Directors' negligence liability to creditors: A comparative and critical view
Cohen, Zipora
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Directors' Negligence Liability to Creditors: A Comparative and Critical View

Zipora Cohen*

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I. INTRODUCTION

The imposition of liability on corporate directors is one of the primary solutions offered by company law to the "agency problem." This problem ensues from the separation between ownership and control, one of the main characteristics of the modern corporation. In large corporations, shareholders do not actually manage the business of the corporation. Directors and officers, who are not necessarily equity holders of the corporation, oversee the day-to-day business of a corporation. Even when corporate directors and officers are also shareholders, the percentage of their holdings is relatively low compared to the total equity of the corporation, and the agency problem applies to

* Professor of Law, Bar-Ilan University, Israel; LL.B., 1971, LL.M., 1976, Ph.D., 1979, Tel-Aviv University. The author is thankful to Yedidya Z. Stern, David Hahn, and Adi Ayal for their helpful comments. This Article is the recipient of Bar-Ilan University's Judge Avern Cohn Prize. The author thanks the Cohn Prize Committee.

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them as well. The imposition of liability on corporate directors is therefore intended to serve two main purposes: (1) deter directors from making improper use of the powers conferred upon them, and (2) compensate the corporation for damage caused by a breach of the directors' duties.

Even in small corporations controlled by few people simultaneously holding shares and acting as directors, these two purposes are relevant. Directors, even when they are shareholders in the corporation, are capable of acting upon whim, on occasion preferring their own interests to those of the creditors of the corporation. They may also refrain from taking precautions when conducting the business of the corporation. The basic principles of the separate legal personality of the corporation and the limited liability of its shareholders may place the creditors of the corporation in an impossible situation. Out of concern for the creditors, it is also appropriate to impose liability upon directors in such small, private corporations. The imposition of liability on corporate directors in a closely held corporation serves the two purposes mentioned above: deterring improper conduct and compensating the corporation for damage caused to it. Compensating the corporation may place the creditors in the position they would have been in had there been no breach of duty. There are those who believe that while there is need for a normative determination of liability for breach of fiduciary duties, no such need exists regarding breach of the duty of care.[1] According to this view, market forces will ensure that the duty of care is met in the most efficient way. Where the director controls the capital of the corporation, he has a direct personal interest in the economic success of the enterprise. In the other cases, there are a number of market forces that can provide an incentive to the directors to uphold the proper duty of care: the corporate control market, the labor market, and directors' benefits.

A. Corporate Control Market

Directors who cause losses to the corporation as a result of their negligence are likely to lose their posts. Their negligence may cause disgruntled shareholders to replace them or make the corporation an easy target for a take-over. The end result in both scenarios is the same: the corporate control market will force out negligent directors.

B. Labor Market

The success of the director is measured by the profitability of the corporation. Negligent management impairing the profits of the corporation also damages the reputation of the corporate director. Consequently, his chances of obtaining office in the future, as well as his salary level, will be damaged by his negligence.

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1. *See* Daniel R. Fischel, *Efficient Capital Market Theory, the Market for Corporate Control and the Regulation of Cash Tender Offers*, 57 TEX. L. REV. 1, 42-45 (1978) (arguing for the use of the compelling purpose test in determining breaches of fiduciary duty in contested control situations); Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1286 (1982) (arguing against the corporate governance movement of increasing corporate regulation).

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C. Directors' Benefits

In many cases, corporate directors are remunerated in accordance with the profitability of the corporation. This remuneration can be expressed by setting the salary, even if only partially, in accordance with the profits of the corporation, and by the award of options to directors. The directors therefore have a strong incentive to act carefully to increase the profitability of the corporation. According to this market-driven approach, these market forces suffice to achieve the goal of deterrence, and are less costly than the institution of a legal claim.

On the other hand, there is an approach rejecting reliance on market forces. This approach is based on the fact that in practice the markets are not efficient and there is no transparency of information. Accordingly, one cannot make do with market forces as a substitute for deterrence through the imposition of liability.[2]

Furthermore, even if we are satisfied with the deterrence achieved by market forces, we cannot ignore the fact that this method does not enable the achievement of the second objective referred to earlier: compensating the injured party for damage caused. It is well known that the deterrence element does not lead to the elimination of negligence. There is room for liability to be imposed on negligent parties to achieve the objective of compensating injured parties and thereby place them, insofar as possible, in the position they would have been in had there been no negligence.

This Article supports the traditional position that it is appropriate to impose liability upon directors for negligence. However, caution must be exercised in determining the scope of this duty. The objectives for the imposition of liability on directors must also determine the limits of the liability. For this reason, a distinction must be drawn between the fiduciary duty and the duty of care. The law must determine the right level of liability in such a manner as to achieve the double objectives of deterrence and compensation. Care should be taken not to impose overly severe standards of conduct, which may be more damaging than efficient.[3] The imposition of overly severe liability on directors in the context of the duty of care may deter qualified persons from undertaking the office of corporate director, and may deter sitting directors from taking business risks for fear of becoming exposed to liability.[4] Willingness to take reasonable risks is an essential condition for the promotion and development of business. The law, therefore, should

2. *See* Dierdre A. Burgman & Paul N. Cox, *Corporate Directors, Corporate Realities and Deliberative Process: An Analysis of the* Trans Union *Case*, 11 J. CORP. L. 311 (1986) (critiquing the market-driven approach where market forces act as substitute for normative enforcement of the duty of care); *see also* Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. PA. L. REV. 851 (1992) (critiquing the efficient market hypothesis). For a general critical discussion of the economic theory of the corporation, see, for example, William W. Bratton, Jr., *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 STAN. L. REV. 1471 (1989); William W. Bratton, Jr., *The "Nexus of Contracts" Corporation: A Critical Appraisal,* 74 CORNELL L. REV. 407 (1989).

3. *See* Marcia T. Moffat, *Directors' Dilemma—An Economic Evaluation of Directors' Liability for Environmental Damages and Unpaid Wages*, 54 U. TORONTO L.J. 293, 304-06 (1996) (discussing the importance of refraining from excessive deterrence in relation to the imposition of directors' liability).

4. A document prepared by the Australian Institute of Company Directors discloses that increasing directors' liability causes directors to make decisions while taking into account the ramifications for the directors' own personal risk instead of focusing on the good of the corporation. Shaun Ansell, *Directors' and Officers' Liability Insurance—Recent Reforms and Developments in Australia and New Zealand*, 23 AUSTL. BUS. L. REV. 164, 164 (1995).

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limit itself to deterring directors only from taking unreasonable risk. This Article will not deal with the scope of the duty of care imposed on directors, but rather with the issue of the extent to which such a duty exists toward third parties, namely, the creditors of the corporation.

The general rule is that the duty of directors regarding the fulfillment of their functions in the corporation is a duty owed to the corporation,[5] and does not extend to the creditors. This principle is accepted in all common law countries, including the United States,[6] England,[7] Australia,[8] New Zealand,[9] and Israel.[10] Circumscribing the liability owed to the corporation is also accepted in civil systems of law. This is the position in Austria, which provides for directors' liability to the corporation and not toward creditors,[11] as well as in the corporations laws of Denmark[12] and Italy.[13] There are other systems of law that impose liability on directors to third parties for negligence. For example, Japanese law provides for directors' liability to third parties if the directors have been guilty of wrongful intent or of gross negligence in the assumption of their duties.[14] A precondition for liability under Japanese law is the existence of gross negligence.

5. In the United States, the classical approach was that the directors owed their duties to the corporation. Recently, shareholders were added as parties to whom the directors owed a fiduciary duty and duty of care. *See* Lawrence E. Mitchell, *The Fairness Rights of Corporate Bondholders*, 65 N.Y.U. L. REV. 1165, 1173 (1990).

6. AMERICAN LAW INSTITUTE, PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 4.01 (1992) [hereinafter ALI, PRINCIPLES]; 3A WILLIAM MEADE FLETCHER ET AL., FLETCHER CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS §§ 1179-1180, 1185 (perm. ed., rev. vol. 1994 & Supp. 1996); H.G. HENN & J.R. ALEXANDER, LAWS OF CORPORATIONS 621 (3d ed. 1983); Norwood P. Beveridge, Jr., *Does a Corporation's Board of Directors Owe a Fiduciary Duty to Its Creditors?*, 25 ST. MARY'S L.J. 589, 592-93 (1994); Vladimir Jelisavcic, Comment, *A Safe Harbor Proposal to Define the Limits of Directors' Fiduciary Duty to Creditors in the "Vicinity of Insolvency":* Credit Lyonnais v. Pathe, 18 J. CORP. L. 145, 145 (1992); Stephen R. McDonnell, Comment, Geyer v. Ingersoll Publications Co.*: Insolvency Shifts Directors' Burden from Shareholders to Creditors*, 19 DEL. J. CORP. L. 177, 183 (1994).

7. *See* PAUL L. DAVIES, GOWER'S PRINCIPLES OF MODERN COMPANY LAW 599 (6th ed. 1997); ROY GOODE, PRINCIPLES OF CORPORATE INSOLVENCY LAW 455 (2d ed. 1997); PETER LOOSE ET AL., THE COMPANY DIRECTOR—POWERS, DUTIES AND LIABILITIES 128 (8th ed. 2000).

8. *See* HAROLD ARTHUR JOHN FORD, FORD'S PRINCIPLES OF CORPORATIONS LAW § 8.100 (8th ed. 1997); ANDREW R. KEAY, THE LAW OF COMPANY LIQUIDATION 515 (4th ed. 1999).

9. *See* David A. Wishart, *Models and Theories of Directors' Duties to Creditors*, 14 N.Z.U. L. REV. 323, 326 (1991). The Law Commission in New Zealand, which prepared the recommendations for the new Companies Act of 1993, also recommended that officers not be made liable towards creditors. *Id.* at 324. According to the new Companies Act as well, the directors owe their duty to the corporation. *See* S.M. Watson, *Directors' Duties in New Zealand*, 1998 J.BUS.L. 495, 513.

10. *See* The Companies Law, 1999, § 252, S.H. 189.

11. *See* Paul Luiki & Michael Barnert, *Austria*, *in* DIRECTORS' LIABILITIES IN CASE OF INSOLVENCY 123 (Anker Sørensen ed., 1999). At the same time, section 56 of the Limited Liability Company Act provides that the "directors are liable *vis-a-vis* the creditors for false evidentiary documents or declarations as to the reduction of capital of the corporation." *Id.* at 126. The basis for this liability is the existence of a negligent representation towards the creditors, as explained *infra* Part III.C.

12. The Act on Public Limited Companies, § 140(1); *see* Michael Serring, *Denmark*, *in* DIRECTORS' LIABILITIES IN CASE OF INSOLVENCY, *supra* note 11, at 172, 175.

13. Giuseppe Barreca & A. Luca Mendicini, *Italy*, *in* DIRECTORS' LIABILITIES IN CASE OF INSOLVENCY, *supra* note 11, at 317.

14. SHŌHŌ, art. 266–3(1); *see* Hideki Kojima, *Japan*, *in* DIRECTORS' LIABILITIES IN CASE OF INSOLVENCY, *supra* note 11, at 14.

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However, where there has been a misstatement of material information required to be stated in the prospectus, mere negligence is enough to impose liability.[15]

The directors are not liable to creditors even when the law enables a corporate officer to take into account the benefit to the creditors. A statutory provision of this type may be found in a large number of states in the United States,[16] and was recently introduced into the new Israeli Companies Law which became effective in February 2000.[17] The significance of this provision is to empower corporate directors to consider the interests of the various constituencies such as shareholders, employees, creditors, and even the public at large. However, the provision does not entitle these entities to bring an action on the grounds that their interests were not weighed properly. Some nonshareholder constituency statutes expressly provide that the law does not create such a duty. For example, section 717(b) of the New York Business Corporation Law provides: "Nothing in this paragraph shall create any duties owed by any director to any person or entity to consider or afford any particular weight to any of the foregoing or abrogate any duty of the directors, either statutory or recognized by common law or court decisions."[18]

The Committee on Corporate Laws of the Section of Business Law of the American Bar Association decided not to incorporate a provision permitting directors to weigh the interests of other constituencies into its Model Act. It states that "permitting . . . directors to consider these interests without relating such consideration in an appropriate fashion to shareholder welfare . . . would conflict with directors' responsibility to shareholders and could undermine the effectiveness of the system that has made the corporation an efficient device for the creation of jobs and wealth."[19]

The Committee also recommended that these provisions be interpreted in such a manner that the directors might take into account the interests of other constituencies, but only to the extent that the directors are acting in the best short- and long-term interests of the shareholders and the corporation.[20] Similarly in England, the law employs mandatory language, stating, "The matters to which the directors of a company are to have regard in the performance of their functions include the interests of the company's employees in

15. SHŌHŌ, art. 266-3(2). The provision also transfers the burden of proof to the director to prove absence of negligence on his part. *See infra* Part III.D.

16. For a list of states that have incorporated this type of provision into their companies law, see Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 TEX. L. REV. 579, 579 n.1 (1992). In some of the states, the provision is limited to control transactions. For a list of the states, see *id.* at 588 n.39. However, in the majority of states, such provisions have wide effect and are not limited to such cases. Recognition of the directors' competence to consider the interests of constituencies other than shareholders is not contingent upon the existence of an express statutory provision. For example, Delaware case law recognizes this power, notwithstanding the absence of an express provision in the Delaware statutes. *See id.* at 625-30.

17. The Companies Law, 1999, § 11, S.H. 189.

18. N.Y. BUS. CORP. LAW § 717(b) (McKinney Supp. 2000).

19. Committee on Corporate Laws, American Bar Association, *Other Constituencies Statutes: Potential for Confusion*, 45 BUS. LAW. 2253, 2268 (1990).

