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DANGER ZONE: HEIGHTENED DUTIES FOR PROFESSIONALS IN THE ZONE OF INSOLVENCY

Whether a company is insolvent or not can have significant implications, and raises a host of issues for a board of directors, management and their advisors to consider. For example, if a company is solvent, all jurisdictions agree that the fiduciary duty a board of director owes is to shareholders and the corporation. However, upon insolvency, bankruptcy or in some circumstances the grey area of the "zone of insolvency", the fiduciary duties can expand to creditors. Also, in an insolvency situation, some courts have held that the protection of the business judgment rule does not apply to the extent it would to a financially healthy enterprise, utilizing a theory that the assets of an insolvent corporation are impressed with a trust for the benefit of creditors and shareholders, and therefore the appropriate standard a court will use in reviewing a corporate action is one of "entire fairness." This hindsight review of a directors' actions to determine "entire fairness" raises serious concerns regarding decisions while the company is entering potential insolvency. In addition, professionals offering advice to companies within the "zone of insolvency", including lawyers, accountants, lenders, and turn around specialists, have to avoid various pitfalls in preventing aiding and abetting breach of fiduciary duty claims and civil conspiracy claims by creditors upon insolvency.

I. THE ORIGIN OF ZONE-OF-INSOLVENCY THEORIES

It is well settled law that if a corporation is solvent, its directors and officers do not have a fiduciary duty to the corporation's creditors. *Judson Atkinson Candies, Inc. v. Latini–Hohberger Dhimantec*, 529 F.3d 371, 384 (7th Cir.2008); see also *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 99, 101 (Del. 2007); *Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504, 1524-25 (S.D.N.Y. 1989) (holding that bondholders are unsecured creditors, not stockholders, and that therefore the corporation owed the bondholders contractual rights, not fiduciary duties). Rather, disputes between a corporation and its creditors arise out of contractual obligations the company has to its creditors.

The concept of "zone of insolvency" arose in 1991 in *Credit Lyonnaise*, an unpublished Delaware Chancery Court decision. *Credit Lyonnaise Bank Nederland, N.V. v. Pathe Commc'ns. Corp*, No. Civ. A 12140, 1991 WL 277613 (Del. Ch. Dec. 30, 1991). Under the zone of insolvency theory, directors were cautioned to refrain from making decisions that favored shareholders to the detriment of creditors. In 2016, Delaware finally clarified the "zone of insolvency" theory in *North American Catholic Education Programming Foundation Inc. v. Gheewalla,* 930 A.2d 92 (2007) and *Quadrant Structured Prods. Co. v.* Vertin, 102 A.3d 155 (Del. Ch. 2014). These case made clear that in Delaware directors do not owe direct fiduciary duties to creditors either

before or after a company enters insolvency, although after a company becomes insolvent, creditors may pursue derivative actions to enforce fiduciary duties owed to the company. In addition, *Gheewalla* and *Quadrant* established that a company's entry into the "zone of insolvency" does not create a freestanding fiduciary duty by officers to creditors.

Most court considering zone-of-insolvency theories after *Gheewalla* and *Quandrant* have followed Delaware's lead and held that directors and officers do not owe duties to creditors while a company is in the zone of insolvency.

Nevertheless, plaintiffs continue to pursue these theories in some jurisdictions because not all courts have revisited their stance on zone of insolvency since *Gheewalla* and *Quandrant*. The continued pursuit of these theories makes it important for directors and professionals to be cognizant of the financial condition of the corporation and refrain from taking actions that could be seen as specifically benefitting shareholders and/or directors over those of creditors.

II. D&O FIDUCIARY DUTIES

Directors owe three fiduciary duties to the corporation and its stockholders: care, loyalty and good faith. If a director breaches one or more of these fiduciary duties, he or she could become personally liable to persons owed fiduciary duties.

