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Twilight in the Zone of Insolvency: Fiduciary Duty and Creditors of Troubled Companies

COMPARATIVE & INTERNATIONAL PERSPECTIVES

REID FELDMAN: Our panel will talk about comparative and international perspectives. I am going to start with a brief introduction, then I am going to call on Andreas Engert to give an explanation of some key conceptual points that are important to understanding the problem we are dealing with in the European context. Hanno Merkt is then going to give us a very rapid geographical tour of how these problems are dealt with in several jurisdictions. I am then going to ask Donna McKenzie-Skene to talk about a very interesting exercise that people in the United Kingdom have gone through considering exactly what treatment should be given to fiduciary duty—the duty of directors to people other than the shareholders—and whether that problem should be left simply to the jurisprudence or treated by stating standards in a statute. Finally, I am going to ask Pamela Huff to give an assessment of this problem from Canada, a jurisdiction that shares traits with those of us in Europe and, of course, the U.S., which we have been hearing about all day.

My introduction is set out in a slide presentation entitled "Twilight in the Zone of Insolvency—View from the EU," and consists of a whirlwind tour of some key points. The first concerns the EU legal context. On the screen is a map of the European Union. It shows that we started off with six countries in 1957, which seems like a long time ago. Several other countries joined, as shown on the screen. We now have twenty-five countries in the EU.[1]

Keep in mind that along with the EU there is a separate institution called the European Economic Area, or "EEA," to which the EU member states and three other jurisdictions belong. In those three countries, by virtue of EEA membership, many of the rules that are applicable in the EU also apply. In fact, the EEA countries are part of the free-trade zone with the EU. So there are at least twenty-five

1. At the time of the conference, there were twenty-five member states in the EU, but, as of January 21, 2007, there were twenty-seven member states.

jurisdictions—and in some cases twenty-eight—that are concerned with many of the things we are going to be talking about.[2]

EU law results from directives, regulations, and jurisprudence. The EU has a court system, headed by the European Court of Justice, which is the final arbiter of EU-law questions. Below that we have a court of first instance, which has jurisdiction over some EU law questions. However, each country still has national law, national regulations, national courts, and national jurisprudence.

This general framework of course applies to the area of company law. The next slide mentions common features of company law in EU countries, including some of the structural elements and the capital-maintenance regime, which Andreas is going to talk about. There are also lots of differences, as shown on the slide, which are beyond the scope of our talk today: employee participation, shareholders rights, board structure, disclosure, and minimum capital. I think that Andreas and Hanno will tell us something about the comparison of the countries in that respect.

Since our subject is insolvency, our next slide mentions in passing the EU insolvency regulation. It does not deal with the issues we are talking about today. It simply recognizes that there is going to be a jurisdiction in which the main insolvency proceedings will be held and that secondary proceedings will be held in other jurisdictions. I was very interested to see that a few months ago the first decision by a French court applying this regulation said that the French court is going to recognize the jurisdiction of the bankruptcy proceedings in the U.K. The court did not do what judges often are tempted to do, and that is disregard what is happening abroad and apply their own local rules. We will see what effect this regulation has; however, I do not think it is directly relevant to the issues that we have on the table today.

I have listed some of the bases on which managers of French companies can be held liable. By "managers" I mean members of the board of directors and the chief executive officers. I listed some obvious things, such as violations of law, as well as publishing accounts not giving a true and fair view of the financial situation. I am going to focus on a criminal statute that sanctions directors and other managers when they use assets or credit of a company in bad faith in a manner that is contrary to the company's interest, whether to satisfy personal interests or to favor another company in which the manager has direct or indirect interest. This statute has broad application. As applied by the jurisprudence, bad faith is always presumed. Also, the reference to companies in which the managers have direct or indirect interest includes companies in which they also serve as directors, whether or not they have any equity interest. So basically what you have here is a situation where, when a company enters into a transaction with another member of the same group, the statute is likely to apply because there is likely to be overlap of the

2. As of January 1, 2007, there were twenty-seven jurisdiction, and in some cases thirty, concerned with the issues discussed in this panel.

boards. If the transaction is not in the interest of one of the participating subsidiaries of the group, the directors may be faced with criminal sanctions.

The last item on the list is particularly relevant for our discussion today. We have had for many years a statute that permits what we call *comblement de passif* (contribution to liabilities). Very simply, when in a liquidation there is a shortfall—in other words, assets do not suffice to pay the company's debts, which almost always happens—the managers can be held liable for the shortfall if they have committed a management error. The obvious question is, "What's an error?" Well, one could say that when things do not go well that could be an error. The statute is very broad. When we talk in France about potential director liability when a company is in the zone of insolvency, this statute has always been there on the horizon.

In the application of this standard, the cases that have imposed liability are cases where the directors have acted in an egregious fashion, very often involving self-dealing. So there is a big gap between the theoretical risks for the director and the practical experience with the directors being sanctioned.

My last point relates to what in France is the perceived risk of managers' incurring sanctions. That is based first on past cases. Generally, they are not as attention-getting as cases in the U.K. or certainly in North America, particularly in the U.S. I think, however, that France probably has had more attention-getting cases than other continental European jurisdictions. I would like to hear what Hanno says about that. But in the past, business executives being counseled would be likely to say, "Well, Mr. Lawyer, I hear what you say about what is on the books, but none of my friends ever got socked with any of these sanctions. And so what are the real risks?"

One answer to that is the perceived trend as to new standards of liability. Shareholder activism is not at all as developed in France as in the U.S., but it is increasing. And perhaps there is what I call a judicial awakening—judges becoming more aware of these economic phenomena from which they have been a little bit distant for a long time. They are perhaps becoming more willing to sanction people for this kind of behavior. I think the result is going to be more prudence on the part of managers. At least the advice I give is that because "none of your friends ever got socked with this stuff" in the past few decades does not mean the sanctions will not be applied to you.

I will conclude by saying that I do not think there is any danger of France's falling down the slippery slope of what some call litigious excess. People often ask me, as an American lawyer and French lawyer, whether this American disease is going to be imported into France. I think the answer is no, because of the culture and the way the legal system works—we have no juries, for example. I do not think we are going to have an American-type system where there is almost a certainty of a lawsuit whenever things go badly, but we are going to see more prudence on the part of managers.

So with that, I am going to turn it over to Andreas.

ANDREAS ENGERT: Thank you, and Richard, thank you very much for having me here. It was a great pleasure following your discussion today. I have learned a lot about the way you in the United States think about these problems.