20. *Id.* at 2269. The law in Indiana adopted a different approach, expressly leaving the directors to decide which, if any, interests should dominate. *See* IND. CODE ANN. § 23–1–35–1(d) (West Supp. 2000). This approach is unique to Indiana and also proved unacceptable to the special committee of the American Law Institute. Section 6.02(b)(2) of the American Law Institute's *Principles of Corporate Governance* provides that directors are prohibited from significantly disfavoring the long-term interests of shareholders. ALI PRINCIPLES, *supra* note 6, § 6.02(b)(2).

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general, as well as the interests of the members."[21] The right of employees to bring an action for breach of this duty is not recognized, and the right of action for breach of the duty is conferred on the corporation. Section 309(2) of the English Act expressly provides, "Accordingly, the duty imposed by this section on the directors is owed by them to the company (and the company alone) and is enforceable in the same way as any other fiduciary duty owed to a company by its directors."[22]

It should be noted that the English Act only refers to the interest of the shareholders and employees and makes no reference whatsoever to creditors or the public as a whole. Indeed, the only state in the United States that imposes liability upon directors to weigh the interests of additional constituencies is Connecticut. The provision is limited to corporations which have a class of voting stock registered pursuant to section 12 of the Securities Exchange Act of 1934,[23] and to situations of fundamental corporate change.[24] Included in this framework are merger and share exchanges,[25] sale of all or substantially all of the corporation's assets,[26] and business combinations.[27] Discussion of other constituencies' statutes and the problems arising therefrom is outside the scope of this Article, which focuses on the possibility of creditors bringing claims against directors for breach of their duty of care.[28] As noted, even when the corporations law includes a provision permitting the interests of creditors to be weighed, this does not vest the creditors with a cause of action.

The purpose of this Article is to examine the circumstances in which directors will be liable to creditors for negligence occurring during the performance of their functions in the corporation. The Article focuses on the liability of corporate directors for breach of their duty of care and does not discuss their liability for breach of their fiduciary duty or the commission of torts other than negligence.[29] In Part II, the considerations preventing recognition of a right of action by creditors for damage caused to them by the negligence of the corporate directors are examined. Parts III and IV will deal with exceptions to the rule that negates the right of action of the creditors, *i.e.*, those cases where such rights are granted. Part III will further discuss the possible claims of creditors in cases involving breach of the duty of care owed to them by directors. Part IV will consider the possibility of creditors bringing an action where the corporation is insolvent. Part V concludes the Article.

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21. Companies Act of 1985, c.6, § 309(1) (Eng.).

22. Companies Act of 1985, c.6, § 309(2) (Eng.); *see* LOOSE ET AL., *supra* note 7, at 130-31 (discussing the duty to employees). The authors note, "In a sense, it is misleading to describe this as a duty. Rather it is a defense when directors are criticised by shareholders for acting with social responsibility towards employees." *Id.* at 131.

23. 15 U.S.C. § 78*l* (1994).

24. CONN. GEN. STAT. § 33-756(d) (1999).

25. *Id.* § 33-817.

26. *Id.* §§ 33-830 to 33-831.

27. *Id.* §§ 33-841, 33-844.

28. For a discussion of this issue, see Mitchell, *supra* note 16, at 579 n.17. *See also* Mark E. Van Der Weide, *Against Fiduciary Duties to Corporate Stakeholders*, 21 DEL. J. CORP. L. 27 (1996).

29. Therefore, the article will not discuss the circumstances in which a claim may be brought against a corporate director for inducing breach of contract by a corporation.

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II. CONSIDERATIONS FOR CONFINING THE RIGHT OF ACTION TO THE CORPORATION

While it is well-accepted that corporate creditors are injured when harm comes to the corporation, judicial policy considerations restrained granting recognition to creditors' claims of directors' liability to them. The primary considerations justifying this rule are as follows:

> 1. Enabling any creditor to bring a suit against the directors may expose the directors to a large number of claims, many of which may be unfounded. The volume of suits may impair the functioning of the corporation's directors.
> 2. Recognition of the rights of action of every creditor may lead to a multiplicity of claims, placing a serious burden on the courts.
> 3. Multiplicity of claims of this type may lead to an unjustified increase in administrative costs.
> 4. There is a danger that in the event that a number of claims are filed against directors, different courts will reach differing results. These splits may be the result of differences in the evidence presented by various plaintiffs, the standard of care applied, and the circumstances under which a breach is found to exist.
> 5. The grant of a right of action to every creditor for damage caused to him by breach of the director's duty of care is likely to expose the director to the risk of a double claim.[30] The claim of a creditor does not obviate the claim of the corporation. For example, if recognition were to be given to the right of action of a creditor against a director for the latter's negligence in conducting the business of the corporation, and the creditor was awarded damages, such an award would not derogate from the damage caused to the corporation. An action filed by the corporation against the director may result in the director making a double payment for the damage caused by his negligence.

These considerations are also relevant to shareholders of a corporation. Directors do not owe them a duty of care that serves to vest the shareholders with a personal right of action for their damages, manifested by a depreciation in the value of their shares.

In contrast to the aforesaid considerations that negate the right of the creditor and the shareholder to bring a personal action against directors regarding the latter's negligence in conducting the business of the corporation, the imposition of director's liability to the corporation serves desirable policy objectives. The award of damages to the corporation for injuries caused by the director places creditors and shareholders in the position that they would have been in had the director not breached his duties. Difficulties may arise if the negligent directors control the corporation and refrain from bringing an action against themselves. The solution to such a situation differs between shareholders and creditors. Shareholders are entitled, in such a case, to bring a derivative action against the directors and enable the corporation to receive damages.[31]

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30. *See* Speer v. Dighton Grain, Inc., 624 P.2d 952, 961 (Kan. 1981) (holding, in part, that a creditor of an insolvent corporation suing solely on his behalf could not maintain a personal action against the directors).

31. Such an action is not available to the shareholders when the corporation enters into liquidation proceedings. In such a case, the liquidator will ensure that an action is brought against the corporate directors.

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A creditor of a corporation is in a different position than that of a shareholder. Notwithstanding that both shareholders and creditors possess contractual rights against the corporation, there is a basic difference in the contents of their respective contracts. A creditor has a defined right of action against the corporation, which is expressed by payment of the debt owed to him by the corporation, whereas the shareholder also has a vested right to intervene in the management of the corporation via the right to vote conferred upon him by his ownership stake. The Court of Appeals of Minnesota in considering this difference between shareholders and creditors held:

> Creditors are not owed a duty by an insolvent corporation's directors and officers to minimize any loss that may occur as a result of the corporation's insolvency. To hold otherwise would allow creditors of a corporation, solvent or insolvent, to interfere unduly and interject themselves in the day-to-day management of the corporation. While it is axiomatic that creditors have the right to be repaid, it is equally true that they do not have the right, absent an agreement to the contrary, to dictate what course of action the directors and officers of a corporation shall take in managing the company . . . .[32]

A creditor cannot be allowed to intervene in matters connected with the conduct of the corporation's business, so long as the corporation meets its obligations toward him. If the corporation becomes insolvent, there is justification for enabling the creditor to bring an action against the directors in respect to the manner in which they conduct the business of the corporation, which has led to his inability to be repaid by the corporation.[33]

The interests of creditors are protected in other ways, primarily through contract and bankruptcy law. Contract law enables the enforcement of contractual arrangements between the creditors and the corporation.[34] Chancellor Allen put this lucidly in his judgment in *Katz v. Oak Industries, Inc.*: "[T]he relationship between a corporation and the holders of its debt securities, is contractual in nature. . . . The terms of the contractual relationship agreed to and not broad concepts such as fairness define the corporation's obligation to its bondholders."[35] Similarly, Justice Walsh held in *Simons v. Cogan*, "Until the debenture is converted into stock the convertible debenture holder acquires no equitable interest, and remains a creditor of the corporation whose interests are protected by the contractual terms of the indenture."[36]

32. St. James Capital v. Pallet Recycling Ass'ns of N. Am., Inc., 589 N.W.2d 511, 516 (Minn. Ct. App. 1999).

33. An exception to the rule, which negates the right of action of the creditor in situations other than liquidation, was recently established in the new Companies Law enacted in Israel. The exception vests the creditor with a right to bring a derivative action against directors for unlawful distributions. Companies Law of 1999, § 204, S.H. 189. Even though the creditor is bringing the action, the action is derivative, and its fruits are owed to the corporation itself and not to the creditor. This exception is unique to Israeli law. Other laws which confer a status on creditors in cases of unlawful distributions do so in cases of dissolution or insolvency. *See, e.g.*, DEL. STAT. ANN. tit. 8, § 174 (Supp. 1998). For the liability of directors towards creditors in these situations, see *infra* Part IV.

34. *See* Jelisavcic, *supra* note 6, at 158.

35. Katz v. Oak Indus., Inc., 508 A.2d 873, 879 (Del. Ch. 1986) (internal citations omitted).

36. Simons v. Cogan, 549 A.2d 300, 304 (Del. 1988).

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Within this contractual framework, the creditors can secure themselves against damage that may be caused as a result of the directors' negligent or fraudulent conduct. Thus, for example, banks and other financial institutions generally incorporate provisions in financial agreements that will accelerate the date of maturity of the obligation and make legal remedies available when the corporation drops below a predetermined level of financial health.[37]

Moreover, modern contract law has recognized that an implied covenant of good faith and fair dealing is inherent in all contracts.[38] Even according to the view that contract law is insufficient to protect the creditors, including the bondholders,[39] of the corporation, there is no room for drawing conclusions regarding the liability of directors towards creditors so long as the corporation is solvent. The justification for creating a direct legal nexus between the creditors and the directors only applies in cases where the creditors cannot obtain repayment.[40]

Bankruptcy law protects creditors by means of various provisions that nullify transactions entered into prior to liquidation and that are capable of damaging creditors, as well as by vesting preferential rights in the creditors to recover from the assets of the corporation, rights that precede those of the corporation's shareholders.[41] Further, those who believe that recognition should be given to the liability of corporate directors to creditors and recognize the right of action of creditors against directors, other than in cases of liquidation, advocate the right of creditors to bring derivative actions, as distinct from personal actions.[42] Whereas the claim in a personal action concerns the plaintiff creditor's damages, in a derivative action the creditor enforces the right of action of the corporation, and the fruits of the action go to the corporation and not to the particular creditor who filed the claim.[43] The proposal, discussed in legal literature, to vest creditors with a right to bring a derivative action against corporate directors for incompetent management has not been accepted by the legislatures of various countries.[44] The American Law Institute has also rejected this approach in its Principles of Corporate Governance,[45] under which creditors do not have the right to bring a derivative action. The explanation for this appears in the comment to § 7.02:

37. *See* Alan W. Tompkins, *Directors' Duties to Corporate Creditors: Delaware and the Insolvency Exception*, 47 SMU L. REV. 165, 183 (1993).

38. *Katz*, 508 A.2d at 880.

39. *See* George S. Corey et al., *Are Bondholders Owed a Fiduciary Duty?*, 18 FLA. ST. U. L. REV. 971 (1991); *see also* Mitchell, *supra* note 5, at 1174-75.

40. See *infra* Part IV.

41. A discussion of these issues is outside the scope of this article.

42. *See* Mitchell, *supra* note 5, at 1195; Note, *Creditors' Derivative Suits on Behalf of Solvent Corporations*, 88 YALE L.J. 1299 (1979); Note, *Public Creditors of Financial Institutions: The Case for a Derivative Right of Action*, 86 YALE L.J. 1422 (1977); *see also* Irene Trethowan, *Directors' Personal Liability to Creditors for Company Debts*, 20 AUSTL. BUS. L. REV. 41, 60 (1992) (citing the recommendation of the Australian Companies and Securities Law Review Committee of 1990, under which the right of a creditor to bring a derivative action would be recognized).

43. A derivative claim by a creditor against directors is recognized by the new Israeli Companies Law in every case of unlawful distribution, as explained *supra* note 33.

44. *See* Beveridge, *supra* note 6, at 590 n.1.

45. ALI, PRINCIPLES, *supra* note 6, § 7.02.

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> Under §7.02(a), a creditor (including a holder of nonconvertible bonds) may not bring a derivative action against a solvent corporation. This traditional rule protects corporate officials from exposure to litigation brought by creditors who would rationally have a far different and more skeptical attitude toward business risks than shareholders, and it is also justified by the greater availability to creditors of contractual mechanisms by which to establish and enforce their rights.[46]

Liability of directors towards third parties for negligence is recognized in two types of cases: the first includes cases where the directors breached the duty of care that they personally owed to those third parties. This category will be discussed in Part III. The second refers to cases of insolvency and will be discussed in Part IV.

III. CLAIMS BY CREDITORS FOR BREACH OF THE DUTY OF CARE

While contract law determines that a director acting on behalf of a corporation binds the corporation and not himself, tort law creates personal liability of the tortfeasor toward the injured party, his official capacity as director notwithstanding. This is because tortious liability is always imposed on the person committing the tort, as was expressed, for example, by Judge Alvin B. Rubin: "The fact that a professional is employed by a corporation ought not protect him from liability for breach of his professional duties."[47]

If the tort is committed in his capacity as director, liability will also be imposed on the corporation.[48] For the purpose of imposing personal liability on directors towards third parties for negligence, it is necessary to prove the personal liability of the directors for the commission of the tort, and it is insufficient that the tort was committed by other employees of the corporation in which the directors hold office.[49] In the language of Justice Broussard, "It is well settled that corporate directors cannot be held *vicariously* liable for the corporation's torts in which they do not participate. Their liability, if any, stems from their own tortious conduct, not from their status as directors or officers of the enterprise."[50]

The personal liability of the director toward a creditor of the corporation is based on the fact that the director breached the duty of care that he owed to that creditor, as distinct from the duty owed to the corporation, which is intended to protect all the shareholders and creditors.[51] The distinction may be drawn by asking whether the cause of action is purely personal, so that other creditors of the corporation have no interest in it, or whether the cause of action is for the benefit of the creditors as a whole, in which the creditor who files the action does so as a representative of all the creditors.[52] When a

46. *Id.* § 7.02 cmt.

