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THE ZONE OF INSOLVENCY: WHEN HAS A COMPANY ENTERED INTO IT, AND ONCE THERE, WHAT ARE THE BOARD'S DUTIES?

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TABLE OF CONTENTS

I. INTRODUCTION

This paper examines the two fundamental questions of (1) when has a company entered into the "zone of insolvency," and (2) once in the zone of insolvency, what are the director's duties and to whom are they owed? An analysis of the common law reveals that despite the fact that the seminal case on the issue of zone of insolvency is ten years old, this continues to be an evolving area of law. While neither the case law nor the commentary contains a crisp analysis of these answers, the case law is clear that once insolvency or bankruptcy is imminent, the director has a duty to consider the interests of the corporation as a whole, and failure to do so can expose the director and the company to claims for breach of fiduciary duty.

II. WHEN HAS A COMPANY ENTERED INTO THE ZONE OF INSOLVENCY?

Prior to the decision of *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp*, the bright line rule had been that upon insolvency in fact of a corporation, the duties of the corporate directors shifted from the shareholders, to the creditors or the greater corporate body. *Clarkson Co. Ltd. v. Shaheen*, 660 F.2d 506 (2d Cir. 1981); *Unsecured Creditor's Committee of Debtor STN Enters. v. Noces*, 779 F.2d 901 (2nd Cir. 1985); *FDIC v. Sea Pines Co.*, 692 F.2d 973 (4th Cir. 1982). In *Credit Lyonnais* the scope of liability of the directors for breach of fiduciary duty is more expansive in that it arises at some point before the corporation is technically insolvent. *Credit Lyonnais*, 1991 WL 277613, at *34 n.55 (Del. Ch. Dec. 30, 1991).

In *Credit Lyonnais*, the plaintiff shareholder owned 98% of MGM which had been in and out of bankruptcy. To get it out of bankruptcy, the plaintiff entered into a corporate governance agreement whereby he turned over control of the company to MGM's lenders. The agreement provided that the plaintiff would regain control when the debt was paid down to a certain amount. The plaintiff demanded that the company's board cause MGM to sell certain of its assets to pay down the debt sufficiently to restore the plaintiff's control. The board did not authorize the sale, and the plaintiff shareholder sued for breach of the Directory's fiduciary duty of loyalty to the plaintiff as MGM's principal shareholder. The Court held:

> 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 [the shareholders], but owes its duty to the corporate enterprise . . . 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 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.

1991 WL 277613, at *34 n.55 (Del. Ch. Dec. 30, 1991). It is important to note however, that there does not appear to have been any actual question as to whether MGM was operating in the vicinity of insolvency because at all relevant times, the company was either in bankruptcy or "thereafter the directors labored in the shadow of that prospect." *Id.* at *34. Accordingly, the court's discussion of director's duties in the vicinity of insolvency is dicta.

Subsequent to the *Credit Lyonnais* case, it has become "universally agreed that when a corporation approaches insolvency or actually becomes insolvent, directors' fiduciary duties expand to include general creditors." *In re Kingston Square Assocs.*, 214 B.R. 713, 735 (Bankr. S.D.N.Y. 1997). Unfortunately, neither the *Credit Lyonnais* decision nor subsequent cases and comments (some of which are set forth below) have explained or been able to capture when the "vicinity of insolvency" arises.

> "No court has yet expressed a view on how one determines whether a corporation is in the 'vicinity' of insolvency for the purposes of applying this test." Donald S. Bernstein & Amit Sibal, *Current Developments: Fiduciary Duties of Directors and Corporate Governance in the Vicinity of Insolvency*, 819 PLI/COMM 653 (2001).

> "That vicinity is presumably somewhere or sometime between solvency and insolvency." Brent Nicholson, *Recent Delaware Case Law Re: Director's Duties to Bondholders*, 19 Del. J. Corp. L. 573, 588 (1994).