My sense is that American lawyers are somewhat uncomfortable with using fiduciary duties and maybe even corporation law generally for the purpose of protecting creditors. Therefore, I thought it might be interesting to look at jurisdictions that consider creditor protection an important issue in corporation law and to contrast this approach with the American one.

So, what is the European approach? When I say European approach, I mostly refer to Germany, although there is now a certain degree of coherence and commonality among the European jurisdictions. Just a few words about fiduciary duties in this context—I think Hanno Merkt is going to go into more detail on fiduciary duties, so I will be short on that topic. First of all, it is very clear for European lawyers that fiduciary duties run to the corporation, so the corporation is the beneficiary of fiduciary duties. That implies, naturally, that they serve the interests of shareholders as well as the interests of creditors.

Interestingly, under German law, there are specific fiduciary duties laid out in the statute that apply in insolvency—not the vicinity of insolvency but only in insolvency. Management is under a specific duty of care in managing the corporation's bankruptcy estate. In my view, that is an interesting parallel to the trust-fund doctrine that plays such a great role in *Production Resources Group, LLC v. NCT Group, Inc.*[3] So we have a specific duty of care in the zone of insolvency on behalf of creditors.

In addition, we have a duty to file for bankruptcy. This may sound surprising to you. It has to do with the kind of bankruptcy law we have. Germany is considered a rather creditor-friendly jurisdiction, especially compared to the U.S., which has one of the most debtor-friendly bankruptcy laws in the world. To say that German law is creditor-friendly is to say that bankruptcy very often leads to liquidation. It is therefore understandable that shareholders and directors are not very interested in obtaining "creditor protection" from bankruptcy law. They want to avoid bankruptcy as long as they can. That is why we have an affirmative duty to file for bankruptcy in insolvency. Obviously, German lawyers do not take issue with conceiving this duty as running to creditors.

An even more important aspect than fiduciary duties to creditors is that we still have a relevant system of legal capital rules in place.[4] I spent some time this summer studying American law on this, and I realized that in the United States, legal capital is quite meaningless. You can easily manipulate or get around it. That is different in Europe, based on the EU second company law directive on legal capi-

3. 863 A.2d 772 (Del. Ch. 2004).

4. *See* Andreas Engert, *Life Without Legal Capital: Lessons from American Law*, *in* LEGAL CAPITAL IN EUROPE 649–56 (Marcus Lutter ed., 2006).

tal.[5] The most relevant part of the European legal-capital regime is the notion of capital maintenance. It aims at keeping some reasonable amount of net assets in the corporation as an equity cushion for creditors. Economically, you can try to justify this as a response to an underinvestment problem: Shareholders always tend to get money out of the corporation because that is a way to increase creditor risk and benefit from increased leverage. At the same time, pulling out equity may create an increased risk incentive in conducting the business. European corporation law tries to cope with this problem using legal capital. There is a lot of debate now on whether the legal capital rules are justifiable on these grounds and whether we should stick to this system. The EU Commission is considering abolishing legal capital and moving in the direction of a U.S.-style system.[6]

In any event, the present legal capital rules still play an important role in creditor protection. One reason is that European corporation law recognizes a concept of "hidden distributions." What is a "hidden distribution?" As I understand it, in this country you would treat only dividends, stock repurchases, and redemptions as distributions in the corporation-law sense. Therefore, the American restrictions on distributions work only on those types of transactions. They do not address other transfers of value by means of a sale, a loan, or any other contract between the corporation and its shareholders that is not at arm's length. Instead, you would probably rely on fraudulent conveyance law. By contrast, these transactions raise issues of capital maintenance in Europe. That is why you find a lot of cases on legal capital in Germany but very few in the United States, as far as I can see. The concept of hidden distributions, therefore, is one major reason legal capital matters a lot in the European Union. From a functional perspective, you could think of it as a fiduciary duty of directors towards creditors: They cannot transfer assets to shareholders and thereby put creditors at risk.

So, I was saying that creditor protection is generally much more of a concern in European and German corporation law. Let us have a look at the various institutions. We have the fiduciary duties I was talking about. Then there is legal capital. We also have, at least in Germany, restrictions on the repayment of shareholder loans. In the U.S., you would probably term this "equitable subordination," which of course is a bankruptcy-law concept.[7] In Germany, it is again a matter of corporation law. We also have some veil piercing that is not as important as in the U.S. but has become more relevant recently.

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5. Second Council Directive 77/91/EEC of December 13, 1976, on coordination of safeguards in respect of the formation of public limited liability companies and the maintenance and alteration of their capital, *available at* http://europa.eu.int/comm/internal_market/company/official/index_en.htm.

6. HIGH LEVEL GROUP OF COMPANY LAW EXPERTS, A MODERN REGULATORY FRAMEWORK FOR COMPANY LAW IN EUROPE 87–88 (2002), *available at* http://ec.europa.eu/internal_market/company/docs/modern/consult_en.pdf.

7. *Cf.* David A. Skeel, Jr. & Georg Krause-Vilma, *Recharacterization and the Nonhindrance of Creditors*, 7 EUR. BUS. ORG. L. REV. 259 (2006).

Now, compare this to what the U.S. has to offer in corporation law. There might be fiduciary duties, which we have heard a lot about today, but which still do not seem very stringent to me. There are very weak limits on distributions, and very little case law on that. So this is also not really a corporation-law issue. Of course, there is veil piercing in some extreme cases. In sum, I see very little creditor protection in American corporation law. It is dealt with mainly outside corporation law, through fraudulent conveyance law—the functional equivalent to legal capital under European law—and equitable subordination. Then, of course, in the U.S. you strongly emphasize contractual self-protection by creditors, which we have heard so much about again today.

I think one reason you are so confident about leaving creditors to protect themselves is that weak creditors in the U.S. seem to be better protected than they are in Germany. For instance, employee pensions in Germany are just unsecured claims against the corporation. As such, they amount to a sizeable percentage of the total liabilities of German corporations. So there you have creditors that certainly do not bargain for covenants or anything of the sort. They are not well protected at all, whereas in the U.S., they are entitled to a separate pool of assets that is held in trust for them to cover those claims. So you are certainly right to be a lot less concerned about them than we are.

The differences in bankruptcy law also matter a lot. As I said, U.S. bankruptcy law is much more reorganization-oriented. To me, bankruptcy in the U.S. seems like simply a means of refinancing the corporation—an accident perhaps, but not a lethal one. It is something that might happen to any corporation, something that a firm goes through and then re-emerges. That rarely happens in Germany. Under German law, bankruptcy still very often leads to liquidation, which explains why we are very anxious to avoid bankruptcy.