47. Avondale Shipyards, Inc. v. Vessel Thomas E. Cuffe, 434 F. Supp. 920, 930 (E.D. La. 1977); *see* 3A FLETCHER, *supra* note 6, §§ 1135, 1137.

48. The liability of the corporation in tort will be personal liability when the tort is committed by an organ of the corporation and will be vicarious liability when the tort is committed by an employee or agent of the corporation.

49. *See, e.g.*, Avery v. Solargizer Int'l, Inc., 427 N.W.2d 675 (Minn. Ct. App. 1988).

50. Frances T. v. Village Green Owners Ass'n., 723 P.2d 573, 580 (Cal. 1986).

51. *See* U.S. Liab. Ins. Co. v. Haidinger-Hayes, Inc., 463 P.2d 770, 775 (Cal. 1970).

52. For a discussion of this issue, see 3A FLETCHER, *supra* note 6, § 1134.

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number of directors are liable for negligence toward a creditor of the corporation, their liability is joint and several.[53]

This part will deal with those cases in which a creditor's personal right of action against the directors is recognized. The other possibility, namely an action being brought by a creditor as a representative of all the creditors, will be considered in Part IV, which is concerned with liability toward creditors in cases where the corporation becomes insolvent.

Personal liability is anchored in the principle of equality, by virtue of which every person who has committed a tort will bear responsibility for the consequences of that tort. This liability is distinguished from the liability that is imposed on directors toward the corporation, and is anchored in the general duty imposed on every person to others.[54] The imposition of liability on directors toward third parties for civil torts committed by them gives effect to the objectives of the law of torts: justice and fairness. A person who committed a tort must bear the consequences ensuing from that tort. This outcome is also consistent with the principles of effective deterrence and economic efficiency. If an organ (or any other body in the corporation) believes that liability will be imposed exclusively on the corporation, the effectiveness of personal deterrence will be reduced. Personal liability promotes the wish to grant compensation to an injured party in cases where the corporation is unable to meet the obligation of tortious compensation. The innocent injured party must be preferred over the guilty wrongdoer; it is proper that the director, who caused the damage, bear the burden of insolvency of the corporation in the tort situation. Personal liability is consistent with the principle that a person who obtains the benefit of a risk cannot evade the consequences of that risk.[55]

The personal liability of directors towards creditors for breach of the duty of care may apply in a variety of cases: (1) where an act or omission causes damage to the property of a creditor, (2) where an act or omission causes personal injuries, (3) where a negligent representation causes financial damage, and (4) where there is a misleading particular in a prospectus. The following discussion will focus on the conditions that have to be met for claims to be brought by creditors against corporate directors in each of the above categories.

A. Act or Omission Causing Damage to the Property of a Creditor

When a director as a reasonable person should foresee that his conduct will cause damage to the property of another, he may owe a duty of care to that other person by virtue of tort law, and breach of this duty will cause him to become liable in damages to the injured party in respect of the latter's loss. The Article will refer to two examples to illustrate this category:

Example 1

> Directors of a construction company—who are not qualified in the building trade—decide to personally supervise building work, in order to save the costs

53. *Id.* § 1138.

54. *See* Saucier v. U.S. Fid. & Guar. Co., 280 So. 2d 584, 585-86. (La. Ct. App. 1973).

55. The Supreme Court in Israel also came to this conclusion in C.A. 407/89, *Zuk Or Ltd. v. Car Sec. Ltd.*, 48(5) P.D. 661.

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of employing an expert engineer. As a result, defects occur in the apartments. The purchasers of the apartments cannot recover for the damage caused to them from the corporation, as the latter is insolvent. There is room to recognize the directors' liability toward the purchasers of the apartments, as a result of the breach of the duty of care owed to them. The directors should have foreseen that if they failed to employ professional persons to supervise the building work, damage might be caused to the apartments' purchasers and from this ensued the duty of care to them. Breach of this duty in consequence of which damage was caused to the apartments' purchasers draws with it the imposition of liability upon the directors for negligence.[56] This liability is anchored in the general laws of agency, according to which:

> An agent who, by promise or otherwise, undertakes to act for his principal under such circumstances that some action is necessary for the protection of the person or tangible things of another, is subject to liability to the other for physical harm to him or to his things caused by the reliance of the principal or of the other upon his undertaking and his subsequent unexcused failure to act, if such failure creates an unreasonable risk of harm to him and the agent should so realize.[57]

Example 2

A manager of a corporation receives a case of jewelry on consignment from a jewelry manufacturer. The case is stolen from the manager's vehicle while the manager is visiting the shop of a potential buyer. The vehicle is parked thirty meters from the shop and its doors are locked, as is the baggage compartment where the case is stored. The manager has gone to check if the shopkeeper is available, and if he is interested in taking the jewels for sale in his shop. When the manager returns to his vehicle, he finds that the case has been stolen. The jewel manufacturer brings an action for damages against the manager and the corporation. However, because the corporation is insolvent, the manufacturer's ability to obtain compensation for the loss incurred is dependent on whether the manager is personally liable for the theft, notwithstanding that he received the case in his capacity as a manager of the corporation. Similar to the first example, leaving the jewelry case in the baggage compartment of the car, which was not protected by an alarm system, comprises negligence on the part of the manager. The fact that this negligence occurred during his functioning as a manager does not exempt him from liability.[58]

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56. Such a situation was considered by the Supreme Court of Israel. *See* C.A. 725/78, British Canadian Builders Ltd. v. Oren, 35(4) P.D. 253. The Israeli Supreme Court recognized the liability of the directors towards the purchasers of the apartments. *Id.* at 260-61.

57. RESTATEMENT (SECOND) OF AGENCY § 354 (1958).

58. This was the decision of the Supreme Court of Israel in C.A. 5438/95, *David Rosenwasser Ltd. v. Lloyds Underwriters Through Willis Faber Ltd.*, 51(5) P.D. 855.

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B. Act or Omission Causing Personal Injuries

Naturally, in the majority of cases, the damage caused by the director as a result of failing to meet the duty of care is property damage. However, there may be cases in which the negligence of the director will cause personal injuries. Such cases will occur when there is a causal connection between a failure on the part of the director to take proper precautionary measures and the damage caused to a creditor of the corporation. To impose liability on the director towards a third party for the omission, it is insufficient that the creditor suffered damages; rather, it must be shown that there was a duty of care on the part of the director to the third party.[59] This requirement is based on the general law of agency, which recognizes the liability of an agent toward a third party in the circumstances explained above.[60]

This situation may be illustrated in the following ways:

1. The directors of a corporation, managing a flight school, did not take appropriate precautions in order to ensure the safety of the training aircraft, and also did not ensure adequate insurance coverage for possible harm to users of the aircraft. A student was injured in a plane crash. The corporation did not have sufficient means to cover the damages of the victim. In such a case, the injured party may be able to bring an action against the directors personally.[61]

The significance of such recognition lies in the fact that the directors owe a duty of care to the student pilots to take precautions to prevent injury. This is true even though, generally, the duty of care of a corporate officer, insofar as relates to his functioning within the corporation, is owed to the corporation. When the issue is a risk of physical harm, directors also owe a duty of care toward creditors of the corporation, who may be injured as a result of the directors' failure to take the necessary precautions.

2. Directors of a condominium association, who were responsible for the management of the project and for the maintenance of the project's common areas, did not ensure the installation of adequate exterior lighting, notwithstanding requests made by the plaintiff in view of an exceptional crime wave in the area.[62] When the plaintiff herself installed lighting outside her apartment, she was asked to remove it by the directors. When plaintiff removed the lighting in accordance with this request, an "unidentified person entered the plaintiff's condominium unit under cover of darkness and molested, raped and robbed her."[63] Here the California Supreme Court recognized the liability of

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59. *See* Frances T. v. Village Green Owners Ass'n., 723 P.2d 573, 589 (Cal. 1986) (Bird, J., concurring).

> A director has a special relationship to a corporation by virtue of the fact that he acts as its agent. Therefore, he is liable to the corporation for nonfeasance or failure to perform his duties. However, failure to perform duties to the corporation will not result in liability to third parties unless the director has a special relationship with the third party such that he or she owes a duty to the third party to act affirmatively.

Id.

60. *See supra* text accompanying note 57.

61. Such liability was recognized by the district court in Israel in C.A. (T.A.) 2474/86, *Nezer v. Knafonit, Light Aircraft Co. Ltd.*, 1994(2) P.M. 441.

62. *Frances T.*, 723 P.2d at 580.

63. *Id.* at 574.

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the directors toward the plaintiff because the directors breached their duty of care owed to her.[64]

This breach occurred in two ways. First, it occurred when the directors demanded that the plaintiff remove the exterior lighting which she had installed.[65] Second, it occurred when the directors failed to ensure the installation of proper lighting within a reasonable period of time, notwithstanding their knowledge of the defective lighting situation, which created a risk of physical harm to the residents of the complex.[66] The directors, who were charged with the management and supervision of the common areas, were under a duty to take precautionary measures to protect the residents of the apartment project.[67] The directors owed a duty to the plaintiff to protect her from the criminal acts of others by means of the installation of appropriate lighting.[68] The consequence of the directors' breach of duty was a finding of personal liability to the plaintiff.[69] The liability of the directors in this case was based, therefore, on both nonfeasance—the non-installation of proper lighting—and misfeasance—the demand that the plaintiff remove the lighting which she had installed.[70]

3. Directors who do not ensure a safe place of work for their employees, resulting in physical injury, are likely to be held liable to the employees.[71] The duty of the directors to the corporation also includes the duty to ensure a safe place of work for employees and the duty to take reasonable precautions to protect the corporation against liability.[72] However, the duty does not negate the separate duty of the directors to the employees to take appropriate precautions in order to prevent damage to them. Thus, for example, the Louisiana Court of Appeals recognized the personal liability of corporate officers who saw or should have seen an iron reel in a dangerous position, and failed to remove the hazard resulting in the employee's death.[73] The court rejected the corporate officers' contention that they were not personally liable, where liability was based on nonfeasance as opposed to an affirmative negligent act or willful and deliberate act.[74] The court held:

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64. *Id.* at 580.
65. *Id.* at 580-86.
66. *Id.* at 585.
67. *Frances T.*, 723 P.2d at 585.
68. *Id.* at 585-86.
69. *See id.* Judge Mosk was in the minority, holding that the corporation did not owe a duty of care to the plaintiff, and thus the directors also owed no such duty. *Id.* at 591-99. Judge Mosk was also of the opinion that the directors had not breached the duty imposed on them by law. *Id.* at 598.
70. *Frances T.*, 723 P.2d at 584-85. The tendency of the courts is to refrain from drawing a distinction between nonfeasance and misfeasance insofar as they relate to the liability of directors. *See* 3A FLETCHER, *supra* note 6, § 1181.10.
71. *See* Adams v. Fid. & Cas. Co. of N.Y., 107 So. 2d 496, 508 (La. Ct. App. 1958).
72. *Id.*
73. *Id.* Similar rulings were made in numerous additional judgments. *See, e.g.*, Saucier v. U.S. Fid. & Guar. Co., 280 So. 2d 584 (La. Ct. App. 1973); Chaney v. Brupbacher, 242 So. 2d 627 (La Ct. App. 1970); Cacibauda v. Gaiennie, 222 So. 2d 632 (La. Ct. App. 1969).
74. *Adams*, 107 So. 2d at 502-07.

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> We believe that the better rule is stated in American Jurisprudence [Vol. 13, p. 1023, § 1092] in which it is stated therein that "the more direct and fundamental rule, accepted in principle at least by all the authorities, is that a director, officer, or agent in the corporation is liable to third persons for injuries proximately resulting from his breach of duty to use care not to injure such persons, whether that breach is one of omission or commission."[75]

C. Negligent Representation Causing Financial Damage

When a corporate director, within the framework of his duties, makes a negligent representation to a creditor of the corporation, he is likely to become liable towards him in accordance with the general principles of tort law. The fact that the representation is made within the context of his functions as a director of the corporation does not exempt him from liability toward a third party. Accordingly, the United States District Court for the Eastern District of Louisiana held that an executive officer who had participated in designing new vessels was liable to a shipbuilder for negligence.[76] The court held:

> While Goldman was an executive officer, it is his personal fault in discharging his own professional duties that is charged as a tort. The situation is not greatly dissimilar in principle from the routine case of an employee who, while driving a vehicle in the course and scope of his employment, injures a third person. The employee is, of course, liable in solido with his employer. Goldman is not sued here merely because he was an executive officer of F. & G. It is alleged that he himself committed negligence acts. The claim against him could have been made with equal force had he been merely a designer, owned not a share in F. & G., and held no office in the corporation.[77]

A different approach was adopted in England and expressed in the recent case of *Williams v. Natural Life Health Foods Ltd.*[78] The claim in that case ensued from a franchise agreement under which the plaintiffs opened a health food shop.[79] The franchise was given by the defendant corporation, founded by one Mistlin who was the business manager and primary shareholder of the corporation and managed a similar shop.[80] Prior to entering the franchise agreement, the defendant corporation provided the plaintiffs with a financial plan demonstrating the "likely future profitability of the shop."[81] Mistlin played a central role in formulating the plan.[82] The negotiations between the plaintiffs and the defendant corporation were conducted by an employee of the defendant corporation.[83] The plaintiffs did not know Mistlin and did not conduct

75. *Id.* at 508 (internal citations omitted).
76. Avondale Shipyards, Inc. v. Vessel Thomas E. Cuffe, 434 F. Supp. 920, 930 (E.D. La. 1977).
77. *Id.*
78. [1998] 1 W.L.R. 830 (H.L. 1998).
79. *Id.* at 832.
80. *Id.*
81. *Id.* at 833
82. *Id.*
83. *Williams*, [1998] 1 W.L.R. at 833.