> "Although this concept seems relatively simply on its face, further examination reveals surprising complexity. For example, even if courts could agree upon the proper definition of insolvency for this purpose, they have not been able to agree at what point the directors' duties extend to creditors." David F. Heroy, *Fiduciary Duties of Officers and Directors of Financially Trouble Companies*. (1999)

> "The 'vicinity of insolvency' standard appears to combine the 'bankruptcy' (or 'balance sheet') standard and the 'equitable' (or 'cash flow') standard of insolvency such that if either condition is approached, the director

fiduciary duties expand to include creditors." Corinne Bell & Robert Messineo, *Fiduciary Duties of Officers and Directors of the Financially Troubled Company: A Primer*, 971 PLI/Corp. 171 (1996).

Only a few cases have discussed the zone of insolvency concept, let alone elaborated on when that might occur. These cases recognize three different fact patterns in which the fiduciary duties of directors of a corporation shift as a consequence of the company's insolvency: (1) the company is insolvent in fact; (2) the board authorizes a transaction that will render the company insolvent or close to insolvency; or (3) the board has sufficient knowledge that insolvency is imminent.

A. Insolvency In Fact

This is the clearest scenario for determining when the directors' duties shift. Once the company is insolvent, there is no question that the directors' duties shift to the creditor body. *Geyer v. Ingersoll Publications Co.*, 621 A.2d 784, 787 (Del. Ch. 1992); *see also Odyssey Partners, L.P. v. Fleming Companies*, 735 A.2d 386, 417-18 (Del. Ch. 1999) (citing *Geyer*). In *Geyer*, the Court noted that the directors do not generally owe any duties to creditors beyond contractual terms absent special circumstances. *Geyer*, 621 A.2d at 668. Insolvency constitutes a "special circumstance." *Id.*

The "insolvency exception," as it has thus been called, arises either upon balance sheet insolvency or inability to pay debts as they come due. *Id.* at 670. So, for example, where the company's financial statements reflect a negative shareholder equity, this has been found to be a sufficient factual requisite demonstrating that the company was in the "vicinity of insolvency." *Pereira v. Cogan*, 2001 WL 243537, at *9 (S.D.N.Y. Mar. 8, 2001). On the other hand, where the company is clearly solvent, such as where the value of assets exceeds liabilities by a significant amount, no shifting of the directors and officers' fiduciary duty will be found. *See La Salle Nat'l Bank v. Perelman*, 82 F. Supp. 2d 279, 291-92 (D. Del. 2000).

As a corollary to the insolvency exception, a presumption of insolvency may also be found to apply immediately before the filing of bankruptcy. For example, in *In re Mortgage & Realty Trust*, the court held that the debtor's board of trustees owed a fiduciary duty to creditors four days before the filing of the bankruptcy. 195 B.R. 740, 751 (Bankr. C.D. Cal. 1996). Even though there was no actual evidence of insolvency at the time the board ratified sale of a major asset in an insider transaction, the court presumed insolvency by virtue of the fact that the company filed bankruptcy only four days after the transaction. The court, relying on the balance sheet insolvency approach, held:

> According to its schedules, MRT [debtor] had assets worth approximately $344.6 million, and liabilities of $347.6 million when this bankruptcy case was filed. Presumably the financial status was similar four days earlier, when MRT decided to file the bankruptcy case and when it approved the Zim transaction. . . . Because MRT was insolvent at all times relevant to this adversary proceeding, Bucher [director] owed fiduciary duties to MRT and to these creditors . . . ."

195 B.R. 740, 751. Similarly, in *New York Credit Men's Adjustment Bureau, Inc. v. Weiss*, 305 N.Y. 1, 5 (1953), the court created a presumption of insolvency immediately before insolvency-in-fact where the corporation was "technically solvent but insolvency was only a few days away."

B. Transaction Will Render Company Insolvent Or Close To Insolvency

The courts have also extended the insolvency exception to scenarios in which the directors approve a transaction that benefits shareholders but leaves the corporation insolvent, on the "brink of insolvency", or with "unreasonably small capital."