To sum up, it is a bit of a stylized distinction, but I think it is fair to say that in Europe we follow a "corporation law" approach and in the U.S. you have a "bankruptcy law" approach to protecting creditors.

One last word on the ultimate goal that any jurisdiction should pursue. I completely agree with what Alan Schwartz said about this. It seems very clear to me that on the level of the law, overall efficiency and social welfare must be the goals. There is a second question as to what role fiduciary duties and corporation law generally ought to play within this framework. On that level, shareholder-wealth maximization may be the right answer. But it can only be a means to an end, a means to enhancing overall efficiency. Whether we should reserve fiduciary duties to shareholders depends on the legal environment which is, as I have tried to show, quite different in Germany and Europe from what it is here in the United States. Thank you.

Simone Sepe: I feel that the European rules on corporate law are perfectly consistent with the European rate of growth, which is almost negative. Second, in Germany, there are two important economic issues. The first is that firms are owned

by traditional investors, and traditional investors are banks, essentially. There's a strong distribution of ownership toward banks in Germany. And Germany—like Italy, to some extent Spain, and maybe also France—is a bank-based country. Firms, when they want to get capital, go to banks. In the worst-case scenario, they try to get money. In Germany you have strange corporate goals and a system that provides another body, which in English is probably called a supervisory board, which is on top of the board of directors. In a supervisory board there are directors who are appointed by creditors—that is, by banks which have investment both as creditors and as equity holders in firms. For these reasons, there is not an important legal issue about fiduciary duties toward creditors because the representatives of creditors are on the boards. Can you confirm that or no?

ANDREAS ENGERT: I think it used to be quite right that banks had such a strong influence, but that has changed a lot in recent years. I would not say it is true anymore. Besides, the rules on capital maintenance do not really favor banks. Banks do not need them at all. So I do not think that has much to do with creditor-protection law. In my view, that body of the law is really about protecting small creditors, like the employees I have been talking about.

REID FELDMAN: Let me add that these generalizations, I think, are very useful, but not necessarily for this issue. Generalizations dealing with what is the basis of the capitalism system in certain countries—for example, bank shareholdings in Germany—are clichés which may ring true to a large extent, but not for these bankruptcy questions. The same questions as to possible director liability arise regardless of who the shareholders are.

SIMONE SEPE: Yes, I know, but there are data stating that more than seventy percent of capital in continental European countries is provided by institutional investors. It is not a generalization; it is a fact. There is 2002 research by Bacca and other German scholars about the distribution of property and how firms mixed capital in Europe.

REID FELDMAN: Right, and Andreas mentioned the EU Commission, which is an executive branch of the EU. They are thinking about company-law reform precisely to try to correct this problem of very slow growth. One of the things they see as a problem is that the market for companies is not sufficiently active. They find that the structure of corporate control is dysfunctional for exactly this reason. A lot of the corporate reforms that come out of the EU Commission are intended to try to correct this problem.

Just to finish up before I turn it over to you, Hanno, Andreas mentioned the reorganization-based approach to bankruptcy in the U.S., as opposed to the liquidation approach. In France, the large majority of reorganization or bankruptcy proceedings end up in liquidation. In France, we have a number of kinds of bankruptcy procedures, including a procedure called reorganization, which is not designed primarily to protect creditors. It is designed primarily to protect jobs, and is not at all creditor-friendly. The new law, which I mentioned, has created a so-called

Chapter 11-type procedure in France designed to be more like the U.S. law. It gives companies a better chance, they think, to survive the process and come out and therefore preserve jobs, lessening harm to growth rates and so forth. I would submit that there is a limited extent to which legislatures can, by tinkering with these things, really affect economic phenomena. The approach, at least in France, is very much, "We've got the slow-growth problem; let us try to solve it by changing the bankruptcy law and so forth," whereas the structural factors are, I think, more important.

We may be getting a little far afield. Maybe I can turn it over to you, Hanno, and you can answer the question and pick up with your presentation.

HANNO MERKT: First, let me briefly address the point that Mr. Sepe made previously. When we talk about creditor interference with the internal affairs of the corporation, we should look at the figures. In Germany, we have about 800,000 closed corporations, just about 8,000 stock corporations, and an even smaller number of stock corporations with a situation like the one you described. In that comparably small group of stock corporations, you might see large influential creditors, usually banks, that are shareholders and creditors at once and, thus, find themselves in a position to interfere with corporate internal affairs. In the overwhelming majority of corporations, however, there is no such interference.

Please note another important difference between European and U.S. law that might tip the scale in our direction when it comes to doubtful creditor interference: unlike U.S. law, Continental law, and in particular German law, does protect creditors by statutory capital-maintenance requirements. We do not make use of contractual substitutes like credit covenants that permit creditors to interfere with corporate internal affairs in order to keep a corporation on track, with a whole bunch of different rights and options to step in and, in fact, take management over. Given that financial-covenant practice, I would estimate that bank creditors in the U.S. have much more clout in corporate affairs than on the Continent.

I now turn to what I was invited for. Thanks for the floor, and thanks for the invitation. Seen from a comparative perspective, many countries make use of fiduciary standards in order to protect corporate creditors. While these standards are variously labelled (for example, as *Treuepflichtverletzung, faute de gestion*, wrongful trading, etc.), they all impose a species of fiduciary duty on a corporation's managers on behalf of its creditors. More particularly, these duties divide into four categories according to whom they target: (i) the company's officers and directors; (ii) its outside auditors; (iii) its controlling shareholders, particularly if they play an active role in management; and (iv) the corporation's "favored" creditors, who have been preferred by the company at the expense of other creditors. For the purpose of comparison, all of these duties can be treated as belonging to corporate law, even though in some jurisdictions they are formally attached to company laws. In other jurisdictions, however, they are attached to insolvency law. In either case, they may be reinforced by complementary elements of tort law or criminal law. Among com-

mon-law jurisdictions, e.g., the United Kingdom, standards mainly result from insolvency law, whereas American law combines corporate and insolvency laws. In civil-law jurisdictions, creditor-protection standards tend to be provided mainly by corporate law.

