SINCE 1854

Chicago Daily Law Bulletin®

Volume 157, No. 69 **Friday, April 8, 2011**

Trial Notebook

Creditor lacked standing to sue officer of insolvent corporation

By Steven P. Garmisa
Hoey & Farina

For more than a century, the Illinois Supreme Court has recognized an exception to the general rule that corporate officers and directors usually don't owe any fiduciary obligations to creditors when a corporation is sliding into bankruptcy. Yet the high court never ruled on whether an individual creditor has standing to sue an officer or director for breach of fiduciary duty under the "special circumstances" doctrine, and there are split decisions on this issue.

Bankruptcy judges applying Illinois law have also disagreed on whether an individual has standing to pursue a special circumstances claim under section 523(a)(4) of the Bankruptcy Code, which bars a discharge "for fraud or defalcation while acting in a fiduciary capacity."

Predicting how the Illinois Supreme Court would rule on the first issue, Bankruptcy Judge Carol A. Doyle concluded that, "An individual creditor has no standing to bring a direct claim for breach of fiduciary duty against a director or officer of an insolvent corporation."

And applying what she deemed to be the "better reasoned decisions" on section 523(a)(4), Doyle decided "that individual creditors have no standing to bring direct claims against directors for breach of this duty." *In re Netzel*, Bankruptcy No. 09 B 46723 (Jan. 20, 2011).

John Netzel and Frank Soverino owned The Plumbing Company; the firm reportedly agreed to purchase Soverino's shares in 2006 for $1.932 million, with weekly payments of $4,000 running more than nine years. But the company became insolvent in 2008, and Netzel filed for personal bankruptcy under Chapter 7.

In an adversary complaint, Soverino alleged that Netzel used corporate assets to pay personal debts, and that Netzel used his control over the defunct company to assign lucrative contracts to other firms.

Contending that Netzel breached a fiduciary duty owed to the corporation's creditors under the special circumstances rule, Soverino argued that section 523(a)(4) of the Bankruptcy Code barred Netzel's request for an order discharging his debts.

Granting Netzel's motion to dismiss, Doyle noted that the alleged acts of misconduct "would have injured the corporation and the entire creditor body. They did not cause any harm to Soverino that was not suffered by all other creditors."

Because he did not suffer any unique harm, Doyle concluded, "Soverino cannot state a claim that Netzel owes him a debt based on fraud or defalcation while acting in a fiduciary capacity based on the alleged breach of the special circumstances fiduciary duty."

Here are highlights of Doyle's analysis (with omissions not noted in the text):

Officers and directors usually do not owe a fiduciary duty to creditors, but Illinois courts have long recognized an exception to this rule when a corporation is insolvent. E.g., *Atwater v. Am. Exch. Nat'l Bank,* 152 Ill. 605, 38 N.E. 1017 (1893); *Roseboom v. Warner,* 132 Ill. 81, 23 N.E. 339 (1890); *Beach v. Miller,* 130 Ill. 162, 22 N.E. 464 (1889); *Paul H. Schwendener, Inc. v. Jupiter Elec. Co.,* 358 Ill.App.3d 65, 829 N.E.2d 818 (2005).

Upon insolvency, "the assets of the corporation must then be regarded as a trust fund for the payment of all its creditors, and the directors occupy the position of trustees." *Beach,* 22 N.E. at 466. The fiduciary duty previously owed to shareholders is then owed to creditors as a whole. Directors and officers may be held liable for breach of this duty. *Schwendener,* N.E.2d at 828.

Courts are divided on whether an individual creditor has standing under Illinois law to sue for breach of special circumstances fiduciary duty.

The Illinois Supreme Court has not directly addressed the question.

A few Illinois courts have permitted creditors to pursue officers and directors of an insolvent corporation directly on their own behalf without discussing standing.

The only Illinois court that directly addressed the standing issue concluded that an individual creditor has no standing to sue a director for breach of the special circumstances fiduciary duty. *Prime Leasing v. Kendig,* 332 Ill.App.3d 300 (2002).

The Prime Leasing court was interpreting Delaware law but it cited Delaware authority only for the general rule that directors do not owe creditors duties beyond the relevant contractual terms unless there are special circumstances, including insolvency.

The court discussed the important distinction recognized by the 7th Circuit in *Koch Refining v. Farmers Union Central Exchange,* 831 F.2d 1339 (7th Cir. 1987), between claims based on a liability owed to the general creditor body that only a trustee in bankruptcy can assert and claims that are personal to a creditor that only the creditor can assert.