In *In re Healthco Int'l, Inc.*, the company was balance-sheet solvent at the time the board authorized a leveraged buyout that saddled the company with loans and subordinated debentures. 208 B.R. 288 (Bankr. D. Mass. 1997). The proceeds of the LBO passed to the selling shareholders rather than to creditors. The Court agreed with the plaintiffs that the directors breached their fiduciary duties, noting: "When a transaction renders a corporation insolvent, or to the brink of insolvency, the rights of the creditors become paramount. In those circumstances, notwithstanding shareholder consent, a representative of the corporation may recover damage from the defaulting directors" *Id.* at 300.

In *Healthco,* the Court also noted that a director can be liable for authorizing transactions that leave the corporation with "unreasonably small capital." *Id.* at 302. In attempting to define "unreasonably small capital," the court explained:

> It connotes a condition of financial debility short of insolvency (in either the bankruptcy or equity sense) but which makes insolvency reasonably foreseeable. In other words, a transaction leaves a company with unreasonably small capital when it creates an unreasonable risk of insolvency, not necessarily a likelihood of insolvency.

Id. Thus, not only can the director be liable for transactions that actually render the company insolvent, the director can be held liable for transactions that render the company on the verge of insolvency. *Healthco* equated this duty of directors not to engage in transactions that render the company insolvent or close to insolvent as "merely an incident of the fiduciary obligations owed by directors to their corporation." *Healthco*, 208 B.R. at 301.

Other courts have also held that if a director approves a transaction that renders the company insolvent or close to insolvency, this will constitute a breach of the director's duties. In *In re Buckhead America Corp.*, the directors of a subsidiary company authorized a transaction whereby the subsidiary would incur $175 million in long-term debt to acquire the parent corporation's stock. 178 B.R. 956, 968-69 (D. Del. 1994). In a subsequent bankruptcy of its subsidiary, the creditors' committee filed an action alleging that the directors' approval of this transaction constituted a breach of fiduciary duty by the directors, among other things. The court held that plaintiffs alleged with sufficient specificity the breach of fiduciary duty claim. Drawing upon *Credit Lyonnais*, the court held that the corporation was insolvent or was "operating within the vicinity of insolvency" at the time that it approved the transaction because the subsidiary corporation received no consideration from the change in ownership of the parent's stock, and the transaction resulted in the subsidiary's insolvency or left the subsidiary "undercapitalized and unable to pay its debts." *Id.* at 969; *see also Askanase v. Fatjo*, 1993 WL 208440 (S.D. Tex. April 22, 1993) (holding that per *Credit Lyonnais*, a corporation's bankruptcy trustee could recover payments made prior to the bankruptcy to a defendant director by the corporation so long as the trustee could establish that the corporation was "insolvent or on the brink of insolvency.").

C. Insolvency Is Imminent

From the above cases, one can extrapolate a third scenario in which the director may be held liable for a breach of fiduciary duty. If the director knows with a fair degree of certainty that the company will be bankrupt or insolvent in the near future, a court will likely find that the director's fiduciary duty shifts at the point of knowledge.

The definition of "unreasonably small capital" set out by *Healthco* connotes that a director should have the necessary foresight to avoid entering into a transaction that "makes insolvency reasonably foreseeable" or creates an "unreasonable risk of insolvency." *Id.* 208 B.R. at 302. At least one scholar has noted of *Healthco*: " This concept of 'unreasonably small capital' seems to approximate what is meant by the nebulous concept of 'in the vicinity of insolvency.'" Christopher L. Barnett, *Healthco and the "Insolvency Exception": An Unnecessary Expansion of the Doctrine?*, 16 Bankr. Dev. J. 441 (2000).