Jurisdictions impose a risk of personal liability on corporate directors in certain circumstances, notably when a corporation is insolvent or close to it and the risk of shareholder opportunism is large, although the breadth of these duties varies considerably. At the narrow end of the spectrum, the United Kingdom imposes a limited duty on directors not to engage in "wrongful trading" when a director knew or should have known that the corporation was insolvent.[8] Similarly, U.S. case law suggests that the fiduciary duties of loyalty run to the creditors, rather than the shareholders,[9] and U.S. statutory law in many states explicitly permits boards to consider the interests of nonshareholder constituencies when making major corporate decisions.[10] Thus, even in the debtor-friendly U.S. jurisdictions, directors appear to owe a fiduciary duty to creditors when the corporation enters the "zone of insolvency."[11] At the broad end of the spectrum, Dutch statutory law protects corporate employees by permitting unions to petition the courts to investigate the conduct of the corporations' directors and managers.[12] Japanese law holds directors liable to third parties if they act in bad faith or are grossly negligent in managing the corporation.[13] Similar duties to third parties theoretically arise under French Law;[14] however, French courts virtually never impose liability on directors on behalf of third parties as long as the company is solvent.[15] Finally, German Law for public corporations mandates that management boards establish risk-management systems for the identification and containment of developments that might threaten the survival of the company.[16] This intriguingly specific provision appears designed to ensure that the risk preferences of all corporate constituencies, and

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8. Insolvency Act, 1986, c. 45, § 214 (Eng.).

9. *See, e.g.*, W. World Funding, Inc. v. Buchanan, 52 B.R. 734, 762–63 (Bankr. D. Nev. 1985); JTS Corp v. Mitchell, 305 B.R. 529, 536–40 (Bankr. N. D. Cal. 2003).

10. *See, e.g.*, OR. REV. STAT. § 60.357 (2006); MASS. ANN. LAWS. Ch. 156B, § 65 (2006); OHIO REV. CODE. ANN. § 1701.59 (2006); N.Y. BUS. CORP. § 717 (2006); FLA. STAT. ANN. 607.0830 (2006).

11. *See* Credit Lyonnais Bank Nederland v. Pathe Commc'ns Corp., Civ. A. No. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991); Geyer v. Ingersoll Publ'n Co., 621 A.2d 784, 787 (Del. Ch. 1992); Comm. of Unsecured Creditors v. Reliance Capital Group, Inc. *(In re Buckhead America Corp.)*, 178 B.R. 956, 968 (D. Del. 1994); Jewel Recovery, L.P. v. Gordon, 196 B.R. 348, 355 (N.D. Tex. 1996); Weaver v. Kellogg, 216 B.R. 563, 583–84 (S.D. Tex. 1997); Askanase v. Fatjo, Civ. A. No. H-91-3140, 1993 WL 208440, at *5 (S.D. Tex. Apr. 22, 1993).

12. *See* Art. 346 Dutch Civil Code.

13. *See* Art. 266-3 Japanese Commercial Code (as amended in 2001).

14. *See* Art. L. 223-22 Code de Commerce (France).

15. *See* Maurice Cozian & Alain Viandier & Florence Deboissy, Droit des sociétés, 19th ed (Litec 2006), no. 368.

16. *See* § 91 subsection 2 Aktiengesetz.

especially employees, are reflected in corporate decision making at the level of the management board.[17]

This does not mean, however, that creditors can generally take legal action against directors before the corporation has filed for insolvency. The law of most jurisdictions, apart from Germany[18] and Japan,[19] denies creditors standing to sue the directors of a solvent corporation. Other jurisdictions limit standing to those creditors that have been directly and individually harmed by directors. French law makes an exception for bondholders by recognizing their shareholderlike standing to sue the board before a corporation's insolvency.[20] In any case, creditors would have a much easier case against a solvent company itself than against one or more of its directors.

Our major jurisdictions employ a broadly similar approach to framing the liability of board members. Directors, including *de facto* or shadow directors, may be held personally liable for damages to creditors resulting from the board's gross negligence or narrow pursuit of shareholder interests when the corporation is insolvent or nearly so.[21] The extent to which such personal liability provides significant protection for creditors varies with the circumstances. To give an example: Directors of smaller firms are often principals, who are likely to lose their personal and business assets simultaneously. Large firms, however, frequently purchase liability insurance for their board members, which protects directors while it can also compensate injured creditors. In some jurisdictions, like Delaware[22] or the United Kingdom,[23] director and officer liability insurance is explicitly authorized by statute.

In addition, a variety of legal doctrines limit the personal liability of directors. In the United States, most states permit corporations to eliminate directorial liability for negligence or gross negligence by charter provision, and most of the corporations avail themselves of this opportunity by eliminating liability or providing for indemnification. In fact, optional exclusion of personal manager liability in the course of the last decades became a most influential element of the famous state competition for corporate charters.[24] As a result, the personal liability of directors is limited to occasions in which they engage in self-dealing or otherwise act in bad

17. The exact scope of this provision, however, remains unclear and disputed, *see, e.g.*, UWE HÜFFER, AKTG-KOMMENTAR § 91 no. 5 (Beck 6th ed. 2004).

18. *See* § 93 subsection 5 Aktiengesetz.

19. *See* Art. 266-3 Japanese Commercial Code; J. MARC RAMSEIER & MINORU NAKAZATO, JAPANESE LAW: AN ECONOMIC APPROACH 119 et seq. (University of Chicago Press 1999).

20. See Art. L. 228-54 Code de Commerce (France).

21. *See* Insolvency Act, 1986, c. 45, § 214 (Eng.).

22. DEL. CODE ANN. tit. 8, § 145(a)(2001).

23. Companies Act, 1985, c. 6, § 310 (Eng.).

24. *See, e.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7)(2001). For an overview over the dissemination of such provisions, *see* William J. Carney, *The Production of Corporate Law*, 71 S. CAL. L. REV. 715, 753 (1998).

faith. To the extent it focuses on corporate fraud, the Sarbanes-Oxley Act[25] seems unlikely to affect such limitation, according to some commentators.[26]

Other scholars argue that liability limitations do not prevent fiduciary duties from influencing directors' behavior because they express socials norms; however, with Enron, WorldCom, Parmalat, and other spectacular cases of gross directorial misconduct worldwide having driven the risk of liability to yet-unknown levels, director and officer liability insurance seems, at least in parts, unmanageable for insurance companies and unaffordable for corporate employers. While those restrictions on personal director liability are primarily aimed at constraining abusive shareholder litigation, they also affect the claims a corporation can make post-insolvency and thereby indirectly reduce creditor protection. Compare the situation in Japan, where increased shareholder litigation also prompted a new rule to limit director liability, but left creditors' rights unaffected.[27]

Other jurisdictions like France[28] and Germany,[29] by contrast, hold directors who act negligently on the brink of insolvency personally liable to creditors. As far as the United Kingdom is concerned, this approach is a rather recent one, embodied in the provision on directors' wrongful trading.[30] In particular, French and German directors become negligent *per se* by failing to observe capital-maintenance rules. This liability is less far-reaching, however, than it might seem.

