantham, the argument for duties being owed to creditors in the zone is that it accords "the greatest protection at the time of the greatest risk."[420]

Creditors should be treated as the primary risk bearers, and the company should be run in their interests after it has entered the zone. It is true that creditors are prone to conservative decision making, and would essentially "run the corporation to the ground" with many crucial decisions exceeding their risk appetite. Thus, any model that is developed must provide enough leeway for directors to make important decisions that would enable the company to continue as a going concern. The specifics of such a model, again, are difficult to contemplate. One possible solution is that a statutory provision be included to permit directors to approach courts and attain specific sanction for such decisions and that approval be granted if such decisions are not unduly prejudicial to creditor interests. Directors would thus be accorded immunity to make such decisions without the threat of an adverse *ex post* determination by courts.

Although this model might result in inconveniences for directors, this approach would ordinarily be followed only for crucial, high-risk decisions that directors would be otherwise skeptical of taking without such approval. In any

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418. Kandestin, *supra* note 16.

419. *See* Bainbridge, *supra* note 12.

420. Ross B. Grantham, *The Judicial Extension of Directors' Duties to Creditors*, J. BUS. L. 1991, at 8.

case, the costs (both in terms of money and time) of repeatedly approaching courts would operate as a disincentive to directors, and they would refrain from doing so in order to seek approval for insignificant decisions. The hidden benefit of this model is that directors can also implicitly seek confirmation that the company has indeed entered the zone, such a determination ideally being a *sine qua non* for the maintainability of such a reference to the courts. In the alternative, given that Indian courts are rather overburdened, the Ministry of Corporate Affairs may appoint a designated officer to provide guidance on these matters, even in the form of "informal guidance" as is currently given to companies by the Securities and Exchange Board of India.[421]

This model brings about issues, like in the U.S. and the U.K., regarding a definitive and objective test for the determination of what constitutes the zone of insolvency and when a company enters the zone. The model would suffer if a plain vanilla "balance sheet" or "cash flow" test was adopted. The test should be more comprehensive and should provide for a variety of both quantitative and qualitative criteria, in order to provide greater guidance to directors. It is important that a company not be deemed to be in the zone simply due to the fact that its directors have made "a sizeable enough bet."[422] Such a test would be akin to the one established in *Brandt v. Micks* in the U.K., and would be very easily triggered without any real probability of the company actually being financially instable.[423] In this regard, India may consider the holding in *BTI 2014 LLC* to ensure that a company is not inappropriately deemed to be in the zone.[424] Further, this test must be supplemented by a *Charterbridge* like trigger in order to grant it greater objectivity.[425][426]

Although this Comment suggests that the trigger for duties in the zone of insolvency in the U.K. be modelled on the test for wrongful trading under Section 214, it does not suggest the same for India. As explained above, the threshold to initiate a CIRP against a company is too low in India. India may, however, draw from the U.K. and include the Section 214 standard as part of the various criteria on which the test is triggered.

There should also be continued applicability of the business judgment rule in the vicinity of insolvency which would in any case be incorporated to a certain extent if the *Charterbridge* principles are incorporated.[427] Further, this should also provide immunity for actions that result in a "deepening" of insolvency, as long as decisions were carried out in the best interests of the corpora-

421. Securities and Exchange Board of India (Informal Guidance) Scheme, 2003.

422. Tung, *supra* note 158, at 623.

423. Brandt v. Hicks, Muse & Co. (In re Healthco International), 208 B.R. 288, 305–07 (Bankr. D. Mass. 1997).

424. BTI 2014 LLC v. B.A.T. Industries PLC [2016] EWHC(Ch)1686(Eng.).

425. Charterbridge Corp. Ltd. v. Lloyds Bank Ltd., [1970] Ch. 62 [Charterbridge].

426. *Id.*

427. *Id.*

tion, as has been specifically clarified in the U.S.[428] Such a standard should necessarily include a "good faith" criterion (as has been the norm elsewhere). Earlier court decisions in India have already interpreted "good faith" to mean that all endeavors of directors are to be directed for the benefit of the company.[429]

On the other hand, if the U.S. position is adopted (although not being preferable), the conundrum brought about by *Gheewala* should be pre-emptively avoided by expressly providing that creditors are not to be afforded the right to initiate any claims (whether direct or derivative) prior to the commencement of actual insolvency. Under this model, directors should continue to function for the benefit of the corporate enterprise and its shareholders until and unless it goes into actual insolvency, at which point the duties would shift to the creditors.