Similarly, in the recent case of *In re Hechinger Investment Company of Delaware*, 274 B.R. 71 (D. Del. 2002), the court held, relying on *Healthco*, that the unsecured creditors' committee of the Hechinger bankruptcy estate had sufficiently alleged a claim for breach of fiduciary duty against the company's directors based on the "forseeability" of insolvency. The complaint alleged that the directors had approved a merger of the company, which was eventually effectuated by a leveraged buy-out that rendered the company insolvent. In their motion to dismiss, the directors argued that the complaint failed to state a cause of action because the directors had only approved the merger of the LBO, and not the pledging of the debtor's assets, which occurred post-LBO. In denying the directors' motion to dismiss, the court ruled that it was possible to construe the entire LBO transaction as "one integrated transaction" or, alternatively, that the "forseeability of the alleged harm" as alleged in the complaint was sufficient to allege a breach of fiduciary duty. *Id.* at 91. "Courts thus focus 'not on the structure of the transaction but the knowledge and intent of the parties involved in the transaction.'" *Id.* (citations omitted).

It can be argued that the inquiry as to when the zone of insolvency arises thus turns on the question of when the director has knowledge of the likelihood of insolvency. For example, in *In re Shultz*, 208 B.R. 723, 729 (Bankr. M.D. Fla. 1997), the court held that when the defendant director knew that if certain proposed transactions came to fruition, they would render the company insolvent, the director knew that the company was at "the brink of insolvency" prior to the transactions. Even though the corporation was solvent at the point the transactions were being considered, the director owed a duty to act in the best interests of the corporation at that point. *Id.* The court acknowledged the vicinity of insolvency rule in *Credit Lyonnais*, and then proceeded to apply a *Healthco*-type analysis to conclude that the director could be liable for breach of fiduciary duty for not acting in the best interests of the corporation at a time before the actual transactions were entered into, but when he knew that insolvency was imminent. The point when the zone of insolvency was found to arise in this instance was not so much temporal closeness to insolvency-in-fact, but rather the instance when the director had knowledge of the specter of insolvency.

III. THE BOARD'S DUTIES IN THE ZONE OF INSOLVENCY

A. To Whom Does The Board Owe Its Duties Once in the Zone of Insolvency?

Once a corporation is insolvent in fact, the case law is conflicted as to whom the board owes its duties. Some courts hold that at the point of insolvency the board's duties are owed only to creditors because the shareholders no longer have an equity stake in the corporation. *FDIC v. Sea Pines Co.*, 692 F.2d 973, 977; *In re Hoffman Assocs., Inc.*, 194 B.R. 943, 964 (Bankr. D.S.C. 1995). Most courts, however, have suggested that the board's constituency at the point of insolvency is the corporate enterprise as a whole. *Geyer v. Ingersonn Publications Co.*, 621 A.2d at 787-89 ("[F]iduciary 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."); *In re Xonics, Inc.*, 99 B.R. 870, 872 (Bankr. N.D. Ill. 1989) (directors of insolvent corporation owe fiduciary duties to corporation, shareholders and creditors).

In *Odyssey Partners*, the court held that the directors did not breach their fiduciary duty while in the zone of insolvency and had properly considered all constituents' interests, including those of its shareholders. The board in *Odyssey Partners* chose to allow the company to be foreclosed by its majority shareholder, which allowed for some return to shareholders and a payoff of all unsecured debt, rather than filing bankruptcy for the company (where the equity would surely not receive a return). 735 A. 2d at 419-20.

This more expanded scope of directors' duties, i.e., to the entire corporate body, which includes shareholders and creditors, appears to be applicable where insolvency in fact is not yet reached, but rather the corporation is in the zone of insolvency. *Credit Lyonnais*, 1991 WL 277613, at *34 n. 55 ("The beneficiaries are expanded to include creditors and any other party having an interest in the "corporate enterprise."); *Askanase v. Fatjo*, 1993 WL 208440, at *5 ("The directors must be capable of conceiving of the corporation as a legal and economic entity, with the interests of the corporation as a whole put before all others.").