First, it is not easy to show that a board failed to act—for example, to call a shareholder meeting or file for insolvency—at the precise point when the company lost half, respectively all of its legal capital. This point depends, *inter alia*, on whether the board uses going-concern or liquidation value.[31] It is surprising to see that on that issue the debate in the United States and in Germany follows pretty much the same lines.[32] Some U.S. and German courts have held that the proper standard of valuation to be applied in determining solvency in a bankruptcy setting is the value of the business as a going concern, not the liquidation value of its assets.[33] Liquidation value is appropriate; however, if at the time in question, the business is so close to shutting its doors that a going-concern standard is unreasonable.[34] One U.S. court has stated that the term "vicinity of insolvency" refers to the "extent of the risk that creditors will not be paid, rather than balance sheet insol-

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25. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified at 15 U.S.C. 7201).

26. Larry E. Ribstein, *Market v. Regulatory Responses to Corporate Fraud: A Critique of the Sarbanes-Oxley Act of 2002*, 28 J. CORP. L. 135 (2002).

27. *See* Art. 266 (7) – (23) Japanese Commercial Code (as amended in 2001).

28. *See* Art. L. 223-22 (SARL) and 225-251 (SA) Code de Commerce; Art. L. 624-3 (action en comblement du passif); L. 624-5 (action en extension de redressement ou de liquidation judicaire).

29. See § 43 GmbH-Gesetz; §§ 93, 116 Aktiengesetz.

30. Insolvency Act, 1986, c. 45, § 214 (Eng.).

31. *See, e.g.*, KARSTEN SCHMIDT, GESELLSCHAFTSRECHT 322 et seq. (Heymanns 4th ed. 2000).

32. For German cases, see MATHIAS HABERSACK, GROSSKOMMENTAR ZUM AKTIENGESETZ § 92 no. 36–45 (De Gruyter 4th ed. 1999).

33. Askanase v. Fatjo, Civ. A. No. H-91-3140, 1993 WL 208440, at *5 (S.D. Tex. Apr. 22, 1993).

34. *Id.*

vency."[35] According to Section 101 of the United States Bankruptcy Code, "insolvent" with respect to a corporation means a financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation.[36] Finally, under the balance sheet test, a corporation is insolvent if its liabilities exceed its assets and the firm is unable to pay debts as they became due in the ordinary course of business. This test has been applied by U.S. courts that require factoring in the value of the business as a going concern, as well as by the German legislature, which introduced it in section 17, subsection 2, of the Insolvency Law. In practice, alternative-valuation methodologies often give directors a one- to two-year window to act without violating their duty to creditors. At the same time, methods to detect near-insolvency based on firms' financial accounts are steadily improved and refined.[37]

Second, even if directors do violate their duty, establishing that they caused a creditor's damage usually turns out to be very difficult. This is especially the case in jurisdictions like Switzerland, where it is recognized that the duty of care and, in particular, the applicable standard of care may vary among several directors of a single corporation.[38] In Japan, for instance, creditors have standing to sue directors even before a corporation becomes insolvent,[39] but no director of a large Japanese public corporation has ever been held liable under this provision. It is, however, frequently litigated in the case of closely held corporations. In addition, the Japanese Supreme Court has developed a "director's duty to monitor" doctrine, under which nonexecutive directors are held liable to creditors when they grossly failed to monitor misbehaving managers. In Germany, empirical data show the opposite direction: according to the cases litigated, the risk of being held liable is considerably higher for directors of large publicly traded corporations than for directors of closely held companies.[40] A possible explanation would be that close-corporation cases are more likely to be settled out of court for lack of public interest.

Third, creditors cannot recover if the board's violation of duty did not increase their consolidated damages, or if they knowingly assumed the risk of dealing with an insolvent corporation.[41] In fact, under German law, the burden to prove a conditional link between the managerial misbehavior and the actual amount of damages suffered turns out to be the major obstacle for creditors in litigating such

35. Steinberg v. Kendig *(In re Ben Franklin Retail Stores)*, 225 B.R. 646, 655 n.14 (Bankr. N.D. Ill. 1998), *aff'd in part, rev'd in part on other grounds*, No. 97C6043, 1999 U.S. Dist. LEXIS 16645 (N.D. Ill. Oct. 25, 1999).

36. 11 U.S.C. § 101 (2006).

37. *See* JOCHEN DRUKARCZYK & TANJA BRÜCHNER, INSOLVENZRECHTSHANDBUCH 27 (Beck 2nd ed. 2001).

38. *See* PETER BÖCKLI, SCHWEIZER AKTIENRECHT 1092 et seq. (Schulthess 3rd ed. 2004).

39. *See* Art. 266-3 Japanese Commercial Code (as amended in 2001).

40. *See* KLAUS J. HOPT, GROSSKOMMENTAR ZUM AKTIENGESETZ § 93 no. 16 (Berlin 4th ed. 1999).

41. *See, e.g.*, Alon Chaver & Jesse M. Fried, *Managers' Fiduciary Duty Upon the Firm's Insolvency: Accounting for Performance Creditors*, 55 VAND. L. REV. 1813 (2002); Steven L. Schwarcz, *Rethinking a Corporation's Obligations to Creditors*, 17 CARDOZO L. REV. 647, 667–68 (1996); Laura Lin, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors Duties to Creditors*, 46 VAND. L. REV. 1485, 1491 (1993); for England, *see* § 214 Insolvency Act (Eng.).

cases. It is presumed that many clear-cut cases of violation of managerial-trust obligations are not taken to court because potential plaintiffs face serious problems in ascertaining the damages attributable to the relevant violations.

Fourth, the quality of creditor protection by holding directors personally liable depends considerably on whether and to what extent the shareholders may dispose of any damage claims. While some jurisdictions, like Germany and France, are rather creditor-friendly and do not give the shareholders a right to waive or settle damages claims to the detriment of the corporation's creditors, other jurisdictions, like the Netherlands[42] and Italy[43] give the shareholder assembly a limited right to dispose of such claims.

Hence, it is mainly the United Kingdom that imposes a somewhat stricter duty on directors to attend to creditor interests in the vicinity of corporate insolvency, compared to other jurisdictions, including the United States. At the same time, the United Kingdom has recently increased enforcement of the Company Directors Disqualification Act of 1986,[44] which allows courts to disqualify directors of insolvent companies who have proved themselves to be unfit for future management activities, whether these parties are actual directors, *de facto* directors, or shadow directors.[45] This standard apparently includes disqualification for failing to attend to accounting matters or engaging in reckless conduct.[46] When considering the issue of unfitness, courts are required to take into account any misfeasance or breach of any fiduciary or other duty. The number of unfit directors disqualified increased steadily over the last decade, reaching almost 1,600 in 2001.[47] Courts have typically disqualified directors for setting up undercapitalized companies, attempting to trade on the back of their creditors, or showing incompetence or negligence to a very marked degree. Moreover, the available evidence indicates a relatively small number of wrongful trading petitions, especially compared to disqualification proceedings. Thus, some commentators suggest that disqualification may be a more effective remedy than liability, although the disqualification action has yet to achieve any real traction in continental Europe. France, for instance, has similar disqualification provisions,[48] but they are not enforced. Even in the United Kingdom, scholars articulated doubts about the effect of disqualification provisions,[49] but this has not prevented the remedy from being considered to be a candidate for European harmonization.

