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DEEPENING INSOLVENCY CLAIMS AND FIDUCIARY DUTIES IN CORPORATIONS IN THE ZONE OF INSOLVENCY: WHETHER THERE IS AN AFFIRMATIVE DUTY TO LIQUIDATE UNDER DELAWARE LAW AND UNDER BRAZILIAN LAW[1]

AÇÃO DE RESPONSABILIDADE CIVIL POR AGRAVAMENTO DE INSOLVÊNCIA E DEVERES FIDUCIÁRIOS EM COMPANHIAS NA ZONA DE INSOLVÊNCIA: DEVEDORES POSSUEM A OBRIGAÇÃO DE PROMOVER A AUTOFALÊNCIA EM DELAWARE E NO BRASIL?

Caetano Penna Franco Altafin Rodrigues da Cunha

Resumo: Baseado no Direito Falimentar vigente em Delaware e no Brasil, o presente artigo discute se credores podem ou devem poder ingressar com ações de responsabilidade civil por agravamento de insolvência e se o conselho de administração de sociedades empresárias possui ou deve possuir deveres fiduciários perante credores. Esse artigo encontra-se estruturado em quatro partes principais. A primeira parte analisa as razões que teoricamente justificam ações de responsabilidade civil por agravamento de insolvência, bem como os sujeitos que tais ações se propõem proteger. A segunda parte discute a natureza e a extensão dos deveres fiduciários dos conselheiros de administração com base na jurisprudência consolidada a partir da

1 The author would like to thank Professors Mark Bienenstock from Harvard Law School and Márcio Souza Guimarães from Fundação Getúlio Vargas — Rio for their comments that inspired this paper.

decisão proferida pela Corte de Delaware em *Credit Lyonnais*. A terceira parte investiga as questões que ainda não se encontram solucionadas em Delaware em ambos os tópicos após a Corte de Chancelaria desse Estado ter se recusado a preliminarmente julgar improcedente uma ação de responsabilidade civil movida por um credor com base no agravamento de insolvência em *The Brown School* ("*TBS*"). A quarta parte relaciona o entendimento vigente sobre o tema em Delaware com a suposta obrigação que devedores possuem de requerer autofalência, consoante o disposto no art. 105 da Lei 11.101/05 conforme interpretado pela 2a Vara de Direito Empresarial do Estado do Rio de Janeiro em agosto de 2010 ao decidir o caso *VARIG*. Este artigo possui dois argumentos principais. Em primeiro lugar, independentemente das incertezas deixadas pelo resultado preliminar em *TBS*, a decisão da Suprema Corte de Delaware em *Gheewalla* restringe o escopo dos deveres fiduciários de conselheiros de administração unicamente à companhia e aos acionistas. Dessa forma, essa decisão, juntamente àquela proferida em *Trenwick*, deve orientar o resultado final em *TBS*, contrariamente à procedência de ações de responsabilidade civil por agravamento de insolvência. De acordo com o Direito vigente em Delaware, credores podem ingressar com ações baseadas em seus direitos contratual ou legalmente reconhecidos, ou ainda ingressar com ações derivativas em nome da companhia. Em segundo lugar, esse artigo argumenta que, com base no Direito Falimentar de Delaware e no Brasil, credores não possuem e nem devem possuir o direito de ingressar com ações de responsabilidade civil por agravamento de insolvência. Contrariamente aos fundamentos que embasaram a decisão proferida em agosto de 2010 no caso *VARIG*, os conselheiros de administração devem ter como salvaguarda a regra de proteção à decisão negocial por decisões tomadas de boa-fé e de maneira informada, independemente do resultado que delas decorra. Essa proteção deve também abranger a decisão de não requerer autofalência com base no art. 105, da Lei Falimentar brasileira.

Palavras-Chave: Ações de Responsabilidade Civil por Agravamento de Situação Econômica-Financeira. Deveres Fiduciários. Fa-

lência. Recuperação Judicial. Plano de Recuperação Judicial. Credores. TBS. VARIG. Trenwick. Credit Lyonnais.

Abstract: This paper presents two positive and two normative claims. Based on Delaware Law and Brazilian Bankruptcy Law, it discusses whether deepening insolvency claims constitute or should constitute an independent cause of action, and whether the board of directors owes or should owe fiduciary duties directly to creditors. For these purposes, this paper is structured in four parts. First, it analyses the rationale behind deepening insolvency claims and whom they are meant to protect. Second, it discusses the nature and the extent of the duties owed by directors under the *Credit Lyonnais* line of cases. Third, it looks into the questions that remain unsolved under Delaware Law on both matters after the Court of Chancery refused to dismiss a deepening insolvency claim in *The Brown School* ("*TBS*") decision. And fourth, it relates the current understanding on deepening insolvency claims under Delaware Law with the alleged affirmative duty imposed on debtors to file for bankruptcy pursuant to Brazil's Chapter 7 (Lei 11.101/05, Art. 105) as interpreted by the Commercial Court of the State of Rio de Janeiro in the August 2010 *VARIG* decision. I have two central claims. First, I argue that, in spite of the uncertainties left by the preliminary outcome in *TBS*, the Supreme Court of Delaware decision in *Gheewalla* limits the extension of the fiduciary duties owed by directors to the company itself and its shareholders. This decision coupled with the Court of Chancery holding in *Trenwick* should orientate the final outcome in *TBS* against recognizing deepening insolvency claims as an independent cause of action. Under Delaware Law, creditors may either file direct claims based on their contractually and legally recognized rights or derivative claims on behalf of corporations. Second, I claim that neither under Delaware Law nor under Brazilian Bankruptcy Law creditors have or should have an independent cause of action for deepening insolvency claims. Contrary to the reasoning that led to the August 2010 *VARIG* outcome, under both bodies of law, directors of corporations in

the zone of insolvency should be entitled to the protection given by the business judgment rule for informed decisions taken in good faith and regardless of their outcome. This protection should also cover the decision not to file for liquidation under Chapter 7.

Key-Worlds: Deepening insolvency Claims. Fiduciary Duties. Bankruptcy. Reorganization. Plan of Reorganization. Creditors. TBS. VARIG. Trenwick. Credit Lyonnais.