B. What are the Board's Duties in the Zone of Insolvency?

Except as discussed below, the traditional ambit of fiduciary duties owed by a director of a solvent corporation, including the duty of care, duty of loyalty, duty of candor, duty of disclosure, duty to protect and preserve confidential information, still appear to be applicable when the corporation is insolvent or in the vicinity of insolvency. "As a general rule, the law provides that directors of the insolvent corporation are subject to the same duties of loyalty and care to creditors as those that run to shareholders when the corporation is solvent." Bell & Messineo, *Fiduciary Duties of Officers and Directors of the Financially Troubled Company: A Primer*, 971 PLI/Corp. at 185 (citing *In re O.P.M. Leasing Servs., Inc.*, 28 B.R. 740 (Bankr. S.D.N.Y. 1983)).

When the corporation becomes insolvent or is in the zone of insolvency, some courts hold directors to a higher standard of scrutiny. At least one court has concluded that in the context of insolvency, "the business judgment rule and other rules applicable to solvent corporations are of no effect in the context of insolvency and serve as no defense to a preferential transfer action under the trust fund doctrine." *Askanase*, 1993 WL 208440, at *5 (citing *New York Credit Men's Adjustment Bureau v. Weiss*, 110 N.E.2d 397, 400 (N.Y.App.1953)); *see also* Bell & Messineo, *Fiduciary Duty of Officers* *and Directors*, 971 PLI/Corp. at 188 (directors may be held to a higher business judgment standard when the corporation is insolvent or at the zone of insolvency), *but cf.*, *Angelo, Gordon & Co., L.P. v. Allied Riser Communications Corp.*, 2002 WL 208074, at *6 (Del. Ch. Jan. 30, 2002) (court "tentatively" concluding that the business judgment rule may still apply in the zone of insolvency).

There are express additional duties that arise in the zone of insolvency as set forth in the *Credit Lyonnais* decision, as follows: "'The MGM board or its executive committee had an obligation to the community of interest that sustained the corporation, to exercise judgment in an informed, good faith effort to maximize the corporation's long-term wealth creating capacity." 1991 WL 277613 at *34 n. 55. The board's duty to "maximize the corporation's long-term wealth creating capacity" has been likened to the board as trustee of the corporate res, which has a duty to preserve the corporation's value for eventual distribution to creditors. *New York Credit Men's Adjustment Bureau v. Weiss*, 110 N.E.2d 397, 400; Mohammad R. Pasban, *A Review of Directors' Liabilities of an Insolvent Company in the U.S. and England*, Journal of Business Law 2001, Jan. 33-57, at 41. In *New York Credit*, the court held that the directors were free to liquidate assets as they saw fit.

> "However, they were obligated to obtain for the corporation the full value of assets as of that period under the circumstances. [The directors] were, in effect, trustees . . . for the creditors . . . obligated to protect the trust res for the creditors and to account for waste in not obtaining full value for the res, if there was any waste by reason of their conduct."

Id. at 400; *see also In re Schulz*, 208 B.R. at 729.

The duty to consider the corporate enterprise as a whole also means that the board should not approve transactions that overtly favor one creditor constituency over another. *In re Ben Franklin Retail Stores*, 225 B.R. 646, 653-54 (Bankr. N.D. Ill. 1998) ("[C]reditors have a right to expect that directors will not divert, dissipate or unduly risk assets necessary to satisfy their [creditors'] claims."). Directors get into trouble when they prefer one group over another. "All of the decisions in which the courts have allowed creditors to recover for breach of fiduciary duty have involved directors of an insolvent corporation diverting corporate assets for the benefit of insiders or preferred creditors." *Id.* at 655 (citing Laura Lin, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 Vand. L. Rev. 1485, 1512 (1993)). Along the same lines, the director's duty of loyalty not to put their personal financial interests above the interests of the corporation is also heightened. *In re Healthco Int'l, Inc.*, 208 B.R. at 302. "As fiduciaries for the firm's creditors, directors cannot cause the firm to pay even bona fide obligations owed to themselves ahead of the firm's noninsider creditors." *Collie v. Becknell*, 762 P.2d 727, 731 (Colo. App. 1988).

Thus, a board in the vicinity of insolvency must walk a fine line of not preferring one constituency over another, while simultaneously attempting to preserve the corporate res for the benefit of eventual distribution to all creditors.