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negotiations with him prior to entering the franchise agreement.[84] Later, it became apparent that the plans which had been given to the plaintiffs were faulty.[85] The plaintiffs suffered heavy losses and were forced to close the shop after eighteen months of operation.[86] The plaintiffs brought an action against the defendant corporation for the negligent advice, and because of its liquidation, plaintiffs added Mistlin as a defendant.[87]

The trial court held that both the defendant corporation and Mistlin were liable to the plaintiffs because of the negligent advice.[88] The Court of Appeal, by majority vote, affirmed that judgment.[89] The Court of Appeal held that caution had to be applied before holding a director liable for a negligent representation, particularly in a corporation having a single shareholder, in order to safeguard the important principle of limited liability.[90] Judge Hirst stated:

> [I]n order to fix a director with personal liability, it must be shown that he assumed personal responsibility for the negligent misstatements made on behalf of the company. In my judgment, having regard to the importance of the status of limited liability, a company director is only to be held liable for the company's negligent misstatements if the plaintiffs can establish some special circumstances setting the case apart from the ordinary; and in the case of a director of a one-man company particular vigilance is needed, lest the protection of incorporation should be virtually nullified. But once such special circumstances are established, the fact of incorporation, even in the case of a one-man company, does not preclude the establishment of personal liability. In each case the decision is one of fact and degree.[91]

Similarly, Judge Waite stated:

> The authorities cited by Hirst L.J. demonstrate that where representations are made negligently by a company so as to attract tortious liability under the principle of Hedley Byrne, the primary liability is that of the corporate representator. In the vast majority of cases it is also the sole liability. The law does, however, recognize a category of case in which a director of the representator will be fixed with personal liability for the negligent misstatements. It is a rare category and a severely restricted one. If that were not so, representees could set at naught the protection which limited liability is designed to confer on those who incorporate their business activities. The mesh is kept fine by the stringency of the question which the law requires to be asked: do the circumstances, when viewed as a whole, involve an assumption by the director of personal responsibility for the impugned statement?[92]

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84. *Id.*
85. *Id.*
86. *Id.*
87. *Id.*
88. *Williams*, [1998] 1 W.L.R. at 833.
89. *Id.*
90. *Id.*
91. *Id.* at 833-34
92. *Id.* at 834.

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In the above case, the majority of the judges in the Court of Appeal held that personal liability should be imposed on the business manager of the defendant corporation in light of the special circumstances of the case. The plans forming the basis for liability did not draw from the experience of the business manager in that capacity, but rather on his personal experience as the operator of a shop in a private capacity. Judge Waite explained:

> Since that knowledge belonged to him personally, and owed nothing to his status as a servant or director of the company, the judge was entitled to find that he had held himself out, independently and on his own account, as a party who would in his own right exercise care before approving sales projections based on that knowledge. [93]

Judge Russel, writing for the minority, expressed the opinion that liability should not be imposed on the director because his acts, which formed the basis of the claim, did not exceed his regular involvement in the corporation. To preseve the principle of limited liability, it would be appropriate not to impose liability in such a case.[94]

The House of Lords overturned the decision of the Court of Appeal.[95] The House of Lords held that in order to impose liability on a corporate director in such a case, a special relationship had to be shown between the plaintiff and the director,[96] that the director had assumed personal responsibility toward the plaintiffs.[97] The test established by the House of Lords for the imposition of personal liability is whether the plaintiff could reasonably have relied on the service-provider assuming personal responsibility in the name of the corporation, and that there actually was such reliance.[98] In the instant case, the House of Lords held that the corporation had held itself out as having the necessary expertise, allowing it to give advice to the plaintiffs.[99] The flyer sent to the plaintiffs clarified that the expertise ensued from Mistlin's experience in managing his own shop. These circumstances were insufficient to impose liability on Mistlin. The fact that the corporation's expertise was based on that of Mistlin did not show that Mistlin intended to assume personal responsibility.[100] Counsel for the plaintiffs tried to base Mislin's liability on an alternative ground; namely, the significant role Mistlin played in formulating the negligent plans for the plaintiffs.[101] The House of Lords rejected this argument, holding: "A moment's reflection will show that, if the argument were to be

93. [1997] 1 B.C.L.C. 131, 154-55; *see also id.* at 153 (remarks of Hirst, L.J.).

94. *Id.* at 155.

95. *Williams*, [1998] 1 W.L.R. at 838-39.

96. *Id.* at 838.

97. An example of a case where personal responsibility was assumed, identified by Lord Steyn, is *Fairline Shipping Corp. v. Adamson*, [1975] Q.B. 180 (1974). In that case, the plaintiffs had sued the defendant, a director of the corporation, for negligent storage of merchandise. The contract had been signed between the plaintiff and the corporation. However, the court held that the director was personally liable. The reason for this was that the director had written to the client and issued an invoice in such a way as to give the clear impression that he was personally responsible for the services. Had he chosen to use the letterhead of the corporation and issued an invoice in the name of the corporation, there would not have been the necessary factual basis for proving that responsibility had been assumed. *See id.*, at 191 (cited in *Williams*, [1998] 1 W.L.R. at 835-36).

98. *Williams*, [1998] 1 W.L.R. at 837.

99. *Id.*

100. *Id.* at 837-38.

101. *Id.* at 838.

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accepted in the present case, it would expose directors, officers and employees of companies carrying on business as providers of services to a plethora of new tort claims. The fallacy in the argument is clear."[102]

The House of Lords held that the liability of the corporation in this case was based on the special relationship with the plaintiffs, which caused the company to take responsibility.[103] Mistlin was extraneous to this special relationship, and therefore he could not be deemed to be a joint tortfeasor with the corporation in relation to the plaintiffs.[104] In order for him to be personally liable, there would have had to be a special relationship between him and the plaintiffs.[105] While the Court of Appeal based the rule denying the liability of the directors for the negligent advice of the corporation, on the principle of limited liability, the House of Lords based the rule on the separate legal personality of the corporation.[106]

With all due respect, neither of the above form a firm basis for the rule. The principle of limited liability refers to the liability of a corporation's shareholders, and not of its directors and officers.[107] Shareholders enjoy limited liability to the extent of the unpaid value of the shares held by them. The principle of limited liability has no application to the liability of directors of the corporation. Moreover, insofar as it relates to shareholders of the corporation, the principle of limited liability does not abrogate the liability of the shareholder for torts he committed. The principle negates the liability of the shareholder for the debts of the corporation, whether they originate from a contractual cause or from a tort; however, when the shareholder himself commits a tort, he will be personally liable for that tort.

The same applies to a director of a corporation. The fact that the corporation committed a tort does not suffice to impose liability on the directors. However, a director who is an accessory to the commission of the tort will be personally liable for the same.[108] This rule is equally applicable to one-man corporations, corporations having a small number of shareholders acting as directors, and large public corporations employing professional managers. A shareholder who acts as a corporate director is personally liable for torts, committed within the framework of his functions, in addition to the liability which falls upon the corporation. It is completely irrelevant if the knowledge which formed the basis of the negligent representation was gained by the director in his capacity as director or in his personal capacity. If the negligent representation is made by him, he will be personally liable, as the person who actually committed the tort, and this liability will be joined to that of the corporation.

The principle of separate legal personality, on which the House of Lords relied, also fails to justify the rule under discussion here,[109] because the liability of a director in tort

102. *Id.*

103. *Williams*, [1998] 1 W.L.R. at 838.

104. *Id.*

105. *Id.* at 838-39.

106. *See id.* at 835.

107. *See* Ross Grantham, Case & Comment, *Company Directors and Tortious Liability*, 56 CAMBRIDGE L.J 259, 260 (1997).

108. *See* Frances T. v. Village Green Owners Ass'n, 723 P.2d 573, 583 (Cal. 1986).

109. For support of the approach adopted by the House of Lords, see Ross Grantham & Charles Rickett, *Directors' 'Tortious' Liability: Contract, Tort or Company Law?*, 62 MOD. L. REV. 133 (1999).

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ensues from the fact that he committed the tort. The fact that he committed it for the corporation does not suffice to exempt him from liability. The separate legal personality of the corporation precludes the imposition of personal liability on the director at the contractual level, in accordance with the ordinary principles of the law of agency, under which the act of the agent binds or exempts only the principal. This rule does not apply in the context of torts and criminal offenses. In the latter cases, the commission of a tort or criminal offense by the agent or the director leads to the imposition of personal liability on him even if he acted in the framework of his corporate functions.

The English approach favors directors more than the American approach, which is also accepted in other countries, such as Israel.[110] According to both American[111] and Israeli[112] law, a director is liable for the torts that he has committed during the ordinary course of his activities in the corporation. Whereas English law makes the liability of a director contingent upon his assuming responsibility by virtue of the special relationship between himself and the plaintiff, American law and Israeli law recognize the liability of the director when he is the one who committed the tort, even if he did not intend to assume personal responsibility.

Returning to the facts of *Williams v. Natural Life Foods*,[113] it is instructive to examine what the outcome would have been had the case been heard in the United States or Israel. Because the defendant director was not a party to the negotiations between the plaintiffs and the corporation,[114] it would not have been possible to hold him liable for the statements made during the course of those negotiations. The question that remains, therefore, is whether the fact that the defendant prepared the financial plans,[115] which later turned out to be negligent, or actively participated in their preparation, suffices to make him liable for negligence.[116]

The basis of liability for a negligent representation ensues from the fact that the defendant, as a reasonable person, should have foreseen that the plaintiff would rely on his opinion, with a consequential duty arising towards the plaintiff.[117] The liability of the defendant ensued when the plaintiff in fact relied on this opinion and was damaged as a result.[118] There is no doubt that the defendant, like the corporation, should have foreseen this reliance.[119] The plaintiffs indeed relied on the opinion of the corporation.[120] That opinion was based on the experience of the defendant director in managing a shop of the same type as the shop franchised to the plaintiffs.[121] Accordingly, there was room to acknowledge that the plaintiffs indeed relied on the opinion which the defendant director

110. Danish law too recognizes the liability of a director toward a creditor who is damaged as a result of relying on misstatements made by the director. *See* Serring, *supra* note 12, at 175-76.

111. *See* 3A FLETCHER, *supra* note 6, § 1161.

112. *See* C.A. 725/78, British Canadian Builders Ltd. v. Oren, 35(4) P.D. 253; C.A. 1170/91, 1227 Bechor v. Yechiel, 48(3) P.D. 207.

113. [1998] 1 W.L.R. 830 (H.L. 1998).

114. *Id.* at 833.

115. *Id.*

116. *Id.* at 837-38.

117. *Id.*

118. *Williams*, [1998] 1 W.L.R. at 837-38.

119. *Id.*

120. *Id.*

121. *Id.*

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played a significant role in formulating. Consequently, had the case been heard in the United States or Israel, it may be presumed that personal liability would have been imposed on the defendant director.

The aforesaid English case law approach leads to a lack of symmetry between the non-recognition of the liability of directors towards third parties for negligent representations made during the course of their activities in the corporation and recognition of the liability of directors to third parties for negligent representations in the corporation's prospectus.[122]

An approach similar to that adopted in England, rejecting the liability of corporate directors and officers concerning negligent representations made during the course of their employment in the corporation, was adopted in New Zealand in the Court of Appeal judgment in *Trevor Ivory Ltd. v. Anderson*.[123] The plaintiffs entered into a contract with one Mr. Ivory, the holder of control of Trevor Ivory Ltd., in order to obtain advice concerning a raspberry orchard.[124] Mr. Ivory was not a party to the contract. Instead, it was made with the corporation under his control.[125] The request to obtain the services of the corporation was made by virtue of the expertise of Ivory himself.[126] Ivory gave the plaintiffs negligent advice about the fumigation of the orchard, resulting in damage.[127] The trial court held that both the corporation and Ivory were liable to the plaintiffs.[128] In contrast, all three judges in the Court of Appeal held that Ivory did not assume personal responsibility for the advice that he gave.[129] His intention was to provide the consulting services through the corporation. Judge Cooke referred to the matter as one of judicial policy.[130] In his opinion, even if the tests of nexus and foreseeability were met, it was not appropriate, for reasons of judicial policy, for a director to be liable jointly with the corporation for an unintentional tort committed during the course of his activities in the corporation.[131] Attributing such liability, in the opinion of the judge, undermined the principle of the separate legal personality of the corporation, the purpose of which was to enable a natural person to conduct business while protecting himself against the risks entailed thereby.[132] With all due respect, as noted above, the imposition of liability on a director in respect of the commission of a tort does not undermine the principle of the separate legal personality of the corporation, [133] but instead confers recognition of the principle of personal responsibility for tortious acts.[134]

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122. *See infra* text accompanying notes 164-172.
123. [1992] 2 N.Z.L.R. 517 (C.A.).
124. *Id.*
125. *Id.* at 519.
126. *Id.*
127. *Id.*
128. *Trevor Ivory Ltd.*, [1992] 2 N.Z.L.R. at 519.
129. *Id.*
130. *Id.* at 524.
131. *Id.*
132. *Id.*
133. This was also the opinion of Judge Gault in an earlier New Zealand case. *See* A. Borrowdale, *Liability of Directors in Tort—Developments in New Zealand*, J. BUS. L. 96, 98 (1998) (quoting Centrepac Partnership v. Foreign Currency Consultants Ltd., [1989] 4 N.Z.C.L.C. 64, 940); *see also* David A. Wishart, *The Personal Liability of Directors in Tort*, 10 CO. & SEC. L.J. 363, 364-65 (1992).
134. For a different approach, which justifies the exemption from liability of directors even for torts committed during the course of their functions in the company, in addition to the exemption conferred on

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D. Liability for a Misleading Particular in a Prospectus

The existence of a misleading particular in a prospectus or the absence of a material particular result in the imposition of liability on directors to any person who acquired securities in reliance thereof.[135] Among the potential plaintiffs are both holders of shares and holders of debentures which were issued on the basis of the registration statement. This liability is prescribed by section 11 of the Securities Act of 1933. By virtue of this section:

> In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue . . . .[136]

An elaborate discussion of the claim that may be brought by virtue of this section is outside the scope of this Article; the Article shall focus on the main elements of the claim insofar as is necessary to understand the possibilities of bringing actions against directors. The person acquiring the securities must prove two elements in order to found his claim: (1) "that there was a material misstatement or omission in the registration statement;" and (2) "that he lost money." [137] The term "material" means: "those matters to which there is a substantial likelihood that a reasonable investor would attach importance in determining whether to purchase the security registered."[138]

The elements of the claim were considered in the leading case of *Escott v. BarChris Construction Corporation*.[139] The claim was instituted by purchasers of five and one half percent convertible subordinated fifteen-year debentures of BarChris. The Court held that:

> The average prudent investor is not concerned with minor inaccuracies or with errors as to matters which are of no interest to him. The facts which tend to deter him from purchasing a security are facts which have an important bearing upon the nature or condition of the issuing corporation or its business.[140]

The right of action is not limited to the person acquiring the securities from the issuing corporation, but is also available to those who acquired them from others, provided that the securities were issued within the framework of the registration statement which incorporated the misleading statement.[141]

The amount of damages which may be awarded to a plaintiff who founds his action on this section is regulated by section 11(e) which provides:

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shareholders, in order to protect those wishing to limit their liability by conducting their business through a corporation, see Borrowdale, *supra* note 133, at 98-99.

