Commentary

The Zone Of Insolvency: A Trap For The Unwary

By
Barbra R. Parlin
and
Sandra E. Mayerson

[Editor's Note: Barbra R. Parlin is a litigation partner in the New York office of Holland & Knight, where she practices in the areas of bankruptcy, creditors' rights and litigation. She represents debtors, indenture trustees, secured and unsecured creditors, bondholders and other parties in interest in chapter 11 cases, 363 sales, and other bankruptcy related matters. She also litigates fiduciary duty claims and advises boards of directors as to their fiduciary duties. Barbra may be reached at barbra.parlin@hklaw.com. Sandra E. Mayerson is a litigation partner and chair of Holland & Knight's New York Restructuring, Insolvency and Creditors' Rights Practice. She has extensive experience in both debtor and creditor work, and has represented creditors' and bondholders' committees, banks and other secured creditors, unsecured creditors, bondholders, indenture trustees, Chapter 11 trustees, debtors in Chapter 11, investors in distressed situations and claims traders. Sandra often serves as special counsel to boards of directors of distressed companies to advise them on their fiduciary duties. She has been named by the National Law Journal as one of the Top Fifty Women Litigators in the country. She may be reached at sandy.mayerson@hklaw.com.

This article is one of a two-part series by the authors. The second part of the series will discuss the effectiveness of D&O insurance coverage when a company is in bankruptcy. Copyright 2007 by the authors. Replies to this commentary are welcome.]

Introduction

The recent meltdown in the credit markets resulting from the devaluation of mortgage-backed securities, the rise in default rates and the slowdown in real estate sales/new housing starts has caused significant financial distress for many companies, even those that are only tangentially involved with the housing markets. In fact, the practice of securitization has dramatically increased the number of parties with exposure to the current crisis. A company's solvency can change day to day and, as a result, become ripe for litigation. Parties suffering losses will look to find deep pockets — preferably ones with insurance — to cover their losses. For all these reasons, it is important for directors and officers of companies that are feeling a liquidity pinch, or seeing the value of their portfolios see-saw with every news cycle, to take stock of the constituencies to which they may owe fiduciary duties and consider how those duties may best be discharged given what may be conflicting priorities.

The law in this area continues to develop. Recent decisions emanating from the Delaware courts, which many other courts look to for guidance on issues of corporate governance, have helped clarify some open questions. However, many other issues remain undecided and not every state or federal court follows Delaware in every respect. Therefore, the zone of insolvency remains a trap for the unwary fiduciary. That being said, there are some steps that can be taken before a crisis occurs, that will protect directors and officers when and if potential claims arise down the road. Being aware of the issues and seeking expert guidance are the best safeguards a fiduciary can have in these shifting sands.

Fiduciary Duties Defined

Under Delaware law,[1] directors and officers owe duties of due care and loyalty. *See, e.g.*, *Minn. Invco of RSA # 7, Inc. v. Midwest Wireless Holdings LLC*, 903 A.2d 786, 797 (Del. Ch. 2006); *Metro Communication Corp. BVI v. Advanced Mobilecomm Technologies, Inc.*, 854 A.2d 121, 156-157 (Del. Ch. 2004). This is true whether the entity is a corporation, a limited liability company, or a limited liability partnership.

The duty of care requires that directors exercise a requisite degree of care in the process of making decisions and in performing other aspects of their directorial responsibilities. *See* Franklin Balotti & Jesse Finkelstein, **Delaware Law of Corporations & Business Organizations** § 4.34 (3d ed. 2007). The standard for establishing a breach of the duty of due care under Delaware law is gross negligence. *See, e.g., Aronson v. Lewis,* 473 A.2d 805, 812 (Del. Sup. Ct. 1984), *rev'd on other grounds*, *Brehm v. Eisner*, 746 A.2d 244 (Del. Supr. 2000).