42. *See* Tim Drygala, *Directors Liability in the Member States of the European Union*, in: Marcus Lutter (ed.), Legal Capital in Europe (De Gruyter 2006), 232, 243.

43. *See* Art. 2393 VI Codice Civile (Italy).

44. Company Directors Disqualification Act, 1986, c. 46 (Eng.).

45. *Id.* at §§ 6–9.

46. *See id.*

47. *See* The Insolvency Service Executive Agency, Company Director Disqualification—A Follow Up Report (1999); Insolvency Services, Annual Report and Account 2000-2001, 17 (2001).

48. *See* L. 625-8 Code de commerce (France).

49. VANESSA FINCH, CORPORATE INSOLVENCY LAW: PERSPECTIVES AND PRINCIPLES 536 (Cambridge Press 2002).

DONNA MCKENZIE-SKENE: I will speak to this audience on the subject of fiduciary duty to creditors, if such a duty does in fact exist. It seems to be well established in Britain, built on commonwealth authority.

I started out in my paper by identifying uncertainties, many of which have been mentioned in the context of the debate of the provisions. So as to the question of whether it is a direct or an indirect duty in Britain, mainly the authorities regard it as an indirect duty that is owed to the corporation. Which creditors do or should benefit from the duty? Again, there is not been a lot of guidance on that. Some recent authority has given more guidance, but it is still very incomplete.

There have been issues as to the extent to which the creditor interest should be considered when insolvency arises. Some case law suggests an exclusive consideration that equates with the subordination that we talked about earlier. Some suggest that you can continue to consider those interests along with other interests such as shareholders, employees, and so on. The issue of whether the director's duty is to be assessed subjectively or objectively according to the case law is simply unclear.

Then there is the issue of when the duty arises. In my paper, I developed those points and made some evaluations as to the extent of the duty as well as drew some conclusions. So there are problems with defining the point at which the duty arises, defining the concept of insolvency, perhaps the difficulties of factually identifying when it is reached and whether the knowledge of insolvency on the part of the directors should be tested subjectively or objectively. In all of these situations, the duty according to case law is still unclear.

It is against that background that we had the Company Law Review, which considered, among other things, the duty in some detail. The Company Law Review was set up in 1998 to consider reform of core company law, and it included consideration of directors' duties where the company is insolvent. Directors' duties as a whole were a major part of what the Company Law Review considered. The Law Commission and the Scottish Law Commission had jointly considered reform of certain aspects of directors' duties, particularly conflict of interests, and proposed a statutory statement of directors' duties, but the Company Law Review was to take a much greater look at the idea of directors' duties and to whom these duties should run.

Initially, the Company Law Review acknowledged an overriding duty to creditors in certain circumstances, including the director's fiduciary duty in the zone of insolvency as well as the duties (like wrongful trading) that arose on insolvency itself, but initially it did not really consider the matter any further. It did not make any recommendations as to what would happen to that fiduciary duty, and neither did the Law Commissions when they reported and recommended a partial codification of directors' duties. They had recognized, as had the Company Law Review, the existence of the duty, but they did not propose to do anything about it in their Report.

As the Company Law Review progressed, however, we saw various changes in attitude. In the next consultation paper that was issued, they did consider whether a specific duty equivalent to the existing common-law fiduciary duty to creditors should be included in the statutory statement of directors' duties. They specifically rejected it for reasons that seemed to have as much to do with rejection of the existence of such a duty as the idea of trying to embody it in the statute. I think that is important, and I will come back to it.

In the next paper, however, they said that they were going to retain the duty, even though they were rejecting putting it in a statutory format. Nonetheless, they also suggested that the statutory statement should contain a reference to the existence of this duty, otherwise that statement would not be a complete picture of all of the directors' duties.

The fifth and final report came out in 2001, and we had not one, but two provisions in the draft statement of duties concerned with the directors' duties to creditors. Now, the first of those basically repeated the insolvency law position on wrongful trading as Hanno just mentioned. The other provision was based on a version of the common-law duty to creditors. The critical thing, however, is that the Company Law Review members were split about the inclusion of that second duty based on the common-law duty to creditors, and perhaps given all of the things we heard today, that is not very surprising. Those who wanted it, however, included in the draft statement of duties a draft of such a provision.

Of course, one might take issue with the terms of that draft, which are included in my paper, but the one thing the draft did do, I suppose, was to give us certainty on a lot of the issues, which had up until that point been uncertain. It confirmed that the duty was owed to the company. It confirmed the point at which it arose—namely, where it was more likely than not that the company would at some point become insolvent. And it defined insolvency. It said that the test for assessing when the duty arises is objective, but the test for assessing compliance was subjective to give some protection to directors—equivalent, if you like, with the business judgment rule. It said the creditor interests should continue to be considered alongside other interests, but it did not give any further guidance on the creditor's duties. As I said, one may take issue with that, but at least it solved some of the problems of uncertainty.

Nonetheless, in its paper that followed the Company Law Review Report in 2002, the government rejected both provisions. I think it was right to reject the provision based on the wrongful-trading provision that already existed on insolvency. There was no point in repeating it in that context.

I am not so sure that it was right to reject the other provision. The government has made it clear that it is going to retain the common law and provide in the statutory statement of duties a warning that this common-law duty applies. If we are going to be stuck with the duty, then in my view, you would be better to have some statutory formulation of that duty that is slightly more certain than we have

at the moment, to allow directors and others to be more fully and confidently advised as to what exactly their duties ought to be. Now, I know that the way the common law has developed, we are given flexibility, but that flexibility, of course, comes at a cost. Arguably, we are being advised in the statutory statement that we have a duty, but we do not know quite what it does and we have to wait for a court to try to clarify that for us.

So do we need it at all? I will say that we have to try to put it in the context of the other provisions—the wrongful-trading provision, which applies where insolvency is inevitable, and a fraudulent-trading provision, a misfeasance provision, and provisions for reducing prior transactions, all of which apply only on insolvency. This duty arises at an earlier stage and so could provide a remedy where the other remedies do not apply.