135. 15 U.S.C. § 77k(a)(2) (1994).

136. *Id.* § 77k(a).

137. DAVID L. RATNER, SECURITIES REGULATION IN A NUTSHELL 81 (6th ed. 1998).

138. 17 C.F.R. § 230.405 (2000).

139. 283 F. Supp. 643 (S.D.N.Y 1968).

140. *Id.* at 681.

141. *See* Barnes v. Osofsky, 373 F.2d 269, 272 (2d Cir. 1967).

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> The suit authorized under subsection (a) may be to recover such damages as shall represent the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and (1) the value thereof as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and the value thereof as of the time such suit was brought. Provided, that if the defendant proves that any portion or all of such damages represents other than the depreciation in value of such security resulting from such part of the registration statement, with respect to which his liability is asserted, not being true or omitting to state a material fact required to be stated therein or necessary to make the statements therein not misleading, such portion of or all such damages shall not be recoverable.[142]

Accordingly, the directors may prove that the depreciation in value of the securities was similar to that of comparable securities of other corporations in the same field, and thereby show that the damage caused to the plaintiff did not ensue from the misleading statement.[143] The law limits the amount recoverable to the price at which the security was offered to the public.[144] This provision was primarily intended to restrict the damages of those who acquired securities in the open market.[145]

The liability of directors concerning misleading particulars in a registration statement is based on negligence, as the law provides a good defense to a corporate officer who is liable by virtue of the section but who sustains the burden of proving that:

> he had, after reasonable investigation, reasonable ground to believe and did believe, at the time such part of the registration statement became effective, that the statements therein were true and that there was no omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading.[146]

The requirement of a "reasonable investigation" is defined in section 11(c): "In determining, for the purpose of paragraph (3) of subsection (b) of this section, what constitutes reasonable investigation and reasonable ground for belief, the standard of reasonableness shall be that required of a prudent man in the management of his own property."[147]

In *BarChris*, the court stated that the defendant could not raise a successful defense of "reasonable investigation" merely by showing that he relied on others to conduct the investigation for him.[148] The answer to the question what comprises a "reasonable

142. 15 U.S.C. § 77k(e) (1994).
143. *See* Beecher v. Able, 435 F. Supp. 397, 407 (S.D.N.Y. 1977).
144. 15 U.S.C. § 77k(g) (1994).
145. *See* LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 4270 (3d ed. 1992).
146. 15 U.S.C. § 77k(b)(3)(A) (1994).
147. *Id.* § 77k(c) (1994).
148. *BarChris*, 283 F. Supp. at 697.

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investigation" and "reasonable ground to believe" is not uniform.[149] It depends on the extent of the involvement of the defendant, his experience, and his access to information.[150] What is reasonable for one director will not necessarily be reasonable for another director, by virtue of their differing status.[151] The position of an internal director in a corporation will not be the same as that of an outside director.[152] An outside director may rely on the reasonable representations of management and he cannot be asked to undertake an independent investigation in order to enjoy the benefit of the aforesaid defense.[153] In a 1995 amendment to the Securities Act of 1933, a special defense was established for outside directors. Section 11(f)(2) provides that

> (A) The liability of an outside director under subsection (e) shall be determined in accordance with section 21D(g) of the Securities Exchange Act of 1934.
> (B) For purposes of this paragraph, the term "outside director" shall have the meaning given such term by rule or regulation of the Commission.[154]

According to this provision, an outside director can be held jointly and severally liable for the full amount of the damages only if the trier of fact specifically determines that he knowingly committed a violation of the securities laws.[155] "In all other cases, he can be held liable 'solely for the portion of the judgment that corresponds to [his] percentage of responsibility,' as determined by the trier of fact."[156]

Within the framework of the circumstances affecting the determination of what constitutes reasonable investigation and reasonable grounds for belief, the Securities and Exchance Commission Rules include, inter alia, "the office held when the person is an officer."[157] An additional possible defense is available to directors in cases where the purchaser knew of the existence of the misleading statement at the time of the acquisition.[158]

In addition to the liability imposed on directors concerning misstatements in the registration statement, they may also be liable for misleading securities holders by means of other documents the corporation is required to submit to the Securities and Exchange Commission (SEC) when the securities were registered for trade. Liability in this situation is prescribed by section 18 of the Securities Exchange Act of 1934. Section 18(a) provides that:

> Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to this Act or any rule or

149. *Id.*
150. *Id.* at 682. The court in *BarChris* referred to this combination as the "mythical 'average prudent investor.'" *Id.*
151. *Id.*
152. *See* Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544 (E.D.N.Y. 1971) (holding that insider directors must conduct a reasonable investigation into the accuracy of material statements of fact appearing in the registration statement).
153. *See* Weinberger v. Jackson, [1990-1991 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶95,693, at 98,256 (N.D. Cal. 1990); Laven v. Flanagan, 695 F. Supp. 800, 811 (D.N.J. 1988).
154. 15 U.S.C. § 77k(f)(2) (1994).
155. *Id.* § 77k(f)(2).
156. RATNER, *supra* note 137, at 85-86 (internal citations omitted); *see also* 15 U.S.C. § 77k(f)(2) (1994).
157. 17 C.F.R. § 230.176(d) (2000).
158. 15 U.S.C. § 77k(a) (1994).

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> regulation thereunder or any undertaking contained in a registration statement as provided in subsection (d) of this Act, which statement was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading . . . .[159]

This section also transfers the burden of proof to the director seeking to be released from liability in the event of a misleading statement in a document.

The liability of a director to third parties who were deceived by a misleading particular in the registration statement or other documents submitted after the issue of the securities is also recognized in other legal systems. The Israeli Securities Law on this matter follows the approach of American law. Thus, Israeli law provides for a director's liability for a misleading statement in a prospectus to any person who sold or acquired securities in accordance with the prospectus, either through trade on the stock exchange or by any other means.[160] Likewise, the law incorporates a provision imposing liability on the directors and general manager to the holder of securities concerning a misleading particular in reports required to be submitted to the SEC.[161]

The Israeli law also incorporated the defenses existing in the American law. Thus, Israeli law exempts a director from liability upon proving that he took all appropriate steps to ensure that the prospectus should not contain a misleading statement.[162] Further, the directors may be exempted from liability if they prove that in purchasing the securities the purchaser knew or ought to have known that the prospectus contained a misleading statement.[163] Israeli law expanded the second defense beyond the corresponding provision in American law. American law provides directors with a defense only if the purchaser knew of the existence of the misleading particular, whereas Israeli law is satisfied with proof that the purchaser ought to have known of the misleading particular.

Negating liability in the event that the purchaser ought to have known of the misleading particular deviates from the general law of torts, which recognizes the contributory fault of the plaintiff as a basis for reducing damages but not for denying them. This deviation may be explained by the difficulty entailed in proving actual knowledge. Israeli law therefore creates an irrebutable presumption to the effect that when a reasonable person ought to have known the plaintiff will also be deemed to have known, and accordingly it would be appropriate to negate the director's liability to the plaintiff.

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159. *Id.* § 78r.

160. The Securities Law, 1968, § 31, 6 L.S.I. 266, (1965-68). An extension of liability with respect to purchasers in the open market, and not within the framework of the allocation itself, was prescribed in a later amendment to the law in 1988. The Securities Law, 1988, S.H. 188.

161. The Securities Law, 1968, § 38B, 6 L.S.I. 266. This provision was added to the law in 1988.

162. *Id.* § 33(1), 6 L.S.I. 266.

163. *Id.* § 33(2), 6 L.S.I. 266.

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English law also acknowledges the liability of directors towards third parties who hold securities in the corporation. The Financial Services Act of 1986 provides for the liability of directors to any person who suffered loss as a result of acquiring securities through relying on a misleading statement in the prospectus, including an untrue statement or the omission of information that should have been contained in the prospectus. Thus, Section 150(1) of the Act provides as follows:

> Subject to Section 151 below, the person or persons responsible for listing any particulars or listing supplementary particulars shall be liable to pay compensation to any person who has acquired any of the securities in question and suffered loss in respect of them as a result of any untrue or misleading statement in the particulars or the omission from them of any matter required to be included by Section 146 or 147 above.[164]

Section 152(1)(b) includes directors of the corporation among the persons responsible for listing particulars or supplementary listing particulars.[165] The liability of directors under this section applies to all those who suffered loss as a result of the acquisition of securities, irrespective of whether the acquisition was made directly from the corporation or was made on the open market. In this, English law modified its legal position before this section came into effect, which confined liability to those who acquired the securities within the framework of the allocation itself.[166]

Similar liability applies to directors who do not ensure the publication of supplementary listing particulars,[167] as required of them in the case of a significant change in the particulars contained in the prospectus or when a significant new matter arises the inclusion of which would have been required had it arisen when the statements were prepared.[168] The liability of the directors is based on the existence of a causal connection between the misleading information and the loss caused to the plaintiff, notwithstanding the absence of an express provision of this type in the law. Consequently, a person who acquires the securities on the market after a period of time has elapsed since the publication of the prospectus, with the result that the particulars contained therein no longer influence the price of the securities, will fail in his claim.[169]

English law, like American and Israeli law, bases directors' liability in this context on their negligence, subject to a shift in the burden of proof. The directors must prove the absence of negligence concerning the existence of the misleading particular as a condition for being exempted from liability. A director will succeed in meeting this burden if he is able to convince the Court that "at the time when the particulars were submitted to the competent authority he reasonably believed, having made such inquiries (if any) as were reasonable, that the statement was true and not misleading or that the

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164. Financial Services Act, 1986, c. 60, § 150(1) (Eng.).

165. *Id.* c. 60, § 152(1)(b). Section 152(5) of the law excludes from the list of responsible directors "any director certified by the competent authority as a person to whom that paragraph should not apply by reason of his having an interest, or any other circumstances, making it inappropriate for him to be responsible by virtue of that paragraph." *Id.* c. 60, § 152(5).

166. DAVIES, *supra* note 7, at 429. Similar development occurred in Israeli law as well. *See supra* note 160.

167. Financial Services Act, 1986, c. 60, § 150(3) (Eng.).

168. *Id.* c. 60, § 147.

169. DAVIES, *supra* note 7, at 429-30.

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matter whose omission caused the loss was properly omitted."[170] An additional way in which a director may be exempted from liability for a misleading particular in the prospectus is by proving—and again the burden rests on him—that the plaintiff acquired the securities "with knowledge that the statement was false or misleading, of the omitted matter or of the change or new matter, as the case may be."[171] English law, like American law, requires actual knowledge on the part of the plaintiff as a condition for the exemption of liability of the director and is not satisfied with the situation where the director "ought to have known," as provided by Israeli law.[172]

The imposition of personal liability on the directors in the event of a misleading particular in a prospectus is compatible with the principle recognizing the personal liability of directors to third parties in the event of a negligent representation to them. In that event, the negligent representation is set out in the prospectus of the corporation. The law acknowledges the fact that the responsible directors owe a duty regarding publication of the prospectus to members of the public who acquired or sold securities relying on information contained in the prospectus. Misleading information, whether it is incorrect substantive particulars or omitted substantive information, required by a reasonable investor in order to determine whether to invest in the corporation, comprises a breach of the duty of care owed by the directors to these members of the public. From this ensues the directors' liability to those investors who have suffered loss as a result of a breach of the aforesaid duty.

Setting apart this category of directors' liability to third parties for a misleading particular in a prospectus—in contrast to the breach of the director's duty of care towards third parties—is the transfer of the burden of proof to the directors to show absence of liability on their part. Whereas in other cases it is for the plaintiff to prove the negligence of the director, in a claim founded on a misleading particular in a prospectus, the law transfers the burden of proof to the director to show that he was not negligent.[173] This transfer is burdensome for the directors, however, it is justified by considerations of judicial policy, underlying which is the desire to protect investors against being misled and thereby ensure the credibility and solidity of the capital market which is of undisputed importance to the modern economy.

IV. Liability to Creditors in Cases of Corporate Insolvency

When the corporation is solvent it is inappropriate to make the directors liable to the creditors for the manner in which the directors manage the corporation, as distinct from liability for the commission of a tort directed at specific creditors. The creditors are an external party to the contract between the corporation and its directors, imposing a duty on the latter to take appropriate precautions. The picture changes when the corporation becomes insolvent. In such a case the residual risk in the corporation shifts from the

170. Financial Services Act, 1986, c. 60, § 151(1) (Eng.).
171. *Id.* c. 60, § 151(5).
172. *See supra* note 163 and accompanying text.
173. Transferring the burden to the directors to prove lack of negligence on their part in so far as relates to a misleading particular, is also practiced in other systems of law, such as in Japan. *See* SHŌHŌ, art. 266-3(2).