In the classic sense, the duty of loyalty requires a director to refrain from self-dealing and from misusing corporate funds or assets for personal gain. *Bell Atlantic Corp. v. Bolger*, 2 F.3d 1304, 1316 (3d Cir. 1993); *Lewis v. Austen*, 1999 WL 378125 (Del. Ch. 1999); *Solash v. Telex Corp.*, 1988 WL 3587 (Del. Ch. 1988). In recent years, courts have explained the duty of loyalty more broadly, as requiring a director or officer to place the interests of the entity above those of any individual director, officer or controlling shareholder and also as requiring that any actions be undertaken in the good faith belief that they are in the best interests of the entity. *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 370 (Del. Sup. Ct. 2006). "A failure to act in good faith may be shown . . . where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties. . . ." *In re Walt Disney Company Derivative Litig.*, *v. Eisner*, 906 A.2d 27, 67- 68 (Del. Sup. Ct. 2006).

When evaluating whether a particular action or omission constitutes a breach of either the duty of care or loyalty, Delaware law affords to the managers of a corporation a presumption that "in making business decisions, the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company." *Walt Disney*, 906 A.2d at 52. The business judgment rule protects good faith decisions of a board of directors if the decisions "can be attributed to any rational business purpose." *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. Sup. Ct. 1971). "Compliance with a director's duty of care can never appropriately be judicially determined by reference to the content of the board decision that leads to a corporate loss, apart from consideration of the good faith or rationality of the process employed. That is, whether a judge or jury considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through 'stupid' to 'egregious' or 'irrational,' provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in a good faith effort to advance corporate interests. *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996). As such, it is the decision making process, not the outcome of the decision, that will be examined to determine whether there is liability.

To Whom Are Fiduciary Duties Owed?

The next question is, to whom do officers and directors owe their fiduciary duties? In other words, who has standing to challenge the propriety of a director or officer's actions, and does this change as an entity moves from solvency to insolvency? While much has been written and there is much confusion about this issue, the Delaware Courts have made it clear that in the first instance, directors and officers owe fiduciaries directly to the *entity* they serve and to the *shareholders* of such entity. *See, e.g.*, *Production Resources Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772, 792 (Del. Ch. 2004); *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. Sup. Ct. 2007) ("The directors of Delaware corporations have the legal responsibility to manage the business of a corporation for the benefit of its shareholder owners."). This makes sense, because it is the entity that suffers direct harm in the event of a breach of the duty of care or loyalty. So too, when an entity is solvent, the direct harm resulting from a director or officer's breach of fiduciary duty causes indirect harm to the entity's residual risk bearers — *i.e.*, its shareholders — typically by causing the value of the entity to drop. For this reason, in addition to the company itself, courts routinely hold that the shareholders of a solvent corporation potentially have standing to pursue claims for breach of fiduciary duty *derivatively* on behalf of the entity, assuming all other requirements of a derivative action are met.[2] Any damages resulting from such a suit would be payable to the entity, however, for the benefit of all shareholders and not directly to the individual shareholder who brings the suit.

By the same token, courts routinely find that creditors of a solvent corporation do not have standing to bring claims for breach of fiduciary duty. Solvent corporations have sufficient funds to pay their debts in full, and unlike shareholders, creditors are not entitled to any sort of upside. Moreover, creditors have other direct remedies, such as claims for breach of contract or fraud, that presumably can protect their interests. *See Production Resources*, 863 A.2d at 787-790; *Gheewalla*, 930 A.2d at 99.

Once a company is insolvent, its creditors become the principal constituency that bears the risk of damages resulting from a breach of fiduciary duty by directors or officers. Under those circumstances, courts in Delaware have held specifically that creditors, in addition to shareholders, may bring a *derivative* action against directors and officers for breach of fiduciary duty. *Gheewalla*, 930 A.2d at 101-102. Courts in other jurisdictions likewise have held that creditors of insolvent corporations have standing to bring derivative actions for breach of fiduciary duty. *See, e.g.*, *In re Vartec Telecom, Inc.,* 2007 WL 2872283, *2-3 (Bankr. N.D. Tex. September 24, 2007) (construing Texas law).