I. Deepening insolvency claims: who they are meant to protect and what incentives they actually produce

Although the argument that deepening insolvency claims should constitute an independent cause of action is generally introduced as a protective measure to benefit all corporate constituencies,[2] it actually intends to safeguard creditors of insolvent corporations. By definition, deepening insolvency claims are meant to function as a

2 Concerning the origins of the deepening insolvency claims' doctrine, Joseph M. McLaughlin explains that: "In Schacht v. Brown [1983], the Seventh Circuit rejected the assertion "that the fraudulent prolongation of a corporation's life beyond insolvency is automatically to be considered a benefit to the corporation's interests." Rather, interpreting Illinois law, the court reasoned, "the corporate body is ineluctably damaged by the deepening of its insolvency, through increased exposure to creditor liability." McLaughlin, Joseph M. *Directors' and officers' liability the deepening insolvency debate* (2007), available at www.stblaw.com/content/publications/pub599.pdf.

backdoor anticipatory remedy to push directors toward the liquidation of corporations in the zone of insolvency for the alleged benefit of creditors.[3] The complexity of the discussion on whether deepening insolvency claims should provide creditors with an autonomous cause of action refers to the intricate definition of the interests that should govern corporations in the zone of insolvency.[4] Nonetheless, the case for recognizing deepening insolvency claims as an independent cause of action arises from a misconstrued understanding of the benefits and incentives that they actually create.

Those that claim that directors have the affirmative duty to liquidate insolvent corporations, as opposed to incur risks of eventually deepening financial strained positions, argue that corporate insiders should not be allowed to indefinitely benefit from the corporate form in detriment of creditors. On the contrary, as the argument follows, terminating the existence of insolvent corporations by ordering their timely liquidation would ideally constrain them within the boundaries set forth by the social purposes corporations should serve. These limits would ultimately be representative of the creditors' interests as financers of the corporate enterprise. Under this rationale, creditors should be entitled to legal protection against corporations deemed financially inviable. Nevertheless, the arguments favorable to recognizing deepening insolvency claims as an independent cause of action are flawed and inconsistent with both the American business judgment rule[5] and the spirit of the Brazilian Bankruptcy Statute.

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3 North American Catholic Educational Programming Foundation, Inc. v. Gheewalla, 930 A.2d 92, 99, at 4 (Del. 2007); Production Res. Group v. NCT Group, Inc., 863 A.2d at 782 (quoting Siple v. S & K Plumbing & Heating, Inc., 1982 WL 8789, at 2).

4 ALLEN, William; KRAAKMAN, Reinier; & SUBRAMANIAN, Guhan. *Commentaries and Cases on the Law of Business Organization*, 3rd Ed. New York: Aspen Publishers, 2009, p. 141-142.

5 Elizabeth Warren questions: "Why not simply provide for the orderly liquidation of business that cannot pay their debts? What possible justification is there for permitting the continued operation of a business that is not paying its legitimate debts? And answers: "Chapter 11 preserves economic value [...] Going concerns typically bring higher values, increasing the potential recovery for many creditors". WARREN, Elizabeth. *Chapter 11: Reorganizing American Businesses*, New York: Aspen Publishers, 2008, p. 10-11.

First, the deepening insolvency claim argument illogically implies that business strategies should be legally evaluated by their results rather than by the fundamentals on which they are based. It intrudes into the business judgment rule and constrains the ability that directors of insolvent corporations have to pursue value-enhancing strategies in good faith and in an informed manner.

As all corporate constituencies, creditors benefit from meritorious decisions and are harmed by unfortunates that every once in a while affect businesses. Recognizing that deepening insolvency claims constitute an independent cause of action forces companies that could otherwise overcome financial difficulties into liquidation and therefore is inconsistent with the spirit embodied in Chapter 11 and in the Brazilian Bankruptcy Statute.

The argument in favor of recognizing deepening insolvency claims as an independent cause of action assumes directors have a clear business decision to make in the case of companies in the zone of insolvency, namely to file under Chapter 7. Nevertheless, the notion of deepening insolvency claims misconstrues the term "zone of insolvency" under Delaware Law.

As the Delaware Supreme Court discussed in *Gheewalla*, the concept of zone of insolvency is sufficiently vague and therefore should be interpreted on a case-by-case basis, "Corporations operate in the zone of insolvency by either showing: (1) a deficiency of assets below liabilities with no reasonable prospect that the business can be successfully continued in the face thereof, or (2) an inability to meet maturing obligations as they fall due in the ordinary course of business."[6]

Thus, a sound regulatory policy does not derive from understanding that an affirmative obligation to file under Chapter 7 should

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6 North American Catholic Educational Programming Foundation, Inc. v. Gheewalla, 930 A.2d 92, 99, at 4 (Del. 2007); Production Res. Group v. NCT Group, Inc., 863 A.2d at 782 (quoting Siple v. S & K Plumbing & Heating, Inc., 1982 WL 8789, at 2).

be triggered by an undefined event, namely entering the zone of insolvency, and thereby directors may be held liable for failing to do so. On the contrary, courts should be restrained from assessing beyond the reasonableness of the board decision to either attempt to overcome financial distress positions or disrupt and liquidate the corporate entity.[7] Indeed, as in any business strategy, boards are in a better position to decide whether to file under Chapter 7 than courts. For this reason, under Delaware Law and under Brazil's Bankruptcy Statute, directors of corporations in the zone of insolvency should be entitled to the protection given by the business judgment rule in deciding whether to file for liquidation.

In addition, denying deepening insolvency the status of an independent cause of action advances the best interests of creditors. Employees and creditors with long-term relationships with corporations are likely to benefit from rules that assure the continuity of the business form, rather than from provisions that push corporations under financial distress toward liquidation. Moreover, recognizing deepening insolvency claims as an independent cause of action distorts incentives that creditors and directors of corporations in the zone of insolvency have for two reasons.

First, creditors only have incentives for filing deepening insolvency claims if, at the time, they expect to benefit from the returns

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7 Similarly, the decision-making process of defining whether a corporation in the zone of insolvency should continue to operate or be liquidated pursuant to the Brazilian Bankruptcy Law is directly related to what Fábio Ulhoa Coelho calls providing businesses with a market solution to define its viability. The author explains: "Nem toda falência é um mal. Algumas empresas, porque são tecnologicamente atrasadas, descapitalizadas ou possuem organização administrativa precária, devem mesmo ser encerradas. Para o bem da economia como um todo, os recursos — materiais, financeiros e humanos — empregados nessa atividade devem ser realocados para que tenham otimizada a capacidade de produzir riqueza". "Not every bankruptcy is an evil. Companies that are technologically outdated, undercapitalized or poorly organized should indeed be liquidated. For the benefit of the economy as a whole, material, financial and human resources employed in unsuccessful activities should be reallocated for being capable of optimizing the production of wealth". Free translation by the author. COELHO, Fábio Ulhoa. *Comentários à Nova Lei de Falências e de Recuperações Judiciais (Lei n. 11.101, de 9-2-2005)*, 5a Ed., São Paulo: Saraiva, 2008, p. 115-116.

from liquidating corporate assets. Therefore, providing creditors with an independent cause of action in that matter would likely create a "gold race" for filing deepening insolvency claims premised on how one's credit is ranked amidst the corporate indebtedness. Second, the uncertainties derived from such a rule would diminish the incentives directors of corporations in the zone of insolvency have to pursue value-enhancing business strategies and, as a result, damage regular creditors.