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shareholders to the creditors.[174] In cases of insolvency the shareholders lose their equity interest, they fall into a situation where they have nothing to lose, and this makes them willing to use the assets of the corporation in a highly risky manner, where the only possible losers will be the creditors.[175] Accordingly, the various laws acknowledge the liability of corporate directors towards creditors in situations of insolvency. Extensive case law recognizes that in the event of insolvency, directors must primarily take into account the interests of the creditors. Judge Street put this eloquently:

> In a solvent company the proprietary interests of the shareholders entitle them as a general body to be regarded as the company when questions of the duty of directors arise. If, as a general body, they authorise or ratify a particular action of the directors, there can be no challenge to the validity of what the directors have done. But where a company is insolvent the interests of the creditors intrude. They become prospectively entitled, through the mechanism of liquidation, to displace the power of the shareholders and directors to deal with the company's assets. It is in a practical sense their assets and not the shareholders' assets that, through the medium of the company are under the management of the directors pending either liquidation, return to solvency, or the imposition of some alternative administration.[176]

Similarly, the Delaware Court held in the famous case of *Credit Lyonnais* that: "At least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise."[177] Use of the vague term "the vicinity of insolvency" was, apparently, made deliberately in order to avoid establishing clear boundaries.[178] The duty towards the creditors does not arise solely where corporate winding-up proceedings have been set in motion, instead it suffices for insolvency to exist in fact.[179]

How should "insolvency" be defined for this purpose? Insolvency may be determined in accordance with two tests.[180] The first is the "equitable insolvency test," according to which the corporation is deemed to be insolvent when it is unable to pay its debts as they become due in the usual course of business. The second test is the "bankruptcy test," according to which the corporation is deemed to be insolvent where there is an excess of liabilities over assets.[181]

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174. *See* Dennis J. Block & Jonathan M. Hoff, *Duties of Directors of Distressed Corporations*, N.Y. L.J., Nov. 8, 1990, at 5; McDonnell, *supra* note 6, at 185; Wishart, *supra* note 9, at 333-34, 350.

175. *See* Laura Lin, *Shift of Fiduciary Duty upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors,* 46 VAND. L. REV. 1485, 1489-93 (1993); *see also* Jelisavcic, *supra* note 6, at 148.

176. Kinsela v. Russel Kinsela Pty Ltd., (1986) 4 N.S.W.L.R. 722, 730; *see also* Lyford v. Commonwealth Bank of Australia (1995) 130 A.L.R. 267, 283-84. This principle was also accepted in England and Ireland. *See* Howard Linnane, *Directors' Duties to Creditors: The Adaption of* Kinsela *into Irish Law*, 16 CO. LAW. 319 (1995).

177. *See* Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., No. 12,150, 17 DEL. J. CORP. L. 1099, 1155 (1992) (Del. Ch. Dec. 30, 1991) *available at* 1991 WL 277613. This is also the view in California. *See, e.g., In re* Jacks, 243 B.R. 385 (Bankr. C.D. Cal. 1999).

178. *See* John C. Coffee, Jr., *Court Has a New Idea on Directors' Duty*, NAT'L L.J., Mar. 2, 1992, at 18.

179. Geyer v. Ingersoll Publ'ns Co., 621 A.2d 784, 788-90 (Del. Ch. 1992).

180. *See* HENN & ALEXANDER, *supra* note 6, at 878.

181. 11 U.S.C. § 101(32) (1994).

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The Delaware Court answered this question in the *Geyer* case, holding that: "An entity is insolvent when it is unable to pay its debts as they fall due in the usual course of business. . . . That is, an entity is insolvent when it has liabilities in excess of a reasonable market value of assets held."[182] The court therefore refers to the two tests as one.[183] The court was aware that applying this test of insolvency instead of the technical test of the institution of insolvency proceedings is onerous for the directors in that the former test is not clear and unequivocal.[184] However, the court preferred this approach for reasons of judicial policy:

> While it is true . . . that defining the exception as arising when statutory proceedings have begun would give directors a clear and objective indication as to when their duties to creditors arise, there are other policy concerns which suggest that I interpret the insolvency exception to arise when insolvency exists in fact. That is, it is efficient and fair to cause the insolvency exception to arise at the moment of insolvency in fact rather than waiting for the institution of statutory proceedings. The existence of the fiduciary duties at the moment of insolvency may cause directors to choose a course of action that best serves the entire corporate enterprise rather than any single group interested in the corporation at a point in time when shareholders' wishes should not be the directors only concern. Furthermore, the existence of the duties at the moment of insolvency rather than the institution of statutory proceedings prevents creditors from having to prophesy when directors are entering into transactions that would render the entity insolvent and improperly prejudice creditors' interests.[185]

This principle places the directors at risk of personal liability to creditors of the corporation in any case where the corporation finds itself in financial difficulties.[186] There is no answer in the case law to the question of the significance of the expression "vicinity of insolvency." As the Court in *Geyer* employed an accounting test to determine insolvency, it is also possible to obtain assistance from accounting tools in order to establish when the corporation is approaching insolvency so as to place it within the vicinity of insolvency.[187] In order to establish the vicinity of insolvency it is possible to make use of models that were developed to predict the insolvency of the corporation, such as the model developed by Edward Altman for the purpose of predicting corporate

182. *Geyer*, 621 A.2d at 789.

183. A special question arises in cases where it is anticipated that actions will be brought following the liquidation, and where without these actions the corporation would be solvent. Such actions include future claims which may arise as a result of defects in the products of the corporation. This issue is outside the scope of this article. For a discussion, see Ann E. Conaway Stilson, *Reexamining the Fiduciary Paradigm at Corporate Insolvency and Dissolution: Defining Directors' Duties to Creditors*, 20 DEL. J. CORP. L. 1 (1995).

184. *See* Vanessa Finch, *Directors' Duties Towards Creditors*, 10 CO. LAW. 23, 24 (1989) (discussing the difficulty involved in determining insolvency).

185. *Geyer*, 621 A.2d at 789 (internal citations ommitted).

186. *See* Brent Nicholson, *Recent Delaware Case Law Regarding Director's Duties to Bondholders*, 19 DEL. J. CORP. L. 573, 591 (1994); Ramesh K.S. Rao et al., *Fiduciary Duty* a la Lyonnais*: An Economic Perspective on Corporate Governance in a Financially-Distressed Firm*, 22 J. CORP. L. 53, 64-66 (1996) (criticizing the use of the vague terms "insolvency" and "vicinity of insolvency," which may prevent the directors from determining when their duties shift from the shareholders to the creditors).

187. For a discussion of this issue, see Jelisavcic, *supra* note 6, at 164.

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bankruptcy.[188] This model has been proved to be a suitable model by empirical studies.[189]

Nonetheless, in order to avoid the difficulty and ambiguity of dating insolvency vicinities,[190] this Article suggests confining liability exclusively to cases where it is clear that the director knew or ought to have known that the corporation was not solvent.[191] The above case law also failed to provide a clear answer regarding the substance and scope of the duty owed by corporate officers to creditors, a matter that tends to encourage claims by creditors against directors.[192] It is possible to see the origin of the approach, which recognizes the duty towards creditors in times of insolvency, in the decision of Justice Story in the 1824 case of *Wood v. Dummer*.[193] Under *Wood*, the assets of an insolvent corporation comprise a "trust fund" that must be held and preserved for the benefit of creditors.[194]

In accordance with this theory, the *Geyer* court held that the duties of the directors, which, when the corporation is solvent, are intended to protect the shareholders, shift to protect the creditors when the corporation becomes insolvent.[195] The theory of the trust fund is the basis for the imposition of liability on directors in a variety of states. Thus, for example, the New York Court of Appeals held in *New York Credit Men's Adjustment Bureau Inc. v. Weiss*,[196] "If the assets—the trust fund for the creditors—were actually improvidently wasted or depleted as a result of defendants' unilateral action the plaintiff is entitled to recover the amount of the loss thus sustained."[197]

In *Weiss*, liability was imposed on directors for negligence because after they were no longer able to conduct the business of the corporation in view of its financial status—they sold the assets of the corporation in public auction at a very low price.[198] The assets were purchased for the sum of $60,000, their book value was $73,492.21, but they were sold for $23,263.33, leaving the corporation net proceeds, after deduction of expenses, of $19,866.98.[199] The New York Court of Appeals held that: "If the corporation was insolvent at that time it is clear that the defendants, as officers and directors thereof, were

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188. This model was developed by Altman in a long line of articles, cited in Jelisavcic, *supra* note 6, at n.166. For a concise summary of the model, see *id.* at 170-72.

189. *See* James Scott, *The Probability of Bankruptcy: A Comparison of Empirical Predications and Theoretical Models*, 5 J. BANKING & FIN. 317 (1981). For additional studies which support the aforesaid model, see Jelisavcic, *supra* note 6, at 168. Altman's model has also been criticized. *See id.* at 168 n.173.

190. For a discussion of this issue, see Lewis U. Davis et al., *Corporate Reorganization in the 1990s: Guiding Directors of Troubled Corporations Through Uncertain Territory*, 47 BUS. LAW. 1, 3-4 (1991).

191. *See* McDonnell, *supra* note 6, at 208.

192. For this matter, see Barbara Franklin, *Directors' Duties: Insolvency Shifts Burden from Shareholders to Creditor*, N.Y. L.J., Aug. 6, 1992, at 5; Meridith M. Brown, *When the Corporation Is Financially Troubled, Director's Role Changes*, NAT'L L.J., May 20, 1991, at S10.

193. 30 F. Cas. 435, 440 (C.C. Me. 1824).

194. *Id.* at 440; *see also* Coffee, *supra* note 178, at 18; Tompkins, *supra* note 37, at 167. For the historical development of the trust fund doctrine, see Stilson, *supra* note 183, at 78-91.

195. *Geyer*, 621 A.2d at 787; *see also* AYR Composition, Inc. v. Rosenberg, 619 A.2d 592, 597 (N.J. Super. Ct. App. Div. 1993).

196. 110 N.E.2d 397 (N.Y. 1953).

197. *Id.* at 400.

198. *Id.* at 399.

199. *Id.*

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to be considered as though trustees of the property for the corporate creditor-beneficiaries."[200]

The court further held that it had been possible to realize the assets of the corporation in another manner, which would have increased the sum received, and therefore the directors were liable for the difference, notwithstanding that they acted in good faith.[201] The court also held that this liability had to be recognized even if the corporation was still technically solvent, but insolvency was approaching and was only a few days away.[202] The court transferred the burden of proof of showing that the auction yielded full value to the directors.[203] This in the light of the court's finding that "[*p*]*rima facie* the assets in this case could have been sold for a sum of money sufficient to satisfy the creditors,"[204] and that the "defendants are the only ones who can furnish the information."[205]

The transfer of the said burden was therefore limited to the "full value" aspect, and the court emphasized that "[t]he burden of establishing the cause of action on the whole case, of course, remains upon the plaintiff."[206] This was an appropriate finding. The ordinary rule is that the plaintiff bears the burden of proving the alleged negligence of the defendant. There is no room for deviation from this rule insofar as it relates to directors in a corporation.[207] This approach is anchored in considerations of judicial policy to the extent that it would be wrong to excessively burden the directors of a corporation and thereby deter qualified persons from engaging in that function.

An additional example of the application of the trust fund theory may be found in the case of *Technic Engineering Limited v. Basic Envirotech Inc.*[208] The court recognized that directors of a corporation are not liable towards the creditors of a corporation save for cases of insolvency.[209] Based on earlier case law, the court held, "the moment a corporation becomes insolvent . . . 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 and fiduciaries."[210]

The theory of the trust fund has not been accepted in all the states.[211] Even those states supporting this theory do not necessarily recognize its application in cases of breach of the duty of care by directors; rather, they confine it to cases of improper

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200. *Id.* at 398.

201. *Weiss*, 110 N.E.2d at 400. The dissenting opinion of Justice Desmond rejected imposing directors' liability in this type of situation. *Id.*

202. *Id.* at 398.

203. *Id.* at 400.

204. *Id.*

205. *Weiss*, 110 N.E.2d at 400.

206. *Id.*

207. For a different approach, see McDonnell, *supra* note 6, at 209 (advocating shifting the burden of proving the reasonableness of their actions when directors are aware of the corporation's insolvency).

208. 53 F. Supp. 2d 1007 (N.D. Ill. 1999).

209. *Id.* at 1010.

210. *Id.* at 1011 (citing Coleman v. Houle, 39 N.E. 725, 727 (Ill. 1895)).

211. For example, its application was rejected in Minnesota, as illustrated in *St. James Capital v. Pallet Recycling Assoc. N.A.*, 589 N.W.2d 511, 515-16 (Minn. Ct. App. 1999). In Delaware, the strict application of the doctrine was rejected as well. For a review of the case law in this context, see McDonnell, *supra* note 6, at 194; Gregory V. Varallo & Jesse A. Finkelstein, *Fiduciary Obligations of Directors of the Financially Troubled Company*, 48 BUS. LAW. 239, 248-55 (1992).