Zone Of Insolvency

What happens, then, when a company is somewhere between bright line solvency and insolvency? This is often referred to as the "zone of insolvency." While there are no precise definitions as to when a solvent company enters the zone of insolvency, fiduciaries should assume that they are operating in the zone of insolvency if the failure of a proposed transaction is reasonably likely to cause a company to become insolvent, or if it is reasonably foreseeable that the corporation will have ongoing trouble paying its creditors as a class. *See, e.g. In re Healthco Intern. Inc.,* 208 B.R. 288, 301-302 (Bankr. D. Mass. 1997). Less obvious fact patterns may also be considered within the "zone of insolvency," so, fiduciaries must constantly assess the facts of their individual entity and seek professional advice, if necessary, to determine whether the entity is in the zone of insolvency. For example, a company may be consistently having covenant defaults but no payment defaults on its senior loan. The lenders are cooperating and have given a waiver every time, so long as they continue to be paid, but future covenant defaults are foreseeable. Upon any default, the lenders could refuse a waiver, which would accelerate the loan and make it due currently, thereby rendering the company insolvent. Is this company in the zone of insolvency? Similarly, a major customer is threatening to pull its business overnight. A technical default under the supply contract, which is immaterial in a practical sense, would give the customer the legal right to do so. The customer has made this threat before to renegotiate pricing terms and never pulled out, but there is little room for pricing negotiations in the contract now. With the customer in place, the company is healthy, but if it pulls out overnight, the company would not recover from the blow. Is this company in the "zone of insolvency" while these threats hang over it, or are these simply everyday, foreseeable business risks?

Obviously, determining where the zone of insolvency begins can be a slippery slope. As noted above, during the past few years there has been a fair amount of confusion as to the scope and beneficiaries of a corporate fiduciary's duty when the entity he or she serves enters the zone of insolvency. Among other issues, courts have grappled with whether entering the zone of insolvency gives creditors additional rights to assert claims for breach of fiduciary duty, either directly or derivatively, and also whether corporate fiduciaries then must shift their focus to repayment of creditors at the expense of shareholders. *See, e.g.*, *Production Resources*, 863 A.2d at 787-791 (discussing cases). This confusion has even led some federal courts to guess that the state courts would recognize a cause of action or possibly a damages theory for "deepening insolvency," *i.e.* a damages claim that defendants' decision to borrow additional funds when the entity was becoming insolvent (presumably in the hope that such funds would help the entity through a crisis period) caused the entity to become more insolvent and thus less able to pay creditors' claims. *See, e.g.*, *Official*

Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 249-52 (3d Cir. 2001) (predicting that Pennsylvania might recognize a deepening insolvency cause of action); *Official Comm. of Unsecured Creditors v. Credit Suisse First Boston (In re Exide Technologies, Inc.)*, 299 B.R. 732, 750-52 (Bankr. D. Del. 2003) (predicting that Delaware courts would recognize such a claim).

Recently, in an effort to provide what they call "definitive guidance," the Delaware courts have confirmed that there is no cause of action for deepening insolvency under Delaware law and that, even when "a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners." *Gheewalla*, 930 A.2d at 101, *Trenwick*, 906 A.2d at 202-203. Under the logic of these decisions, corporate fiduciaries are under no obligation to liquidate a company even in the face of insolvency, and directors and officers of Delaware entities do not breach their fiduciary duties merely by trying to effect a strategy that, if it succeeds, will create value for creditors as well as shareholders by putting the company back in the black, even if it turns out that such strategy ultimately fails. As long as the decision making process is proper and undertaken in good faith, the board is permitted to pursue strategies that it believes will maximize the value of the company, and the mere act of incurring additional debt in the face of insolvency, alone, does not establish bad faith or disloyalty. *Trenwick,* 906 A.2d 168, 174. Under these decisions, a Delaware fiduciary would continue to owe his duty to the enterprise even as it enters the zone of insolvency. That duty would not "shift" as a company drifts deeper or stays longer in the "zone of insolvency" as many commentators had previously posited.

As a corollary, the Delaware Supreme Court has held that, under Delaware law, creditors of a corporation that is insolvent or operating in the zone of insolvency cannot assert a direct claim for breach of fiduciary duty against the company's officers and directors. "To recognize a new right for creditors to bring direct fiduciary claims against . . . directors would create a conflict between those directors' duty to maximize the value of the insolvent corporation for the benefit of all those having an interest in it, and the newly recognized direct fiduciary duty to individual creditors." *Gheewalla*, 930 A.2d at 103. Accordingly, while creditors of an insolvent corporation may bring a derivative action for breach of fiduciary duty, individual creditors of a Delaware entity may not bring a direct claim for breach of fiduciary duty. *Id*.