The only way to provide directors with adequate incentives to assess the fundamentals of businesses under distress is to ensure that the decision on whether to file for liquidation is protected by the business judgment rule. Therefore, courts should entitle boards of corporations in the zone of insolvency to decide on the viability of businesses in good faith and in an informed manner, rather than lead them to push corporations that could otherwise be restructured into liquidation.

A possible argument in favor of recognizing deepening insolvency claims as an independent cause of action would rely on the fact that creditors are already entitled to push debtors into liquidation pursuant to Chapter 7 and under Brazilian Bankruptcy Law (Lei No 11.101, art. 97, IV).[8] Nevertheless, under Chapter 7, a court may deny liquidation if a debtor fails the so-called means test under 11 U.S.C. § 707(b) or if a creditor is eligible for reorganization either under Chapter 11 or pursuant to Chapter 13.[9] Accordingly, under Brazilian Bankruptcy Law, a debtor is allowed to file motion for reorganization in

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8 Lei No 11,101 de 9 de Fevereiro de 2005, Diário Oficial da União [D.O.U.] de 9.2.2005 (Braz.), available at http://www.planalto.gov.br/ccivil_03/_ato2004-2006/2005/lei/l11101.htm.

9 Although in the US creditors can also file for a debtor's bankruptcy, they rarely do. As Elizabeth Warren explains: "Involuntary bankruptcy petitions (filed by creditors) are so rare that the Administrative Office of the United States Courts quit publishing the data on the number of involuntary cases nearly twenty years ago. Occasionally, a creditor may see reason to force a debtor into bankruptcy, particularly in cases when the creditor suspects fraud or otherwise wants a court to intervene". Warren, *supra* note 5, at 23; United States Courts, http://www.uscourts.gov/FederalCourts/Bankruptcy/BankruptcyBasics/Chapter7.aspx.

response to a bankruptcy filing from creditors (Lei No 11.101, art. 95).[10] Besides formal requisites, it is this paper claim that courts are not in the best position to evaluate the board's decision on whether to continue the corporate enterprise, regardless of the possible outcome.

An alternative approach to the broad understanding that deepening insolvency claims should constitute a valid cause of action would limit their viability to situations in which debtors have behaved fraudulently. From this perspective, deepening insolvency is conceived as: "an injury to the debtors' corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life."[11]

Even though this view gives greater deference to the business judgment of boards by acknowledging fraud as a requisite for recognizing deepening insolvency claims as a cause of action, it misconceives the real motive that should render a debtor liable. For example, in ***Lafferty***, the United States Court of Appeals for the Third Circuit affirmed an order of the United States District Court for the Eastern District of Pennsylvania in favor of recognizing deepening insolvent claims as a valid cause of action under Pennsylvanian State Law in the context of a Ponzi scheme, but, at the same time, denied damages for parties that were in pari delicto with the debtor.[12] In ***Lafferty***, it was

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10 Lei No 11,101 de 9 de Fevereiro de 2005, Diário Oficial da União [D.O.U.] de 9.2.2005 (Braz.).

11 Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 347, at 5 (3d Cir. 2001). PHELPS, Kathy. *Deepening Insolvency Claims as a Cause of Action and as a Theory of Damages,* Association of Insolvency and Restructuring Advisors, 26th Annual Bankruptcy & Restructuring Conference, San Diego, CA, 2010, p. 5. Available at http://www.dgdk.com/pdfs/AIRIDeepeningInsolvencyFinal.pdf. That is the prevailing understanding in various Circuits: Thabault v. Chait, 541 F.3d 512, 522 (3d Cir. 2008). Silverman v. KPMG, LLP (In re Allou Distribs., Inc.), 395 B.R. 246, 264-65 (E.D.N.Y. 2008). Vieira v. AGM II, LLC (In re Worldwide Wholesale Lumber, Inc.) 378 B.R. 120 (Bankr. D.S.C. 2007). Schnelling v. Crawford (In re James River Coal Co.), 360 B.R. 139 (Bankr. E.D. Va. 2007).

12 Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 347, at 5 (3d Cir. 2001). Phelps, *Id.* That is the prevailing understanding in various Circuits: Thabault v. Chait, 541 F.3d 512, 522 (3d Cir. 2008). Silverman v. KPMG, LLP (In re Allou Distribs., Inc.), 395 B.R.

not the board's failure to timely file under Chapter 7, but rather the Ponzi scheme, which led the debtor corporation to fraudulently issue debt securities and thereby be rendered insolvent, that justified the dismissal of the claim for damages from parties that were in pari delicto with the original debtor.

Notice that the Court in ***Lafferty*** could have achieved the same outcome by simply denying claimants an independent cause of action for deepening insolvency. Such a holding would not impede creditors in good faith and that did not contribute to the bankruptcy of debtors to pursue the creditors' claims, since they would still have a cause of action for fraud under state law.

Putting it differently, as the Delaware Court of Chancery reasoned in ***Trenwick***: "Under Delaware Law, "deepening insolvency" is no more of a cause of action when a firm is insolvent than a cause of action for "shallowing profitability" would be when a firm is solvent. Existing equitable causes of action for breach of fiduciary duty, and existing legal causes of action for fraud, fraudulent conveyance, and breach of contract are the appropriate means by which to challenge the actions of boards of insolvent corporations."[13]

That alternative rationale for deciding ***Lafferty*** would at best limit the recognition of deepening insolvency claims as an extent of damages, as opposed to understanding them as a valid and independent cause of action.[14] Even so, such an understanding would

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246, 264-65 (E.D.N.Y. 2008). Vieira v. AGM II, LLC (In re Worldwide Wholesale Lumber, Inc.) 378 B.R. 120 (Bankr. D.S.C. 2007). Schnelling v. Crawford (In re James River Coal Co.), 360 B.R. 139 (Bankr. E.D. Va. 2007).

13 Trenwick Am. Litigation Trust v. Ernst & Young, LLP, 906 A.2d 168, 204-205 (Del. Ch. 2006), aff'd, 931 A.2d 438, at 4 (Del. 2007).