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preferential treatment by directors.[212] This distinction is founded on considerations of judicial policy: the imposition of liability towards creditors in matters based on pure negligence may deter capable persons from acting as directors, and moreover, may deter directors from taking measures in circumstances where the corporation is nearing insolvency, out of fear that these measures will reduce even further the assets of the corporation and thus lead to the imposition of personal liability on the directors towards the creditors.[213] This may lead the directors of corporations that are having financial difficulties to file for bankruptcy protection "sooner than necessary, rather than risking uncertain liabilities."[214]

It is also appropriate to note the distinction that exists between the theory of the trust fund and the ruling of the Delaware Chancery Court in the *Credit Lyonnais* case. Whereas the former theory sees the interests of the creditors as the sole interests which corporate directors are allowed to take into account in situations of insolvency, the judgment in the *Credit Lyonnais* case suggests consideration be given to the interests of the firm as a whole.[215] It would seem that this distinction arises from the fact that the judgment was addressing a situation where the corporation was still solvent, but was at risk of becoming insolvent. The theory of the trust fund, however, relates to the duties of officers in cases where the corporation is already in a state of insolvency. In the latter situation, it is clear that the sole interests are those of the creditors—the shareholders will certainly not enjoy the benefit of the assets of the corporation. This is because the shareholders' right to repayment from the assets of the corporation, when the latter is in a state of insolvency, will only arise after all the creditors of the corporation have been satisfied. When the corporation has not yet reached this situation, but is only at risk of becoming insolvent—as emerges from the example put forward by the court—it is inappropriate to completely ignore the interests of the shareholders; the directors must take into account the entire complex of relevant interests, which include both those of the shareholders and those of the creditors.

There are those who criticize the *Credit Lyonnais* case on the ground that creditors take a risk that the corporation will become insolvent and that they will not be able to recover payment from the corporation, and that this risk is taken into account in the rate of interest which they receive.[216] Thus, the creditors receive compensation for this risk and "judicial insulation from that risk is over-protection."[217] This criticism does not apply to involuntary creditors of the corporation (*e.g.*, tort creditors) or authorities to which the corporation owes taxes, or indeed to voluntary creditors who have no way of determining the level of interest that is compatible with the risk they take. Similarly, in Australia it has been held that the requirement for account to be taken of the interests of the creditors is not confined solely to situations where the corporation is already

212. *St. James Capital*, 589 N.W.2d at 515.

213. McDonnell, *supra* note 6, at 193.

214. *Id.* at 207.

215. Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., No. 12,150, 17 DEL. J. CORP. L. 1099, 1155-57 (1992) (Del. Ch. Dec. 30, 1991), *available at* 1991 WL 277613; *see also* Coffee, *supra* note 178, at 20.

216. C. Robert Morris, *Directors' Duties in Nearly Insolvent Corporations: A Comment on* Credit Lyonnais, 19 J. CORP. L. 61, 64-65 (1993).

217. *Id.*

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insolvent, but applies also to situations where there is a real risk of insolvency in consequence of the fact that the corporation is in financial difficulties.[218]

Recognition of the duty of directors to take into account the interests of creditors in situations of insolvency or near insolvency relates to the content of the duty,[219] and does not necessarily indicate that creditors have been vested with a right of action regarding its breach.[220] At the same time, the requirement that the interests of creditors be taken into account can be effective only if recognition is awarded to the right of action of the creditors in respect of its breach.[221] Indeed, case law in various states has recognized a direct duty owed to creditors in situations of insolvency. This does not necessarily mean that a right of action will be available to every creditor; it may be available to the entire body of creditors through the liquidator, as will be explained below.

There are those who believe that there is no room to recognize such responsibility towards creditors on the part of corporate directors, even in situations of insolvency, on the ground that:

> [i]f a duty was owed, it could encourage creditors to place pressure on directors who might manipulate payments by their companies to ensure that they are not personally liable; this would be likely to cause the collapse of the company and it would undermine the *pari passu* principle applicable in respect of insolvent companies, leaving the general body of creditors disadvantaged. Furthermore, if a duty was owed to creditors it could lead to a deluge of actions against directors and in such circumstances the stronger creditors are likely to succeed in receiving payment from the directors at the expense of weaker ones in that directors may be rendered impecunious by the claims which the first satisfied; again this does not provide a fair and reasonable distribution of the property which is available. In such circumstances, the only hope for unsatisfied creditors would be that the directors are bankrupted subsequently, and in such a time period which would allow a trustee to attack payments to creditors as preferences.[222]

Indeed, in order to obviate these risks, statutory provisions are necessary that will ensure the prevention of the damage described above to the entire body of creditors of the corporation. Protection of the entire body of creditors may be carried out both by means of imposing liability on the directors—when the latter have yielded to the pressure of strong creditors and thereby injured the entire body of creditors—and by means of nullifying actions that entail preferential treatment of creditors. Such provisions are

218. Grove v. Flavel (1986) 11 A.C.L.R. 161.

219. Professor Lawrence Mitchell suggests recognition of a general duty on corporate officers to take into account the interests of bondholders and not to limit this duty to situations connected with insolvency. *See* Mitchell, *supra* note 5, at 1222-28.

220. *Cf.* Beveridge, *supra* note 6, at 619-21 (noting the absence of case law supporting direct actions by creditors); Loose et al., *supra* note 7, at 130 (noting that despite the existence of a duty, the law does not afford a personal remedy to the creditor).

221. On this matter, Professor Sealy commented, "A supposed legal duty which is not matched by a remedy is a nonsense." L. S. Sealy, *Directors' "Wider" Responsibilities—Problems Conceptual, Practical and Procedural*, 13 MONASH U. L. REV. 164, 177 (1987).

222. A. KEAY, INSOLVENCY—PERSONAL AND CORPORATE LAW AND PRACTICE 515 (4th ed. 1998).

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contained in the laws of various states, and a discussion of them exceeds the scope of this article.

The type of situations discussed in this Part refer to something other than a personal duty towards a particular creditor. The duty is owed to the entire body of creditors, and realization of the right of action will be carried out for the benefit of all the creditors.[223] American law, like English[224] and Belgian[225] law, vests the right of action in the liquidator alone, when the claim is intended to augment the total sum of money available for distribution to the creditors. The liquidator is an organ of the corporation under liquidation and his claim is intended to protect the interests of all the creditors. In contrast, other legal systems—such as the Australian and Israeli systems—recognize the right of every creditor to file a suit against directors in times of liquidation, in addition to the right of action of the liquidator. This distinction focuses on the identity of the person entitled to file the suit. There is no difference between said legal systems insofar as the outcome of filing the suit is concerned. Even when the right of the creditor to bring an action is recognized, the consequences of the creditor succeeding in his claim are similar to the consequences of success by liquidator, in the sense that the amount of the award becomes part of the liquidation fund for the purpose of distribution among the creditors. The following discussion will focus on the said rights of action as applied in various legal systems.

A. American Law

American law recognizes the fact that breach of a corporate officer's duty may be enforced in a "winding-up," by means of the trustee. Thus, the Court held in *Pepper v. Litton*:[226]

> While normally that fiduciary obligation is enforceable directly by the corporation, or through a stockholder's derivative action, it is, in the event of bankruptcy of the corporation, enforceable by the trustee. For that standard of fiduciary obligation is designed for the protection of the entire community interests in the corporation—creditors as well as stockholders.[227]

Similarly, in the case of *Speer v. Dighton Grain, Inc.*, the Supreme Court of Kansas held:[228]

> A creditor of an insolvent corporation who sues solely on his own behalf cannot maintain a personal action against directors or officers who, by

223. *See, e.g.*, *In re* Jacks, 243 B.R. 385 (Bankr. C.D. Cal. 1999) (holding, in part, that a cause of action brought by corporate creditor (employee psychologist) against a debtor director (President and CEO of employing medical corporation) must be brought to benefit all corporate creditors).

224. The Insolvency Act, 1986, c. 45, § 214 (Eng.). English law does so only partially, whereas section 212 also enables an individual creditor to bring an action. *Id.* c. 45, § 212.

225. *See* Thierry Bosly & Françoise Lefèvre, *Belgium*, *in* DIRECTORS' LIABILITIES IN CASE OF INSOLVENCY, *supra* note 11, at 141, 151.

226. 308 U.S. 295 (1939).

227. *Id.* at 307 (internal citations omitted).

228. 624 P.2d 952 (Kan. 1981).

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negligent mismanagement of the corporation's affairs, have breached their duty to the corporation to the consequent damage or injury of its creditors.[229]

B. English Law

In 1986, English law created a special responsibility for damage to a creditor of the corporation as a result of the negligence of corporate directors. This responsibility was prescribed by section 214 of the Insolvency Act.[230] The provision was enacted as a result of the recommendations of the Cork Commission, according to which there was no justification for demanding proof of fraud in order to found the civil liability of a director—as distinct from criminal liability.[231] According to section 214, the court is entitled to compel a director[232] to contribute to the assets of the corporation in such a manner as the court sees fit, at the application of the liquidator, where the following conditions apply:[233]

1. The corporation entered liquidation by reason of being insolvent. Insolvent liquidation for this purpose occurs when the corporation enters liquidation at a time when its assets are insufficient to pay all its debts and the expenses of the liquidation;[234]
2. At any time prior to the liquidation the director knew, or ought to have known, that there was no reasonable possibility of the corporation being able to avoid entering insolvent liquidation;[235]
3. The defendant was a director of the corporation at this time.[236]

The court will not issue a declaration under this section relating to a person when it is persuaded that after the second condition was met he took all the steps that he should have taken, with the intention of mitigating the potential damage to the creditors of the corporation.[237]

The facts which the director ought to have known, and the steps which he ought to have taken, are those of a reasonable person who possesses the knowledge, skill, and experience that may reasonably be expected from a person fulfilling a function similar to that of the director under consideration, and the knowledge, skill and experience of the actual director.[238] The result, therefore, is a combination of subjective and objective tests. A director who does not meet the minimal, objective standard will not receive protection

229. *Id.* at 961.
230. The Insolvency Act, 1986, c. 45, § 214 (Eng.).
231. CORK COMM'N, CORK REPORT: INSOLVENCY LAW AND PRACTICE §§ 1776-1777 (1982).
232. Directors include "shadow directors." The Insolvency Act, 1986, c. 45, § 214(7) (Eng.).
233. *Id.* c. 45, § 214(2).
234. *Id.* c. 45, § 214(6).
235. *Id.* c. 45, § 214(2); *see also* T.E. Cooke & A. Hicks, *Wrongful Trading—Predicting Insolvency*, 1993 J. BUS. L. 338 (discussing methods used by courts to determine the point in time a director should have concluded that insolvent liquidation was inevitable).
236. The Insolvency Act, 1986, c. 45, § 214(2)(c) (Eng.).
237. *Id.* c. 45, § 214(3).
238. *Id.* c. 45, § 214(4).

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even if he did the best he could. However, a director having skills exceeding the minimal standard must exercise his greater skills in order to be exempted from liability.[239]

Alarm signals regarding the difficulties of the corporation, which may lead to its insolvency, may be of diverse types, such as the loss of a major client, the refusal of a supplier to give credit to the corporation, loss of key employees, and receipt of professional advice to the effect that insolvency is inevitable.[240] The basis of the liability lies in the failure to take reasonable steps to mitigate the damage of the creditors.[241] Accordingly, a director may be found liable by virtue of the section for prematurely terminating the corporation's business, for failing to collect monies due to the corporation, for paying excessive wages to directors and the like.[242] A director who wishes to avoid liability should obtain outside advice so that he can not be deemed to have failed to take the appropriate measures. Directors who do not obtain the assistance of experts and decide to continue conducting the business of the corporation in the hope and faith that the corporation will survive the crisis take the risk that the court will decide, *post factum*, that they failed to take the necessary measures.[243]

The right to bring an action in accordance with this section is vested solely in the liquidator. The explanation for confining the right to the liquidator is found in the collective character of liquidation proceedings, which are intended to realize the principle of the proper distribution of assets in accordance with the principles prescribed by law.[244] This does not mean that an individual creditor is powerless concerning the filing of the above action. If the liquidator refrains from exercising the power conferred on him by law, a creditor is entitled to apply to the court to exercise its oversight powers over the liquidator and examine the justification for the latter's refusal to bring an action against the corporate officer.[245]

The scope of the directors' liability under the section is based on causation, *i.e.*, to what extent was the creditor's loss caused by the conduct of the directors.[246] The amount which will be awarded against the directors will enter the liquidation fund and will be available for the benefit of all the creditors and not only the benefit of those who were the victims of the wrongful trading.[247]

In addition to a claim under section 214, English law provides for a right of action against a corporate officer when it becomes clear during the course of the winding-up that he: "has misapplied or retained, or become accountable for, any money or other property

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239. *Id.* c. 45, § 214; *see also* R. M. GOODE, PRINCIPLES OF CORPORATE INSOLVENCY LAW 470-71 (2d ed. 1997) (discussing the standard of knowledge and skill required for directors).

240. *See* Cooke & Hicks, *supra* note 235, at 339.

241. The section refers to creditors in general and not specifically to future creditors. The Insolvency Act, 1986, c. 45, § 214 (Eng.).

242. *See* GOODE, *supra* note 239, at 465-66.

243. *See* L. S. SEALY, DISQUALIFICATION AND PERSONAL LIABILITY OF DIRECTORS § 610 (3d ed. 1989).

244. *See* Vanessa Finch, *Directors' Duties: Insolvency and the Unsecured Creditor*, *in* CURRENT ISSUES IN INSOLVENCY LAW 87, 98 (Alison Clarke ed., 1991).

245. The Insolvency Act, 1986, c. 45, §§ 112, 167 (Eng.).

246. *See Re* Produce Marketing Consortium Ltd. (No 2), [1989] B.C.L.C. 520, 553 (holding, in part, that, for determining liability, a director should be treated as having knowledge of ascertainable information and of the information published in the corporation's annual report).

247. *See* D. D. Prentice, *Creditor's Interests and Director's Duties*, 10 OXFORD J. LEGAL STUD. 265, 272 (1990).