Uncertainty Remains

While the Delaware decisions were clearly meant to provide guidance, and the inhabitants of corporate board rooms can breathe a sigh of relief, it is not time for rejoicing just yet. Not every court has or will adopt Delaware's view that directors and officers remain free to take risks that, if successful, will benefit shareholders, but if not, may make an entity even less able to pay its valid creditors. Indeed, even in Delaware the picture is not crystal clear. At least one Federal bankruptcy court, sitting in Delaware and applying Delaware law, refused to grant a motion to dismiss a claim for deepening insolvency despite the issuance of the Chancery Court's opinion in *Trenwick*. *See, e.g., Miller v. McCown De Leeuw & Co., Inc. (In re The Brown Schools)*, 368 B.R. 394 (Bankr. D. Del. 2007) (denying motion to dismiss deepening insolvency claim). Courts applying other states' laws likewise have found that creditors of insolvent entities ***do*** have standing to bring direct claims for breach of fiduciary duty against directors and officers. *See, e.g., Jetpay Merchant Services, LLC v. Miller*, 2007 WL 2701636, *7 (N.D. Tex. Sept. 17, 2007) (Colorado law); *Technic Engineering, Ltd. v. Basic Envirotech, Inc.*, 53 F. Supp.2d 1007, 1010-1012 (N.D. Ill. 1999) (Illinois law); *Lopez v. TDI Services, Inc.*, 631 So.2d 679, 688 (La. App. 3d Cir. 1994).

Moreover, as noted above, even Delaware courts have found that creditors have standing to pursue derivative claims for breach of fiduciary duty once a company is insolvent, and there is no question that the time within which an entity moves from the zone of insolvency to actual insolvency can occur in an instant especially with hindsight. Indeed, the recent free-fall collapse in the market for sub-prime mortgage securities only underscores how fast liquidity can disappear and asset values plummet. Solvency also is certainly an issue that is ripe for expensive litigation involving expert testimony, is subject to being reassessed in hindsight and often cannot be resolved in a motion to dismiss. This area will continue to be ripe for litigation, and it is often prudent to assume that if the zone of insolvency is here, insolvency is just around the corner.

Procedural Safeguards

What can or should a director or officer faced with a financial crisis do? Certainly, there is no absolute way to prevent litigation from being filed. Indeed, it is almost certain that when the interests of shareholders and creditors compete as when a board is faced with the possibility that the failure of its business strategy could mean that creditors are not paid in full, but success means that shareholders are back in the money — litigation will ensue from one set of interests or another. Competition among creditor groups in a capital structure with putatively secured debt, trade debt and subordinated debt is just as likely to lead to the threat of litigation.

That being said, the more reasoned, informed and carefully considered the process by which corporate directors and officers arrive at a business decision, the more likely that such decision will be deemed a proper exercise of business judgment. Directors can and should acknowledge that their enterprise may be in the zone of insolvency. There should be a clear record that they sought clarification as to whom their fiduciary duties are owed in light of the particular facts facing their company and the shifting legal framework. By doing so, they can establish that decisions were undertaken with these duties firmly in mind, even if the decisions later prove wrong. Directors also can and should obtain the advice of outside experts such as lawyers, financial advisors, auditors and restructuring specialists to help them in their decision making and in understanding which constituency, shareholders or creditors, should be their primary focus at any given time. Such advice also should be obtained as early as possible and reevaluated constantly, so that the board is ready if and when a temporary liquidity crisis turns into insolvency. Even if advance planning isn't possible, decisions that are made carefully, with the advice of professionals and with a clear understanding of the board's responsibilities at that time are more likely to be upheld as a valid exercise of business judgment.