14 In that respect, Joseph M. McLaughlin explains that: "The Third Circuit revisited deepening insolvency in In re CitX Corp. and clarified that "Lafferty holds only that fraudulent conduct will suffice to support a deepening-insolvency claim under Pennsylvania law." The Third Circuit refused to expand the theory, holding that deepening insolvency is not a valid theory of damages in a negligence action, and that allegations of negligence cannot support a cause of action for deepening insolvency". McLaughlin, *supra* note 2.

only be plausible in the case of companies that became insolvent as a result of a tortious conduct. Under this view, which is more logical than ***Lafferty***'s reasoning, a debtor could be held liable for an independent tort such as fraud to the extent that the insolvency was caused or worsen by the misbehavior in question.[15-16]

Nevertheless, even the understanding of deepening insolvency as a measure for damages is troublesome because it assumes that the debtor's decision to preserve the corporate form is what damaged creditors in the first place.[17] Accordingly, this view on deepening insolvency as a measure of damages does not represent the dominant understanding in other circuits.[18]

In particular, the argument against recognizing deepening insolvency claims as an independent cause of action is strengthened by the debate on the subjective extension of the fiduciary duties directly owed by directors. For this purpose, part II discusses whether directors owe or should owe fiduciary duties to creditors.

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15 As Kathy Phelps explains: "Many courts find that, to the extent that a party has committed an independent, legally cognizable tort, they may be liable to the extent that the misconduct led to the deepening insolvency of the debtor, even though they may not recognize deepening insolvency as an independent cause of action". Phelps, *supra* note 11. That is the dominant understanding in various Circuits: Thabault v. Chait, 541 F.3d 512, 522 (3d Cir. 2008). Silverman v. KPMG, LLP (In re Allou Distribs. Inc.), 395 B.R. 246, 264-65 (E.D.N.Y. 2008). Vieira v. AGM II, LLC (In re Worldwide Wholesale Lumber, Inc.) 378 B.R. 120 (Bankr. D.S.C. 2007). Schnelling v. Crawford (In re James River Coal Co.), 360 B.R. 139 (Bankr. E.D. Va. 2007).

16 COFFINO, Dianne F.; & JEANFREAU, Charles H. *Delaware Hits the Brakes: The Effect of Gheewalla and Trenwick on Creditor Claims*, 17 Norton J. Bankr. Law and Pract., 2007 p. 77. Available at http://www.cov.com/files/Publication/38698323-7a53-4e03-82ea-01eb83cd7e72/Presentation/PublicationAttachment/514fa7cb-685e-43da-ac48-01e8abc49d9f/Delaware%20hits%20the%20Brakes%20-%20The%20effect%20of%20Gheewalla%20and%20Trenwick%20on%20Cred.pdf

17 BIENENSTOCK, Martin J. *A Fiduciary Duty to Kill a Company? Lessons from one court's refusal to dismiss breach of loyalty claims*, New York Law Journal, (September 15, 2008). Available at http://www.law.com/jsp/cc/PubArticleCC.jsp?id=1202424499467.

18 Kathy Phelps explains that: "The Fifth Circuit rejected the theory of deepening insolvency as an independent cause of action and as a theory of damages" in Wooley v. Faulkner (In re SI Restructuring, Inc.), 532 F.3d 355, 363 (5th Cir. 2008). PHELPS, *supra* note 11.

II. Directors and officers' fiduciary duties: the outcome in Gheewalla and rereading the Credit Lyonnais decision

The arguments for stating that deepening insolvency claims constitute a valid cause of action and that directors owe fiduciary duties directly to creditors are flawed for being premised on misconstrued and overbroad interpretations of state case law. As discussed, the understanding that deepening insolvency claims should be acknowledged as an independent cause of action generally derives from a logical misconception of their nature. More specifically, some jurisdictions confound them with fraud and therefore hold that deepening insolvency claims should constitute an independent cause of action while others limit their scope by conceiving them only as a measure for damages in the case of torts that push companies into insolvency. In either case, endorsing the deepening insolvency view is troublesome. The origins of the argument that directors owe fiduciary duties to creditors are clearer, though: they are rooted in a footnote in the *Credit Lyonnais* decision.[19]

In the last fifteen years, the Delaware case law has been developed in order to assert that directors of corporations in the zone or in the vicinity of insolvency do not owe fiduciary duties directly to creditors. In spite of the refusal of the Delaware Court of Chancery to dismiss a deepening insolvency claim in *TBS*, directors should not be deemed to have an affirmative duty to liquidate corporations for the alleged benefit of creditors.

Chancellor Allen discussed the intricate decision-making process inherent to corporations in the zone of insolvency in the following hypothetical as dicta in a footnote in the *Credit Lyonnais* decision:

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19 The strongest arguments in support of deepening insolvency claims have similar grounds to those of the argument that directors of corporations in the vicinity of insolvency owe fiduciary duties directly to creditors. MCLAUGHLIN, *supra*, note 1.

"The possibility of insolvency can do curious things to incentives, exposing creditors to risks of opportunistic behavior and creating complexities for directors. Consider, for example, a solvent corporation having a single asset, a judgment for $51 million against a solvent debtor. The judgment is on appeal and thus subject to modification or reversal. Assume that the only liabilities of the company are to bondholders in the amount of $ 12 million. Assume that the array of probable outcomes of the appeal is as follows: Thus, the best evaluation is that the current value of the equity is $ 3.55 million. ($ 15.55 million expected value of judgment on appeal $12 million liability to bondholders). Now assume an offer to settle at $ 12.5 million (also consider one at $ 17.5 million). By what standard do the directors of the company evaluate the fairness of these offers? The creditors of this solvent company would be in favor of accepting either a $12.5 million offer or a $ 17.5 million offer. In either event they will avoid the 75% risk of insolvency and default. The stockholders, however, will plainly be opposed to acceptance of a $ 12.5 million settlement (under which they get practically nothing). More importantly, they very well may be opposed to acceptance of the $ 17.5 million offer under which the residual value of the corporation would increase from $ 3.5 to $ 5.5 million. This is so because the litigation alternative, with its 25% probability of a $ 39 million outcome to them ($ 51 million —- $ 12 million $ 39 million) has an expected value to the residual risk bearer of $ 9.75 million ($ 39 million x 25% chance of affirmance), substantially greater than the $ 5.5 million available to them in the settlement. While in fact the stockholders' preference would reflect their appetite for risk, it is possible (and with diversified shareholders likely) that shareholders would prefer rejection of both settlement offers".[20]

As a possible outcome, Chancellor Allen suggested:

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20 Credit Lyonnais Bank Nederland N.V. v. Pathe Commc'ns Corp., No. 12150, 1991 WL 277613, at *55 (Del Ch. Dec. 30, 1991).