The court concluded that an action for breach of special circumstances fiduciary duty can be brought only by the corporation or its representative, not individual creditors, because the duty is owed to the entire corporate constituency.

Although the Illinois Supreme Court has not directly addressed the question of individual creditor standing, a number of early decisions of the court hold that all creditors are entitled to share equally in any recovery for breach of special circumstances fiduciary duty. In each case, the court held that a breach of this duty harms all creditors of the insolvent corporation because there are fewer assets available for distribution.

In *Beach v. Miller*, for example, the court stated that "the directors are

continued...

trustees of all the property of the corporation, for all of its creditors, and an equal distribution must be made, and no preference to any one of the creditors." 22 N.E. at 466.

Similarly, in *Atwater v. American Exchange National Bank,* an action brought by two creditors on behalf of themselves and all other creditors, the court set aside a judgment obtained by a director against the corporation in violation of his fiduciary duty to creditors upon insolvency. 38 N.E. at 1022.

The court concluded that "it is therefore all the creditors who are entitled to share in the fund" and ordered that the creditors "share pro rata in this fund." Id. at 1020.

Again in *Roseboom v. Warner*, the court recognized that "the instant the corporation becomes insolvent, said assets became a trust fund for the payment of all the debts pro rata." It held that, once the aid of a court is invoked, the court will administer the insolvent estate according to "the maxim that equality is equity." Id.

It concluded that "no creditor can pursue a legal remedy, at least, in such a way as to obtain for himself a preference." Id.

These decisions strongly suggest that the Illinois Supreme Court would not permit an individual creditor to sue on his own behalf for breach of the special circumstances fiduciary duty and obtain more than his pro rata share of any recovery.

The Illinois Supreme Court is also likely to be guided by the decisions of other jurisdictions, particularly the Delaware Supreme Court, on important issues of corporate law.

The Delaware Supreme Court held in *North American Catholic Educational Programming Foundation v. Gheewalla,* 930 A.2d 92 (Del. 2007), that individual creditors may not assert claims for breach of fiduciary duty on their own behalf against directors of insolvent corporations.

The *Gheewalla* court explained that creditors of an insolvent corporation take the place of shareholders, becoming "the residual beneficiaries of any increase in value" and consequently "the principal constituency injured by any fiduciary breaches that diminish the firm's value." Id. at 101-02.

A breach harms creditors "only indirectly by diminishing the value of the firm and therefore the assets from which the creditors may satisfy their claims." Id. at 102.

The court held that the proper vehicle for remedying these general harms is a derivative action brought on behalf of all creditors, not a direct action by any individual creditor. Id. at 101.

The *Gheewalla* court was also concerned that recognizing a direct fiduciary duty owed by directors to individual creditors would create uncertainty and a potential conflict of interest for directors. Id. at 103.

A direct fiduciary relationship between directors and individual creditors could interfere with a director's ability to negotiate with creditors during insolvency, when robust negotiations with creditors are perhaps most important. Id.

The court therefore held that "individual *creditors* of an *insolvent* corporation have *no right to assert* direct claims for breach of fiduciary duty against corporate directors." Id.

The holding in *Gheewalla* is consistent with the Illinois Supreme Court's own early decisions and presents compelling reasons for denying standing to individual creditors.

The Illinois Supreme Court is likely to agree with *Gheewalla* and conclude that an individual creditor may not directly sue a director of an insolvent corporation for breach of fiduciary duty.

Bankruptcy decisions under § 523(a)(4)

Bankruptcy courts applying Illinois law to claims for breach of special circumstances fiduciary duty under § 523(a)(4) of the Bankruptcy Code are also divided on the standing issue, but the better reasoned decisions conclude that individual creditors have no standing to bring direct claims against directors for breach of this duty.

In this case, Soverino has no standing to assert a claim for breach of fiduciary duty against Netzel.

Soverino alleges that Netzel his paid personal bills with corporate funds and assigned contracts to other plumbing companies. These alleged acts would have injured the corporation and the entire creditor body. They did not cause any harm to Soverino that was not suffered by all other creditors.

Accordingly, Soverino has no standing under Illinois law to bring a direct action against Netzel for breach of the special circumstances fiduciary duty. Soverino cannot state a claim under § 523(a)(4) based on a debt "for fraud or defalcation while acting in a fiduciary capacity."

---

garmisa@hoeyfarina.com

Copyright © 2011 Law Bulletin Publishing Company. All rights reserved.
Reprinted with permission from Law Bulletin Publishing Company.