In some cases, particularly when the entity's solvency is in question, it may also be appropriate to bring significant creditors or creditor groups into the decision making process, provided that appropriate confidentiality protections can be put in place. This can help to ensure that the parties with a stake in the process have a hand in developing strategy for the business and will have less reason to raise questions or assert claims later. Directors and officers must be careful not to let the special interests of any one creditor influence this process, however.

Corporate fiduciaries also should take steps to ensure that appropriate systems and controls are in place to prevent oversight deficiencies. Such steps make it less likely that the entity will fail to comply with any applicable regulatory obligations, which also could lead to liability down the road. Such systems also should be reviewed regularly, to make sure that they continue to function appropriately. A record should be kept that these issues were considered, and board meetings may increase in number to show the board is dealing with a crisis. Reliance on the advice of experts should be clearly documented. Minor details like ensuring that the board has materials sufficiently in advance of a meeting to render an informed judgment can become critically important details when viewed through the lens of litigation. In the end, the best protection a board has is its own careful, thoughtful processes guided by expert advice.

Finally, Section 102(b)(7) of the Delaware General Corporate Law permits, but does not require, a corporation to include a provision in its articles of incorporation exculpating directors and officers for personal liability for damages arising out of a breach of the duty of due care, but not for damages arising out of a breach of the duty of loyalty. The Delaware Limited Liability Company law permits even broader exculpations than those permitted in the corporate context. *See* 6 Del. C. § 18-1101; *Abry Partners V, L.P. v. F&W Acquisition LLC*, 891 A.2d 1032, 1063 (Del. Ch. 2006) ("In the alternative entity context, where it is more likely that sophisticated parties have carefully negotiated the governing agreement, the [Delaware] General Assembly has authorized even broader exculpation [than permitted in the corporate context], to the extent of eliminating fiduciary duties altogether"); *Metro Communication Corp. BVI v. Advanced Mobilecomm Technologies, Inc.*, 854 A.2d 121, 157 (Del. Ch. 2004). Many other states have similar provisions in their corporate and alternative entity codes, although not every state permits exculpation clauses as broad as those permitted under Delaware law. *See, e.g.*, *Fla. Stat*. § 608.423 (2004) (describing limits of exculpation clauses in LLC membership agreements). Most states, including Delaware, also permit, but do not require, entities to indemnify and/or advance legal fees to directors and officers who are named as defendants in actions arising out of their service to the entity, and also permit such entities to use corporate funds to acquire insurance to cover such costs in the event of a claim. Directors and officers can protect themselves in advance by making sure, while the business is still healthy, that the charters of the entities on which they serve include Section 102(b)(7) type exculpation clauses if permitted under applicable state law. While these clauses may not bar all suits by all claimants, they can serve to protect against some types of claims. Directors and officers likewise should be sure that their indemnity/advancement rights are made mandatory and are backed up with an appropriate level of insurance. Director and officer insurance also should be renewed on a timely basis and the limits of liability should be revisited from time to time to ensure that sufficient coverage is available. If directors leave the board, appropriate "tails" should be purchased, so that no director has an incentive to turn against the others. Again, the guidance of a knowledgeable D&O specialist can be invaluable in this context.

Conclusion

The onset of a financial crisis can give rise to a whole new set of claimants for the attention and, potentially, the fealty, of corporate fiduciaries. Advance planning is helpful, but not always possible. More importantly, the rules determining who may sue and for whom corporate fiduciaries must act at any given time continue to evolve, while companies can move from solvency to insolvency and back very quickly. Directors and officers faced with potential crises should seek advice from experienced advisors so as to keep up to date on the current state of the law, and ensure that their decisions will have the best chance of being protected by the business judgment rule.

Endnotes

1. The law of the state in which an entity is formed usually controls issues of corporate governance and particularly will govern the scope of any duties owed to that entity by its officers and directors. *See, e.g.*, *The Glidden Co. v. Jandernoa*, 5 F. Supp.2d 541, 554 (W.D. Mich. 1998). A large proportion of U.S. companies are incorporated in Delaware, and many other states will look to Delaware law for guidance on these issues. For this reason, we will focus on Delaware law but point out where differences still exist.

2. These requirements may include first making a demand on the board, continuing to hold the shares throughout the litigation, and other matters that are beyond the scope of this article. ■