"But if we consider the community of interests that the corporation represents it seems apparent that one should in this hypothetical accept the best settlement offer available providing it is greater than $ 15.55 million, and one below that amount should be rejected. But that result will not be reached by a director who thinks he owes duties directly to shareholders only. It will be reached by directors who are capable of conceiving of the corporation as a legal and economic entity. Such directors will recognize that in managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act".[21]

Such statement led various authors[22] and courts[23] to discuss

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21 Id., at *55.

22 ALLEN, KRAAKMAN & SUBRAMANIAN, *supra* note 4, at 141-142. As cited in North American Catholic Educational Programming Foundation, Inc. v. Gheewalla, 930 A.2d 92, 99, at *28 (Del. 2007): CAMPBELL JR. Rutheford B. & FROST, Christopher W. *Managers' Fiduciary Duties in Financially Distressed Corporations: Chaos in Delaware (and Elsewhere)*, 32 J. Corp. L. 491 (2007); CIERI, Richard M. & RIELA, Michael J. *Protecting Directors and Officers of Corporations That Are Insolvent or In the Zone or Vicinity of Insolvency: Important Considerations, Practical Solutions*, 2 DePaul Bus. & Com. L.J. 295, 301-02 (2004); JONES, Patrick M. & HARRIS, Katherine Heid. *Chicken Little Was Wrong (Again): Perceived Trends in the Delaware Corporate Law of Fiduciary Duties and Standing in the Zone of Insolvency*, 16 J. Bankr. L. & Prac. 2 (2007); LIN, Laura. *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 Vand. L. Rev. 1485, 1487 (1993); LIPSON. Jonathan C., *Directors' Duties to Creditors: Power Imbalance and the Financially Distressed Corporation*, 50 UCLA L. Rev. 1189 (2003); RAO, Ramesh K. S. et al., *Fiduciary Duty A La Lyonnais: An Economic Perspective on Corporate Governance in a Financially-Distressed Firm*, 22 J. Corp. L. 53 (1996); SHEINFELD, Myron M. & PIPPITT, Harris. *Fiduciary Duties of Directors of a Corporation in the vicinity of Insolvency and After Initiation of a Bankruptcy Case*, 60 Bus. Law. 79 (2004); SAHYAN, Robert K. Note, *The Myth of the Zone of Insolvency: Production Resources Group v. NCG Group*, 3 Hastings Bus. L.J. 181 (2006). JELISAVCIC, Vladimir. *Corporate Law — A Safe Harbor Proposal to Define the Limits of Directors' Fiduciary Duty to Creditors in the "Vicinity of Insolvency*:" Credit Lyonnais Bank Nederland N.V. v. Pathe Commc'ns Corp., 18 J. Corp. L. 145 (Fall 1993). See also *Selected Papers from the University of Maryland's "Twilight in the Zone of Insolvency*" Conference: BAI-

whether directors of corporations in the vicinity of insolvency owed fiduciary duties directly to creditors. The Delaware Supreme Court settled this issue in 2007 in *Gheewalla*. In its reasoning, the Delaware Supreme Court clarified that, "While shareholders rely on directors acting as fiduciaries to protect their interests, creditors are afforded protection through contractual agreements, fraud and fraudulent conveyance law, implied covenants of good faith and fair dealing, bankruptcy law, general commercial law and other sources of creditor rights. [...] The general rule is that directors do not owe creditors duties beyond the relevant contractual terms".[24] And concluded: "The creditors of a Delaware corporation that is either insolvent or in the zone of insolvency have no right, as a matter of law, to assert direct claims for breach of fiduciary duty against the corporation's directors".[25]

Accordingly,[26] it is this paper's main argument that deepening insolvency claims do not and should not be recognized as an independent cause of action under Delaware Law as decided in *Trenwick*.

BRIDGE, Stephen M. *Much Ado About Little? Directors' Fiduciary Duties in the Vicinity of Insolvency*, 1 J.Bus.&Tech.L. 335 (2007); CALLISON, J. William. *Why a Fiduciary Duty Shift to Creditors of Insolvent Business Entities Is Incorrect as a Matter of Theory and Practice*, 1 J.Bus.&Tech.L. 431 (2007); RIBSTEIN, Larry E. & ALCES, Kelli A., *Directors' Duties in Failing Firms*, 1 J.Bus.&Tech.L. 529 (2007); TUNG, Frederick. *Gap Filling in the Zone of Insolvency*, 1 J.Bus.&Tech.L. 607 (2007).

23 As cited in North American Catholic Educational Programming Foundation, Inc. v. Gheewalla, 930 A.2d 92, 99, at *27 (Del. 2007): Credit Lyonnais Bank Nederland N.V. v. Pathe Commc'ns Corp., 1991 WL 277613 (Del. Ch.); Production Resources Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772 (Del. Ch. 2004); Trenwick America Litig. Trust v. Ernst & Young, L.L.P., 906 A.2d 168 (Del. Ch. 2006); Big Lots Stores, Inc. v. Bain Capital Fund VII, LLC, 2006 WL 846121 (Del. Ch.).

24 North American Catholic Educational Programming Foundation, Inc. v. Gheewalla, 930 A.2d 92, 99, at 15 (Del. 2007); Wal-Mart Stores, Inc. v. AIG Life Ins. Co., 872 A.2d 611, 625 (Del. Ch. 2005), aff'd in part and rev'd in part on other grounds, 901 A.2d 106 (Del. 2006).

25 *Id*., at 4.

26 "Under Delaware law, "deepening insolvency" is no more of a cause of action when a firm is insolvent than a cause of action for "shallowing profitability" would be when a firm is solvent. Trenwick America Litig. Trust v. Ernst & Young, L.L.P., 906 A.2d 168, 4 (Del. Ch. 2006).

To support this thesis, part III discusses the questions raised by the refusal of the Delaware Court of Chancery to dismiss a deepening insolvency claim in *TBS* and part IV contextualizes the deepening insolvency debate under Brazilian Bankruptcy Law.