India might also consider revisiting its wrongful trading standard (as prescribed under Section 66(2) of the IB Code). As mentioned above, the threshold applicable to the provision is too low for directors to properly account for its implications at the relevant times. Although the intent of the provision clearly seems to be to accord duties to creditors in the zone, these duties come into effect too late to offer any real protection at all. The "waiting period" between the occurrence of a default (of INR 1 lakh and upwards) and the initiation of CIRP is very short (a financial creditor being eligible to file an application as soon as the default occurs (and ordinarily after accelerating the repayment of its debt), and the NCLT being obligated to admit such an application within 14 days of its filing[430]).[431]

Although the "explanation" incorporated towards the end of the provision goes further than the U.K. provision in terms of providing clarity, it is still not clear what exactly must be done in order to minimize potential loss to creditors. As already stated, the IB Code proscribes *inter alia* preferential transactions, undervalued transactions and transactions defrauding creditors during certain "look-back periods" prior to the commencement of insolvency. Does this mean that the effect of Section 66(2) is to ensure that directors do not take any decisions that involve an element of risk? No such clarity has been provided. If a new and robust trigger test is established for insolvency, the test under Section 66(2) must also be amended to be pegged against such a test. Further, as Gabriel Moss states, such a test must not necessitate the demonstration of a "net deficiency in the asset value of the company," but should be triggered on the basis of an actual quantification of liabilities incurred after the relevant cut-off

428. Trenwick America Litigation Trust v. Ernst & Young, L.L.P., 906 A.2d 168, 218(Del. Ch. 2006).

429. Turner Morrison & Co. v. Shalimar Tar Products, (1980) 50 Comp Cas 296 (Cal).

430. This timeline has been held to be directory and not mandatory by the Supreme Court in Surendra Trading Company v. Juggilal Kamlapat Jute Mills Company Limited, AIR 2018 SC 186.

431. Section 7(4), INSOLVENCY AND BANKRUPTCY CODE (2016).

date.[432] In this regard, India may also consider adopting the German approach of according special protection to 'new' creditors that have lent money to the company after the cut-off date provided for in the test, in order to prevent circumvention of the provision. Further, as also suggested with respect to Section 214 of the U.K. Insolvency Act, creditors should be afforded the right to initiate direct actions for wrongful trading and not have to rely on the resolution professional to do so.

It is also imperative that Indian courts explicitly recognize and account for the possibility of "hindsight bias" in deciding cases pertaining to breach of fiduciary duties in the vicinity of insolvency, and especially under Section 66(2) (a right to apply under this Section only accruing to the resolution professional after the initiation of a CIRP).

V. Conclusion

It is clear that the U.S. and the U.K. have come far in their analysis of the scope and operation of fiduciary duties and their beneficiaries. Although certain broad principles apply across the board, the divergence in models has largely been a result of the difference in interpretational methodologies applied by the courts and legislatures in both jurisdictions. For instance, by giving more importance and recognition to contractual rights that are available to creditors, the decisions in *Gheewala*, *Production Resources*, and *Trenwick America* took U.S. law in a completely different direction than U.K. law in the context of the vicinity of insolvency.

It is also clear that the models in both jurisdictions are still lacking in many regards and continue to function sub-optimally. The lack of clarity on several issues has left directors flummoxed about the true nature and the beneficiaries of their fiduciary duties and when a shift in those duties triggers. It is disconcerting that two of the most developed legal systems in the world have not been able to fully address important gaps in respect of an issue that is at the forefront of corporate governance today.

The Indian legal framework in this regard is still in a nascent stage and is in desperate need of a more nuanced approach towards fiduciary duties. As of today, the Indian framework only expressly provides for fiduciary duties owed in financial solvency, and is silent on what is to happen when the company enters the zone of insolvency or finally becomes insolvent. As has always been the case, India is bound to look at more developed jurisdictions in the West for answers.

The fact that India has just recently moved to a more robust insolvency regime under the IB Code provides a ripe opportunity for it to be pro-active and to incorporate a suitable model governing fiduciary duties. Not doing so might result in grave consequences for India's business sector and the various stake-

432. Moss, *supra* note 352.

holders who depend on Indian corporations for their sustenance and financial stability. The framework as it exists today provides immense opportunity for misuse and for rogue directors to manage their companies in a manner that would benefit only themselves. As can be seen from the Western models, ambiguity in the regime governing fiduciary duties creates opportunities for abuse and allows for directors to disregard others with impunity. Prolonged litigation is not an option for the weak and vulnerable, especially in a country like India.

In order to ensure that India does not also incorporate within its model the various flaws that are native to these Western jurisdictions, these flaws must be recognized and properly accounted for in statute. The Indian model must also include a level of detail and sophistication that would prevent any misinterpretation by courts and repetition of the mistakes of the Western models. India may thus look to adopt a novel approach (the details of which have been set out in this Comment), which has been untested by the West, but has the potential to offer a truly workable model.