We also have disqualification. It is arguable that disqualification, if one looks at the cases, has actually developed this duty to a much greater extent than the cases that are based directly on it have done. They have picked up on the idea of trading with knowledge of insolvency, which is the formula the courts normally use in this context, where there is no reasonable prospect that creditors will get paid. That is important because it is an objective test. They have said that doing that, i.e., trading with knowledge of insolvency, can amount to unfitness, which will result in disqualification. That clearly does not result in any money for the creditors, which is why disqualification is different from the other remedies that we are talking about, but it does, to a certain extent, reflect, if you like, what creditors can expect to receive.

Directors are looking not only at the specter of personal liability, but at the specter of disqualification, which could prevent them from earning a living without personal liability. That might be as big a deterrent against ignoring creditors' interests in the zone of insolvency as personal liability for breach of the fiduciary duty.

PAMELA HUFF: As the last speaker of the panel and the last speaker of the day, I have the pleasure of bringing the discussion back to North America, not back to the U.S., but back to Canada.

Russell Silberglied and I coauthored a paper comparing the remarkable similarities of statements made by Vice Chancellor Strine in *Production Resources*[50] to the Supreme Court of Canada in the *People v. Wise*[51] case. The decisions were released within about one month of each other. I have learned two new acronyms today, the DDC doctrine and the IFDC, both of which I am going to take back to Canada to infiltrate in our legal journals.

Now it is my job to give you a brief overview of the DDC doctrine in the common-law jurisdiction of Canada. I can speak with some clarity on this, since the Supreme Court of Canada has just considered it. Russell said at the outset that

50. Prod. Res. Group, LLC. v. NCT Group, Inc., 863 A. 2d 772 (2004).

51. Peoples Dep't Stores, Inc. v. Wise, [2004] S.C.R. 461, 484–85.

some commentators think that Vice Chancellor Strine blew it by not doing away with fiduciary duties of directors to the creditors. Those commentators would like the Supreme Court of Canada because it did do away with the fiduciary duty to creditors on the theory that there was no gap to fill, there was no need for this additional remedy. The Supreme Court of Canada decision followed a series of lower-court decisions in Canada that were flirting with the concept of director duties' shifting to creditors on the eve of insolvency.

There was no clear or reliable statement. There was some obiter on it, but now we do have the final statement of the Supreme Court of Canada on the issues. In order to understand what the Supreme Court of Canada was doing, you need to understand, at least briefly, the legal framework in Canada, which has some remarkable differences to its counterpart in the United States.

In the mid-1970s, we embarked on a complete rewrite of the Canada Business Corporations Act,[52] which governs Federal companies, and was also followed by various provinces in their business corporations acts. In the provincial business corporations and Canada Business Corporations Acts, the preexisting common-law duties of care of directors to corporations were codified by statutes. So what is now section 122 of the Canada Business Corporations Act says that directors have two duties.[53] First is a duty to "act honestly and in good faith with a view to the best interests of the corporation"—what is called the statutory fiduciary duty. Second is the duty to "exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances"—what is called the duty of care.[54]

These codified duties of directors were supplemented by something that we have in Canada that I have not heard of in any of the other jurisdictions represented, and that is our oppression remedy. Under the CBCA (the Canada Business Corporations Act) and similar statutes in the provinces, a complainant can apply to the court for an order if the powers of the directors of the corporation have been exercised in a manner that is oppressive or unfairly prejudicial to or that unfairly disregards the interests of any security holder, creditors, director or officers, and the Court may make an order to reconcile the matters complained of.[55]

The Court has extremely broad powers. It can issue an injunction, it can appoint a receiver to take over the business, it can order the liquidation of the company, or it can issue orders for compensation. A complainant is broadly defined as a security holder or a former security holder, a director and officer or a former director and officer, certain government administrators, or "any other person who, in the discretion of the court, is a proper person to make an application."[56] The case law has

52. Canada Business Corporations Act, R.S.C. 1985, ch. C-44 § 122(1).

53. *Id.* at § 122.

54. *Id.*

55. *Id.* at § 241.

56. *Id.* at § 238.

said that such complainant can be a creditor.[57] So a creditor has direct action in Canada against a director. It raises the question, if the director has acted in a manner that is oppressive or unfairly prejudicial to or unfairly disregards the interests of that creditor, then it can get extraordinary relief, if it is able to establish that.

So, in addition to the statutory duties of directors to the corporation, the statutory fiduciary duty to the corporation and the duty of care in carrying out the duties, there is a whole panoply of creditor remedies in Canada, just as in the U.S., for the fraudulent transfers and the other types of creditor legislation, creditor remedies. There is also this oppression remedy in our corporate statutes.

The Supreme Court of Canada noted in the *People's Department Store* case, the particular Canadian corporate-law landscape, and it said:

> *The Canadian legal landscape with respect to stakeholders is unique. Creditors are only one set of stakeholders, but their interests are protected in a number of ways. Some are specific, as in the case of amalgamation . . . Others cover a broad range of situations. The oppression remedy . . . and the similar provisions of provincial legislation regarding corporations grant the broadest rights to creditors of any common law jurisdiction . . . The fact that creditors' interests increase in relevancy as a corporation's finances deteriorate is apt to be relevant to . . . the exercise of discretion by a court in granting standing to a party as a 'complainant' under . . . the CBCA as a 'proper person' . . .*[58]

This applies in bringing either a derivative action in the name of the corporation—the same remedies as are available in the United States—or to bring an oppression remedy, which I just described to you.

After setting out the Canadian legal framework, which is unique in providing the most available remedies to creditors who are faced with insolvency of the corporation, the court then considered the two specific duties set out in the Business Corporations Act. The first is the fiduciary duty to act honestly and in good faith, in the best interest of the corporation. The court held that it was also described as a duty of loyalty, incorporating American terminology.

The Supreme Court of Canada described such duty of loyalty or the statutory fiduciary duty as one to maximize the value of the corporation:

> *Insofar as the statutory fiduciary duty is concerned, it is clear that the phrase, 'the best interests of the corporation,' should be read not simply as 'the best interests of the shareholders.' From an economic perspective, the 'best interests of the corporation' means the maximization of the value of the corporation.*[59]

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57. *See, e.g.*, Levy-Russell Ltd. v. Shieldings Inc., [1998] 165 D.L. R. (4th) 183, 191–92 (Can.).
58. Peoples Dep't Stores, Inc. v. Wise, [2004] S.C.R. 461, 484–85.
59. *Id.* at 497.