III. What questions remain unsolved after the refusal of the Delaware Court of Chancery to dismiss a deepening insolvency claim in TBS

In *TBS*, the Delaware Court of Chancery declined to grant a motion to dismiss a deepening insolvency claim. Such an outcome raised the issue on whether deepening insolvency claims constituted an independent cause of action under Delaware Law, which seemed to be settled after the holding of the Delaware Supreme Court in *Trenwick*. As a result, the decision in *TBS* brought about uncertainties surrounding the scope of the duties owed by directors of corporations in the zone of insolvency. Nevertheless, the facts in *TBS* are particularly relevant to confine speculative assumptions in this regard within their own boundaries.

I argue that the decision in *TBS* should not be interpreted as imposing on debtors an affirmative duty to end a company's existence by filing for bankruptcy under Chapter 7 pursuant to Delaware Law. On the contrary, directors are and should be entitled to the business judgment protection when deciding whether to continue or disrupt a corporate entity in the zone of insolvency.

TBS involved a lawsuit brought by a bankruptcy trustee against the company's controlling shareholder, its directors and its legal counsel.[27] The plaintiff alleged that the *TBS* majority shareholder

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27 KORNBERG, Alan W; SHIMSHAK, Stephen J. & DEARBORN, Penny L. *In re The Brown Schools: Deepening Insolvency Still Alive*, Paul Weiss, (June 2, 2008), available at http://www.paulweiss.com/files/Publication/e604fe18-7f7b-43af-a0fe 617519776340/Presentation/PublicationAttachment/c0ca3729-dcfb-4e42-bb81-618c127f0311/2Jun08Brown.pdf

with a 65% ownership stake, MDC, caused TBS to illegally pay consultancy fees in its favor at the time the company was insolvent. Additionally, the plaintiff argued that TBS's recapitalization plan favored its controlling shareholder and its affiliates in detriment of other creditors, and it worsened TBS's financial situation.[28] According to the opinion issued by the Delaware Court of Chancery, the trustee sued the defendants for the following counts: "breach of fiduciary duty, aiding and abetting breach of fiduciary duty, fraudulent and/or voidable transfers, deepening insolvency, civil conspiracy, and declaratory relief". Furthermore, the procedural history of the case stated that: "there was a separate count for corporate waste against the stockholder defendants and directors".[29] Based on these charges, the defendants jointly moved to dismiss the trustee's complaint, but the court refused to do so on various grounds.[30]

The Delaware Court of Chancery deemed the business judgment rule an affirmative defense and as such the Court did not have sufficient grounds for dismissal at that stage.[31] Nonetheless, nothing in the Court's opinion indicates that it would not give deference to the business judgment if the defendants were found to have met the legal requirements thereof based on the produced evidence.

Despite the constraints with which the ***TBS*** decision should be interpreted, the Court made the remarkable following statement on the trustee's deepening insolvency claim: "Although the ***Trenwick*** decision [in which the court found that deepening insolvency claims did not constitute an independent cause of action under Delaware Law] is well-reasoned, the Court is not prepared at this stage to dismiss this count based on that decision. [...] It is likely that this litigation will be

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28 *Id.*

29 George L. Miller v. McCown De Leeuw & Co. (In re The Brown Schools), 2008 Bankr., at 1 (Bankr. D. Del. April 24, 2008).

30 *Id.*, at 1.

31 In re. The Brown Schools, 368 B.R. 394, 400, at 7 (Bankr. D. Del. 2007).

protracted and further elucidation on this issue [...] by the Delaware Supreme Court may be forthcoming in the interim. Accordingly, the Court will not dismiss the deepening insolvency count".[32]

Alan W. Kornberg suggests that the take-away from the *TBS* decision is that "equity sponsors must be mindful of participating in transactions that could benefit them at the expense of other creditors".[33] In this regard, Mark Bienenstock argues that controlling shareholders and directors should be aware of the safeguards available under Delaware Law. For example, submitting the transactions questioned in *TBS* to the approval of disinterested directors would likely lead the trustee's claim on breach of loyalty not to survive the pleading stage.[34] Therefore, it is essential that, as in financially wealthy corporations, insiders exercise due care to address their duty of loyalty to shareholders and ensure that reorganizations and transactions undertaken by controlled corporations in the zone of insolvency are entirely fair in both its material and procedural dimensions.[35] In addition, deepening insolvency implies a somewhat problematic and speculative measure for damages, since an insolvent corporation could have been left under worse financial conditions by alternative business decisions to continue the corporate enterprise.

Based on these assumptions, Mark Bienenstock points out that the *TBS* decision should not be seen as having resuscitated independent causes of action for deepening insolvency claims under Delaware Law. On the contrary, under the Delaware Court of Chancery limited holding in *TBS*, controlling shareholders should employ the correct procedures to ensure that agreements made with affiliates are

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32 George L. Miller v. McCown De Leeuw & Co. (In re The Brown Schools), 2008 Bankr., at 1 (Bankr. D. Del. April 24, 2008).

33 Kornberg, Shimshak & Dearborn, *supra* note 27.

34 Bienenstock, *supra* note 17.

35 *Id.*

fair and that their duty of loyalty toward financially distressed corporations are entirely met.[36]

Notwithstanding these remarks, the Delaware Court of Chancery deemed that further elucidating the deepening insolvency count was necessary based on both the *Trenwick* holding and the *TBS* facts. Not much was left unanswered under Delaware Law after *Gheewalla* and *Trenwick* concerning whether directors owe fiduciary duties to creditors, and whether deepening insolvency claims constitute a valid cause of action respectively. Unless the *TBS* final outcome diverges from these assumptions, both questions should be answered negatively. It is based on these remarks that this paper proceeds to part IV and questions whether under Brazilian Law debtors, controlling shareholders and boards have or should have an affirmative duty to force corporations within the zone of insolvency to liquidate. For this purpose, I discuss the holding of the Commercial Court of the State of Rio de Janeiro in the August 2010 *VARIG* decision.

IV. Is there an affirmative duty to liquidate pursuant to current Delaware law and under Brazil's chapter 7 (Lei 11.101/05, Art. 105)?

The doubts on whether Brazilian Bankruptcy Law imposes on debtors an affirmative duty to file for liquidation have to do with its ambiguous wording. Brazil's Chapter 7 (Lei No 11.101, art. 105) states in its first part that a "a debtor in economic-financial crisis that finds itself not meeting the requirements to pursue a reorganization plan "must" file for bankruptcy by justifying the impossibility to continue the business enterprise".[37] One of the leading cases on the matter re-

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36 Kornberg, Shimshak & Dearborn, *supra* note 27.