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of the company, or been guilty of any misfeasance or breach of any fiduciary or other duty in relation to the company."[248] This section does not create a new duty, but rather an effective and convenient procedure for bringing an action against corporate officers who breached any duty while conducting the business of the corporation.[249] In light of the broad formulation of the section, which refers to every duty, it will also embrace breach of the duty of care by the director.[250] The right of action under this section is conferred on the Official Receiver, liquidator and any creditor or contributory, in contrast to section 214, which confers the right of action solely on the liquidator.[251] From the point of view of the outcome, even a claim brought under section 212, which is instituted by a creditor, does not confer the fruits of the action on the specific creditor, rather by virtue of his action, the court is empowered to order the corporate officer:

> (a) to repay, restore or account for the money or property or any part of it, with interest at such rate as the court thinks just, or (b) to contribute such sum to the company's assets by way of compensation in respect of the misfeasance or breach of fiduciary or other duty as the court thinks just.[252]

In other words, the right of action under this section is conferred on every creditor, but the plaintiff does not obtain direct compensation from the corporate director, rather the compensation reaches the fund of assets administered by the liquidator. The plaintiff creditor, exactly as all other creditors, will receive what is owed to him in accordance with the order of preference applicable to the distribution of the corporate assets in a winding-up of the corporation, as prescribed by law.

C. *Australian Law*

In 1992, the Australian legislature enacted provisions concerning the responsibility of directors to prevent "insolvent trading" effective on June 23, 1993. Section 588G of the Australian Companies Act prescribes the conditions for this responsibility to come into effect:

> 1. A person who is a director in the corporation at the time the corporation created the debt;
> 2. The corporation was not solvent at that time or had become insolvent by creating this debt or by creating debts which include this debt;
> 3. At that time there was a reasonable basis for suspecting that the corporation was not solvent or would become insolvent, as appropriate;

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248. Insolvency Act, 1986, c. 45, § 212(1) (Eng.). For the possibility of bringing an action both under section 212 and under section 214 in cases of negligence, see PETER LOOSE & MICHAEL GRIFFITHS, LOOSE ON LIQUIDATORS 88-89 (4th ed. 1997).

249. *See* IAN F. FLETCHER, THE LAW OF INSOLVENCY 658-59 (2d ed. 1996); *see also* FIONA TOLMIE, INTRODUCTION TO CORPORATE AND PERSONAL INSOLVENCY LAW 354 (1998).

250. *See Re* D'Jan of London Ltd., [1994] 1 B.C.L.C. 561. Prior to the Insolvency Act there were doubts regarding the application of the corresponding section in the Companies Act in cases of negligence. The broad wording of Section 212 removed these doubts. Insolvency Act, 1986, c. 45, § 212 (Eng.).

251. *Compare* Insolvency Act, 1986, c. 45, § 212 (Eng.), *with id.* c. 45, § 214.

252. *Id.* c. 45, § 212(3).

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4. That time was subsequent to the entering into force of the provisions under discussion—23 June 1993.[253]

The responsibility of the director under the section ensues from the fact that he did not prevent the corporation from creating the debt in one of the following two situations: (1) he was aware that there was a basis for the aforesaid suspicion, and (2) a reasonable man of the same status in the corporation, in the same circumstances, would have been aware of the same.[254]

It follows from this provision that Australian law prohibits the continued conduct of business where the creation of the debt may lead to the insolvency of the corporation. The purpose of this provision is to encourage directors to ensure the earliest possible administration process in order to increase the likelihood of the recovery of the corporation.[255] Australian law grants a defense to a director who proves that at the time the debt was incurred he has a reasonable basis for anticipating—and he indeed anticipated—that the corporation was solvent and would remain solvent, even if it incurred the debt and other debts which it created at that time.[256] In addition to this general defense, Australian law grants a defense to a director who relied on another corporate officer regarding information concerning the solvency of the corporation.[257] A further defense is given to a director who, as a result of sickness or other good reason, did not take part in conducting the business of the corporation.[258] Similarly, a defense is available to a director who took all reasonable steps to prevent the corporation from incurring the debt.[259] As distinct from English law, which, as noted, vests the right of action exclusively in the liquidator, the liability under Australian law is both towards the corporation, resulting from a claim by the liquidator of the corporation,[260] and towards the creditor, who suffered loss as a result of the insolvency of the corporation.[261]

D. New Zealand Law

The Companies Act of 1993 introduced a new duty, which is imposed on directors for reckless trading.[262] The expression "reckless trading" is defined as "agreeing to or causing or allowing conduct likely to create a substantial risk of serious loss to the

253. *See* Corporations Law, 1992, § 588G (Austl.).

254. *Id.* § 588G(2).

255. The procedure for opening a recovery process under Australian law is simpler and faster than that provided by English law. *See* Roy Goode, *Insolvent Trading Under English and Australian Law*, 16 CO. & SEC. L.J. 170, 172 (1998).

256. Corporations Law, 1992, § 588H(2) (Austl.).

257. *Id.* § 588H(3).

258. *Id.* § 588H(4).

259. *Id.* § 588H(5).

260. *Id.* § 588M(2).

261. Corporations Law, 1992, § 588M(3) (Austl.). In order to bring an action a creditor must obtain the written consent of the liquidator. *Id.* § 588R. The creditor may give notice to the liquidator six months after the commencement of the winding-up to the effect that he intends to bring an action against the directors and ask the liquidator to give, within three months, his consent to the creditor bringing the action, or grounds for not bringing it. *Id.* § 588S. If the consent of the liquidator has not been given within three months, the creditor may file the action against the director if the Court has given leave for the proceedings to begin. *Id.* § 588T(2).

262. Companies Act, 1993, § 135 (N.Z.).

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company's creditors."[263] There are those who criticize this section on the ground "that it does not make allowances for normal business risks."[264] The law places the directors at risk of liability by leaving to the court the interpretation of the terms "substantial risk" and "serious loss." It is clear that every court must judge the conduct of the directors in accordance with what was reasonable at the time they made the decision and should not consider the matter in hindsight and impose liability on directors in every case in which creditors ultimately sustain a loss.

E. Israeli Law

Israeli law enables any creditor to bring an action against the directors after winding-up proceedings have been commenced against the corporation.[265] The creditor's claim may be in addition to the claim by the liquidator.[266] A claim may be brought in every case where it becomes clear during the winding-up that the directors breached any duty to the corporation, including the duty of care.[267] Even though the right of action is available to every creditor, the fruits of the action are not awarded to the creditors, but go into the liquidation fund. The Supreme Court of Israel has held that the period of prescription commences after the winding-up—from the date that the liquidator becomes aware of the facts forming the cause of action.[268] This ruling significantly increases the risk facing corporate directors. Negligence on their part, in conducting the business of the corporation, may expose them to future claims if the corporation becomes subject to a winding-up order. Directors could be liable even if the winding-up has commenced after the end of the ordinary prescription period.

F. German Law

German law enables creditors to file an action against directors in a corporation as a result of breach of their duty of care. Creditors may file an action if they are unable to obtain satisfaction from the corporation. Further, members of the management board must have grossly violated the duty of care of a diligent and conscientious manager.[269]

Vesting creditors with a right of action in cases of the insolvency of the corporation is compatible with procedures in other systems of law. However, German law is unique in two ways. First, German law vests in creditors the right of action in cases of

263. *Id.* § 135.

264. Watson, *supra* note 9, at 500.

265. *See* The Companies Ordinance § 374 (1983). Notwithstanding that the new Israeli Companies Act entered into force in February 2000, the Act left in place the provisions of The Companies Ordinance regarding charges and winding-up of corporations.

266. The right of action under the section is also vested in the Official Receiver and every shareholder of the corporation.

267. C.A. 333/59, Rotlevy v. Barashi, 14 P.D. 1156; C.A. 3016/90, Arenreich v. Cochav Hashomron Ltd. (in Liquidation) 36 Dinim Elyon 437.

268. C.A. 5017/92, Merkaz Ha'argazim Ltd. (in Liquidation and Receivership) v. Ozer, 51(2) P.D. 200.

269. § 93(5) Nr. 4 AktG. The liability imposed by virtue of this section on the management board also applies to the members of the supervisory board by virtue of section 116 of the AktG. § 116 Nr. 4 AktG. A similar provision, which recognizes the right of action of creditors against corporate officers in cases where creditors are unable to obtain satisfaction from the corporation is found in section 117(5) of the AktG. § 117(5) Nr. 4 AktG.

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insolvency without making the right of action contingent upon the existence of winding-up proceedings against the corporation. Second, the creditors' right of action is contingent upon a gross breach of the duty of care. German law transfers the creditors' right of action to the liquidator upon the commencement of winding-up proceedings against the corporation. Thus, section 93(5) of the AktG provides as follows: "If insolvency proceedings have been instituted over the company's assets, the receiver or the trustee, as the case may be, shall exercise the rights of the creditors against the members of the management board during the course of such proceedings."[270]

G. Belgian Law

The Belgian Companies Law imposes personal liability on directors whose negligence has contributed to the bankruptcy of the corporation.[271] "The negligence for which directors are responsible has a dual characteristic: it must be both manifest and gross."[272] Situations which have been recognized as meeting the requirements of "manifest and gross negligence" are continued management of the corporation's business when the corporation is clearly insolvent; use of the corporation's monies for private purposes;[273] and the implementation of risky industrial policies, without any economic and financial foundation, "which will inevitably lead to the corporation's bankruptcy."[274] The right of action is vested solely in the trustee in bankruptcy and not in the creditors.

V. CONCLUSION

Corporate directors owe a duty of care towards the corporation. A creditor of the corporation cannot bring a personal action against the directors for their negligence in conducting the business of the corporation. The claim must be brought by those that the law empowers to institute actions against the directors of the corporation for breach of their duties. This principle is based on considerations of judicial policy.[275]

In addition to the duty of care to the corporation, there are a number of other situations in which the law recognizes the direct responsibility of corporate directors to third parties for director negligence. These situations are divided into two categories. The first category embraces those situations in which the law recognizes the existence of a direct duty of care to creditors. This category is based on the law of torts, which recognizes the personal responsibility of a tortfeasor for the tort committed, even where he acted, at the relevant time, within the framework of his employment or agency. Accordingly, the director can be liable where his act or omission caused damage to the property or person of the creditor, as well as where his negligent representation caused financial damage to the creditor.

English and New Zealand case law refuse to recognize the liability of directors to third parties for negligent representations on their part. This approach conflicts with general principles of law even in these countries. It is also incompatible with the

270. § 93(5) Nr. 4 AktG.
271. Company Law, art. 63ter (Belgium).
272. Bosly & Lefèvre, *supra* note 225, at 159.
273. Such a situation should be classified as a breach of a fiduciary duty, which exceeds negligence.
274. Bosly & Lefèvre, *supra* note 225, at 159.
275. *See supra* Part II.

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willingness to recognize the liability of corporate directors in cases where physical or property damage is caused by an act committed by the corporate director. It is also incompatible with the recognition of directors' liability towards third parties for a misleading particular in a prospectus. This approach may therefore be rejected and preference given to an approach recognizing the personal liability of directors for negligent representations, when the conditions for such liability under the law of torts have been met, and even when the tort has been committed within the framework of the directors' functions in the corporation.

The various systems of law that have been reviewed in this Article recognize the personal liability of directors for misleading particulars in a prospectus. This duty is owed to those who acquired debentures under the prospectus. Breach of the duty to include in the prospectus full and accurate information regarding substantive particulars, which are required by a reasonable investor to come to a decision regarding investment in the corporation, also falls within the category of personal liability of the corporate director. This is so because the imposition of liability in such a case means recognition of the duty of care of the corporate director towards investors in the above context. This situation is distinct from the others falling within this category of duty of care towards third parties because the burden of proof is transferred to directors to show lack of responsibility on their part. This increased liability of directors is anchored in policy considerations of strengthening the credibility of the capital market.

The second category in which the liability of directors towards creditors is recognized relates to situations where the corporation enters into a state of insolvency. This category is distinguished from the first category. In this category, the law does not recognize breach of a personal duty of care towards creditors, but rather the capacity of the latter to cause actions to be brought against directors for the purpose of filling the empty coffers of the corporation. The consequence of this action is not the transfer of a payment to a particular creditor, as in the first category of cases. Rather, it is the transfer of the payment to the coffers of the corporation. This payment benefits all the creditors in accordance with the practice of distribution of assets in a corporate winding-up.

The question of whether any creditor may exercise the right of action or whether it is confined to the liquidator, who represents the entire body of creditors, has not been given a uniform answer in the various systems of law. There are some legal systems that recognize the right of any creditor to bring the action, while others confine the right of action to the liquidator. This variance does not affect the substance of the claim. Under either alternative the compensation, which the directors are found liable to pay, is transferred to the fund of assets for the benefit of all those entitled to payment from the corporation being wound up.

In those systems of law where the right of action is confined solely to the liquidator, this category is not an exception to the basic rule according to which the directors' duty of care is owed to the corporation, because the liquidator is an organ of the corporation and his action against the directors may be seen as enforcement of the rights of the corporation. This is the case notwithstanding that the purpose of the claim is to increase the fund available for distribution to the creditors. The situation is different in countries that recognize the personal right of action of creditors in such cases. Such recognition forms an exception to the above rule. However, the scope of the exception is limited and

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its significance lies in conferring power to bring an action; it does not vest the fruits of the action in the plaintiff personally.

The legal policy considerations that reject the possibility of enabling a creditor to interfere in the manner in which the directors function in the corporation, so long as the corporation is able to meet its obligations towards the creditors, do not apply when the corporation is in a state of insolvency. The recognition—given by recent case law to the duty of corporate directors to take into account the interests of creditors when the corporation is in a state of insolvency—must be confined to the context of the duty to take into consideration these interests when the corporate directors knew or ought to have known of the lack of solvency of the corporation. It cannot be allowed to slide into recognition of the right of action of these creditors before winding up proceedings have been brought against the corporation. Upon the commencement of winding-up proceedings, recognition is given to the right of creditors to bring an action against directors for negligence in conducting the business of the corporation, either independently or through the liquidator. Recognition of the right of action of creditors against directors in a winding-up preserves, on one hand, the principle rejecting the right of a creditor to interfere in matters connected with the corporation's management, and on the other hand, safeguards the interests of the creditors, when these are faced with a crisis by reason of the insolvency of the corporation.

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