We've heard different views on maximization of value of the corporation and the directors' responsibility to do that over the course of the day.

The court was specific. It said that the interests of the corporation to which the directors owe their duties are not to be confused with the interests of the creditors or those of any other stakeholder, although those interests, creditors, employees, the environment, shareholders, government—all of those interests fall within the consideration of the directors in seeking to maximize the value of the corporation.[60] The court elaborated on what that meant and also suggested that the director duties could be described as seeking a better corporation—maximizing the value and seeking a better corporation was how to describe the exercise of their duties.[61]

So unlike the Delaware Court, the Supreme Court of Canada stated specifically that the statutory fiduciary duty is not extended to creditors, although creditors are within the scope of interests, but that the directors must consider how to maximize the value of the corporation.[62] Like the Delaware court and using very similar language, the Supreme Court of Canada dismissed the concept of any shifting duties when a corporation is in the vicinity of insolvency.[63] It recognized that throughout the corporation's existence, there will be various shifts in interests that naturally occur as a corporation's fortunes rise and fall, but that does not alter in any way the fiduciary duty of the directors to the corporation.[64]

The court was quite strong on this, as Russell alluded to this morning. He said they were all over the shifting duties in the vicinity of insolvency. This is what they said:

> *The directors' fiduciary duty does not change when a corporation is in the nebulous "vicinity of insolvency". That phrase has not been defined; moreover, it is incapable of definition and has no legal meaning. What it is obviously intended to convey is a deterioration in the corporation's financial stability. In assessing the actions of directors it is evident that any honest and good faith attempt to redress the corporation's financial problems will, if successful, both retain value for shareholders and improve the position of creditors. If unsuccessful, it will not qualify as a breach of duty set out in 122(1)(a) of the CBCA.*[65]

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60. *Id.* at 499.
61. *Id.* at 501.
62. *Id.* at 499, 504.
63. *Id.* at 500.
64. *Id.* at 499.
65. *Id.* at 505–06.

That is what the Supreme Court of Canada has said, which certainly does advise the directors on what they have to consider when faced with an insolvency of the business.

Vice Chancellor Strine held in *Production Resources* that the fiduciary duty of directors should not be used to fill gaps that do not exist.[66] That was the very similar issue that was addressed by the Supreme Court of Canada. It found no gap to fill as a result of the existing remedies that were available for stakeholders of an insolvent business and for creditors in particular. It said: "In light of the availability of both the oppression remedy and of an action based on the duty of care"—which they discussed further—"stakeholders have viable remedies at their disposal. There is no need to read the interests of creditors into the statutory fiduciary duty."[67] Moreover, in the circumstances of this case, a breach wasn't committed in any event. So, the court held that the statutory fiduciary duty of directors to act in the best interests of the corporation was owed to the corporation, and not to creditors in particular.

It then went on to talk about the business judgment rule and the defense of the business judgment rule in terms that were very similar to what has been discussed over the course of the day. The court then turned to duty of care and said that, yes, the duty of care would be available to creditors.[68] But reading their decision carefully, that is clearly intended to only be available as a derivative claim.

It is only in Quebec, which is a civil-law jurisdiction, where there is a specific civil-law provision that says that an individual can sue on the breach of a statute, that the Supreme Court of Canada has said that creditors can sue the directors on the duty of care directly, but in the rest of the common-law provinces in Canada,[69] we just do not have that same provision. It is clear that the Court was not going to the extent of a direct remedy by saying that the duty of care that directors have also extends to creditors. That does give rise to a derivative action if that duty is allegedly breached, but does not give the creditors a direct action against the directors.

So the reason Russell and I wrote this paper together was to flag the remarkable similarities in how the court in Delaware and the Supreme Court of Canada looked at these issues and how the Supreme Court of Canada came to a different conclusion on the fiduciary duties. One might say that is because of the different legal framework in Canada, but you will have noted from the few quotes that I read that the court was pretty clear—not much to debate. There is no such duty and certainly no shifting duties, on the eve of insolvency, or in the twilight zone of insolvency.

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66. Prod. Res. Group, LLC. v. NCT Group, Inc., 863 A. 2d 772, 789–90 (Del. Ch. 2004).

67. Peoples Dep't Stores, Inc. v. Wise, [2004] S.C.R. 461, 505–06.

68. *Id.* at 509.

69. *Id.* at 507, 509; *see also* Civil Code of Quebec, 1991 S.Q., ch. 64-1, *amended by* 2001 S.Q., ch 19 (Can.).

Along with the rest of my panel members, I am happy to answer any questions you might have.

PARTICIPANT: I am curious. In France and Germany, is there judicial deference to directors?

REID FELDMAN: Well, *deference* really is not the word. I mentioned the situation which Hanno also mentioned, *comblement de passif.* The statute says that a manager can be held liable for a shortfall of assets caused by a management error. That is a wide-open term. But in applying that standard, the courts have been hesitant to second-guess managers—and they haven't really phrased it in terms of the business judgment rule. Just as in the U.S., in France, judges usually do not venture into that terrain. On the other hand, the way the statute is framed, it does not require them to second-guess very much because, as I said, *ipso facto*, when things turn out badly, somebody made a mistake. So they do not have to get into second-guessing and they do not need to raise the question of whether business judgment is good or bad.

ANDREAS ENGERT: It is the same in Germany. Negligence used to be the standard in the statute. Actually, it was amended a few days ago to include some sort of a business judgment rule. There's also a Supreme Court decision from 1998 which made reference to the U.S. concept.

HANNO MERKT: Yes. It is interesting to see that in Germany this was for many years an area in which we did not have either case law or statutory law. There was, in fact, virtually no orientation for managers on the legal requirements of a business judgment. It started only in the mid-1990s that single cases were brought to higher courts. As late as 1998, the Federal Supreme Court in a landmark decision articulated a business judgment rule–type standard for the first time. The court did not use the technical term nor did it make any reference to U.S. law, but it is clear from all that we know that the federal judges did have in mind the U.S.-type business judgment rule. Later on, in 2005, the German Legislature introduced a statutory provision implementing the business judgment rule into the Stock Company Act. Note that the German version of the business judgment rule differs from its U.S. counterpart in one important respect: Under the German provision, the burden of proof is on the defendant-director. This is likely to limit the beneficial effect of the rule seriously. But we will see how we are going to cope with that, and perhaps in a couple of years one can tell more about the effectiveness of that German-type business judgment rule.

RICHARD BOOTH: I will leave you with one parting thought. It seems that directors and creditors are analogous to each other. That gives you something to think about.

REID FELDMAN: Thank you, Richard, for organizing this.