37 Free translation by the author. Lei No 11,101 de 9 de Fevereiro de 2005, Diário Oficial da União [D.O.U.] de 9.2.2005 (Braz.). In its original: "O devedor em crise econômico-financeira que julgue não atender aos requisitos para pleitear sua recuperação judicial deverá requerer

fers to the bankruptcy of one of the remaining parts of the once leading airline in Brazil, *VARIG — Viação Aérea Rio-Grandense S.A.*, decided in August 2010.

In summary, since 2005, VARIG went through an intricate reorganization. Besides the sale of its subsidiaries and particular assets, the VARIG reorganization resulted in its split into two separate entities. While what was known as the "new VARIG" and called *VRG Linhas Aéreas S.A.* was sold to *GOL Airlines S.A.*, the so-called "old VARIG" was named *Nordeste Linhas Aéreas S.A.* and operated under *Flex Linhas Aéreas.* After major shortfalls, in August 2010, the trustee of "old VARIG" and of its affiliates petitioned the Commercial Court of the State of Rio de Janeiro to convert its reorganization into bankruptcy.

As required under Brazilian Law, the Attorney General's Office for the State of Rio de Janeiro pronounced its view on whether the trustee's motion to convert the reorganization into liquidation should be granted. The reasons favorable to grant the motion were entirely based on the debtors' arguable affirmative duty to file for bankruptcy protection pursuant to Lei No 11.101, art. 105.[38] More specifically, the pronouncement of the Attorney General's Office for the State of Rio de Janeiro was expressively premised on the current understanding of deepening insolvency claims pursuant to both Spanish[39] and Delaware Law.

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ao juízo sua falência, expondo as razões da impossibilidade de prosseguimento da atividade empresarial [...]", available at http://www.planalto.gov.br/ccivil_03/_ato2004-2006/2005/lei/l11101.htm. Notices that under Lei No 11,101 only applies to business entities (sociedades empresárias) and businessmen (empresários individuais). Differently than Chapter 7 that governs the liquidation procedure of both business entities and individuals, under Brazilian Law, the latter is governed by a specific statute under the Code of Civil Procedure (Lei No 5.869, de 11 de Janeiro de 1973, Arts. 748 — 786-A. Diário Oficial da União [D.O.U.] de 17.1.1973 (Braz.), available at http://www.planalto.gov.br/ccivil/leis/L5869compilada.htm. Lei 11.101 repealed Brazil's previous bankruptcy statute, Decreto Lei No 7,661, de 21 de Junho de 1945. Diário Oficial da União [D.O.U.] de 31.7.1945 (Braz.).

38 Ministério Público do Estado do Rio de Janeiro, Tribunal de Justiça do Estado do Rio de Janeiro, Processo No 0260447-16.2010.8.19.0001, August 2010, at 3-7.

39 The Attorney General's Office for the State of Rio de Janeiro argued that: "the duty to file

In particular, with respect to Delaware Law, it stated that debtor and controlling shareholders had an affirmative duty to avoid deepening insolvency on behalf of creditors. As the argument followed, debtors had the duty to confess the bankruptcy of a corporation under severe economic and financial distress, as long as they had rendered a plan of reorganization unviable.[40]

Furthermore, it argued that pursuant to Brazilian Bankruptcy Law (Lei No 11.101, art. 105)[41] directors might be held personally liable for breach of their fiduciary duties to creditors.[42] It also stated that creditors were theoretically in a better position to have their claims satisfied if a debtor caused the orderly liquidation of its assets by filing for bankruptcy.[43] Lastly, it referred to the holding in ***TBS*** by affirming that: "It is necessary to mention that the Delaware Supreme Court in [***TBS***] confirms the world's tendency to mandate that direc-

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for bankruptcy or deepening insolvency is recognized under Spanish Law under the Real Decreto-ley n: º3/2009, de 27 de Março, de 2009, "Boletin Oficial Del Estado" nº 78, Seção 01, 30367, in 31.3.2009: "Artículo 5. Deber de solicitar la declaración de concurso. 1. El deudor deberá solicitar la declaración de concurso dentro de los dos meses siguientes a la fecha en que hubiera conocido o debido conocer su estado de insolvencia. 2. Salvo prueba en contrario, se presumirá que el deudor ha conocido su estado de insolvencia cuando haya acaecido alguno de los hechos que pueden servir de fundamento a una solicitud de concurso necesario () Artículo 165. Presunciones de dolo o culpa grave. Se presume la existencia de dolo o culpa grave, salvo prueba en contrario, cuando el deudor o, en su caso, sus representantes legales, administradores o liquidadores: 1º Hubieran incumplido el deber de solicitar la declaración del concurso". "Duty to file for bankruptcy relief. 1. A debtor shall file for bankruptcy protection within the months following the awareness of its state of insolvency. 2. Unless proven otherwise, the debtor shall be deemed to have known about its state of insolvency when any of the circumstances that gave rise to the possibility of having its bankruptcy required occured under the applicable Law () Courts shall presume the existence of the intention to deceit or of gross fault when the debtor, its legal counsel, trustees or liquidators fail to meet their duty to file for bankruptcy relief". Free translation by the Author. *Id*., at 4-5.

40 *Id*., at 3-7.

41 Lei No 11,101 de 9 de Fevereiro de 2005, Diário Oficial da União [D.O.U.] de 9.2.2005 (Braz.), available at http://www.planalto.gov.br/ccivil_03/_ato2004-2006/2005/lei/l11101.htm.

42 Ministério Público do Estado do Rio de Janeiro, *supra* note 37, at 5.

43 *Id*., at 6.

tors and controlling shareholders have the affirmative duty to file for bankruptcy as a means to safeguard their duty of loyalty to creditors."[44]

Based on the reasoning of the pronouncement of the Attorney General's Office for the State of Rio de Janeiro, the Commercial Court of the State of Rio de Janeiro granted the trustee's motion to convert the reorganization of "old VARIG" into bankruptcy. The Court reasoned that "as the Attorney General's Office for the State of Rio de Janeiro well stated, it is the duty of directors of a corporation under severe economic and financial distress, after rendering the corporation's plan of reorganization unviable, to file for bankruptcy. [...] Failing to do so subjects them to personal liability [...] In that case, extending the corporation patrimonial and financial agony would only harm creditors by increasing liabilities and, most likely, diminishing assets."[45]

The debtor's controlling shareholder appealed from the Commercial Court decision and as of April 2011 the Appellate Court of the State of Rio de Janeiro still had not decided on the matter. Three remarks must be made concerning the rationale adopted by the Attorney General's Office for the State of Rio de Janeiro and by the Rio de Janeiro Court when granting the debtors' motion in the *VARIG* August 2010 decision.

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44 In its original: "É necessário registrar que a Suprema Corte de Delaware, no caso George L. Miller v. McCown De Leeuw & Co. (In re The Brown Schools), [...] confirma a tendência mundial em exigir dos administradores e controladores o dever de confessor a falência, como forma de manifestação do dever de lealdade destes para com os seus credores". *Id*., at 6.

45 In the original: "Como bem disse o Ministério Público, é dever dos administradores da sociedade em crise econômico-financeira, que não vislumbrem possibilidade de recuperação, requerer a própria falência, conforme previsto no art. 105 da Lei 11.101/2005, sob pena de responsabilização pessoal, na forma do art. 82 da mesma lei. Nesse caso, o prolongamento da agonia patrimonial e financeira da sociedade somente prejudicaria os credores, com o aumento do passivo e, muito provavelmente, a redução do ativo". Processo No 0260447-16.2010.8.19.0001, August 2010, at 3.

First, as parts I and II discussed, directors do not owe fiduciary duties directly to creditors under Delaware Law.[46] Similarly, no provisions in Brazil's Bankruptcy Law suggest that it deviates from the general rule that creditors have their rights protected by contract and statutes of various natures, but not by undefined fiduciary duties. Second, the assumption that creditors could be in a better position if debtors proceeded to liquidate corporations in the zone of insolvency is factual and, in the absence of fraud, it is at best speculative. In the "old VARIG" case, it was the trustee's business judgment that the reorganization was unviable, as opposed to an alleged affirmative duty in this regard. Therefore, for being more aligned with both the rationale behind the deepening insolvency jurisprudence and the law of fiduciary duty, such reasoning would be more appropriate than the Rio de Janeiro Commercial Court fundaments. Third and as part III stressed, the Delaware Court of Chancery in the ***TBS*** decision did not recognize deepening insolvency claims as a valid cause of action under Delaware Law.

In spite of ***Trenwick***'s binding authority, the Delaware Court of Chancery decided that it was premature to dismiss the deepening insolvency count based on the ***TBS*** facts. Unmistakably, Delaware

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46 "It is well established that the directors owe their fiduciary obligations to the corporation and its shareholders." North American Catholic Educational Programming Foundation, Inc. v. Gheewalla, 930 A.2d 92, 99 (Del. 2007) [...] (citing Guth v. Loft, 5 A.2d 503, 510 (Del. 1939) and Malone v. Brincat, 722 A.2d 5, 10 (Del. 1998))." Furthermore, under the holding in Gheewalla, Delaware Courts only recognize that creditors of insolvent corporations may file derivative claims for breach of fiduciary duty. Judith Elkin and Kendyl Hanks explain: "It should be noted that although the Gheewalla opinion restricts creditor claims to derivative suits, it nonetheless reaffirms the "insolvency exception" concept, i.e., that a director's duties shift and creditors join the corporate constituency to which directors owe duties. See, e.g., Schoon v. Smith, 953 A.2d 196, 208 n.46 (Del. 2008) ("Gheewalla confers standing upon creditors to bring a derivative action where the corporation is insolvent, but only because the shareholders of an insolvent corporation no longer have an economic interest in the corporate entity—only its creditors have that interest. Only for that reason and in that context does Gheewalla permit creditors to stand in the shoes of the shareholders."). EIKIN, Judith. & HANKS, Kendyl. *Fiduciary Duties in Troubled Times,* at 5 and at 10 (2009), available at http://ebookbrowse.com/fiduciary-duties-in-troubled-times-pdf-d43549172.

courts still understand that directors neither have an affirmative obligation to file for Chapter 7, nor fiduciary duties to creditors.[47] Interestingly enough and as this paper argues, the Commercial Court of the State of Rio de Janeiro could have achieved the same outcome in *VARIG* by simply giving deference to the trustee's business judgment when requiring the conversion of the "old VARIG" reorganization into liquidation. Nevertheless, and as shown in this case, courts often achieve sound outcomes by inaccurate means.

V. Conclusions: reconciling deepening insolvency claims and the business judgment rule

This paper presented two positive and two normative claims. Based on Delaware Law and Brazilian Bankruptcy Law, it discussed whether deepening insolvency claims constitute or should constitute an independent cause of action, and whether the board of directors owes or should owe fiduciary duties to creditors.

I argued that the rationale behind recognizing deepening insolvency claims as an independent cause of action is flawed and inconsistent with the economic incentives that creditors and directors of corporations in the zone of insolvency have. Furthermore, I explained why deepening insolvency claims should neither constitute an independent cause of action, nor be conceived as a measure for damages. I contended that courts should give deference to the business judgment of boards when deciding whether to file under Chapter 7.

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47 The Delaware *Trenwick* decision is of particular help in the interpretation of the Brazilian Bankruptcy statute. As it stated: "Delaware law imposes no absolute obligation on the board of a company that is unable to pay its bills to cease operations and to liquidate. Even when the company is insolvent, the board may pursue, in good faith, strategies to maximize the value of the firm. As a thoughtful federal decision recognizes, Chapter 11 of the Bankruptcy Code expresses a societal recognition that an insolvent corporation's creditors (and society as a whole) may benefit if the corporation continues to conduct operations in the hope of turning things around". Trenwick Am. Litigation Trust v. Ernst & Young, LLP, 906 A.2d 168, 204-205 (Del. Ch. 2006), aff'd, 931 A.2d 438, at 28 (Del. 2007).

By doing so, courts create a superior rule by providing boards of corporations in the zone of insolvency with adequate incentives.

I discussed the reasons that led Delaware courts to refuse to recognize that directors owe fiduciary duties directly to creditors. It is this paper's statement that the *TBS* outcome should be read narrowly and that *Trenwick* still has binding authority over Delaware courts. Lastly, I inquired whether debtors and directors have an affirmative duty to file for liquidation under Brazil's Chapter 7 (Lei 11.101/05, Art. 105).

Based on the reasoning presented by the Attorney General's Office for the State of Rio de Janeiro, which was agreed on by the Commercial Court of the State of Rio de Janeiro in the August 2010 *VARIG* decision, I argued that Brazilian courts should reassess the nature and the subjective extension of the duties owed by boards and controlling shareholders of corporations in the zone of insolvency. Under any legal system and in any business decision, the take-away from *TBS* and *VARIG* remains the same. In the words of Judith Elkin & Kendyl Hanks, "the decision whether to file for bankruptcy protection or not should be a matter of business judgment."[48]

48 Elkin & Hanks, *supra* note 46.