The Duty of Care means that directors and officers must exercise the care and skill of a prudent person in similar circumstances. While they are not charged with having a requisite level of business acumen, they are required to inform themselves of all information reasonably available before making a business decision. This includes potentially seeking the advice of professionals and experts. Directors and officers are entitled to rely on the skills and expertise of attorneys, accountants and other experts in carrying out their duty of care.

The Duty of Loyalty becomes relevant when there is a conflict between the interests of the fiduciary and the entity to which he owes loyalty. The duty of loyalty requires an undivided and unselfish loyalty to the corporation and demands that there be no conflict between the duty and self-interest. In *Meinhard v. Salmon,* 249 N.Y. 458 (N.Y. 1928), Judge Cardozo described the duty of loyalty between fiduciaries as "something stricter than the morals of the market place," and honesty. Simply put, the duty of loyalty dictates that the interests of the corporation and shareholders are tantamount to the director's own interests.

The Duty of Good Faith is a component of both the duty of care and the duty of loyalty. The duty of good faith requires directors and officers to act at all times with honesty of purpose and in the best interests and welfare of the corporation. *In re Walt Disney Co. Derivative Litigation*, 907 A.2d at 755.

When a company is solvent, the directors and officers owe their fiduciary duties of due care and loyalty to the corporation and its stockholders. That remains true even if the company is in the "zone of insolvency."

In most cases, a director or officer's decision may be protected by the business judgment rule.

The directors and officers still owe fiduciary duties of care and loyalty to the corporation even when the corporation is insolvent. However, upon insolvency the creditors have the right to bring derivative (but not direct claims) for breach of fiduciary duty against directors and officers.

The real issue to consider is whether a company is just in the zone or insolvency (meaning still solvent but approaching insolvency) or whether it has crossed the line into actual insolvency. Companies can experience one of four financial conditions – solvency, zone of insolvency, insolvency and bankruptcy – each of which brings its own potential liabilities on the directors and officers of the corporation

Solvency

When the corporation is solvent the only duties that are owed are to the corporation and its stakeholders. *Simons v. Cogan*, 549 A. 2d 300, 204 (Del. 1988). Simply put, as long as the company is solvent creditors are not owed any fiduciary duties by the directors and officers. *Geyer v. Ingerso.. Publications Co.*, 621 A.2d 784, 787 (Del.Ch. 1992). The only possible duty that could be owed to creditors during solvency would be a duty arising from contract.

Zone of Insolvency

The zone of insolvency is not easily defined. *Gheewalla*, 930 A.2d 92 at n.20 (stating that the Court of Chancery did not attempt to set forth a precise definition of what constitutes "zone of insolvency.") For example, *In re Healthco Int'l, Inc.*, 208 B.R. 288, 302 (Bnkr. D. Mass. 1997) stated that a corporation is in the zone of insolvency if it has "unreasonably small capital," which is "a condition of financial debility short of insolvency but which makes insolvency reasonably foreseeable." By contrast, *RSL Communs, PLC v. Bildirici*, 649 F. Supp. 2d 184, 206 (S.D.N.Y. 2009) held that in a recession it is difficult to imagine a coherent limiting principle that would preclude a plausible allegation that a corporation is operating in the zone of insolvency.

As noted above, Delaware case law has attempted to eliminate the director and officers' fiduciary duties to creditors while in the zone of insolvency. In *Gheewalla*, the Delaware Court held that creditors of a corporation in the zone of insolvency have no right to a direct action for breach of fiduciary duty against the directors and officers of the corporation. Similarly, in *Berg*, a California court held that there is no fiduciary duty owed to creditors solely by virtue of the corporation being in the zone of insolvency. In *Torch Liquidating Trust*, a Louisiana court expanded the *Gheewalla* holding to prohibit derivative lawsuits in addition to direct lawsuits by creditors.

These cases, and others like it, which attempt to resolve the issues that plagued directors and officers for over a decade regarding the fiduciary duties owed during the zone of insolvency leave several unresolved issues.

Insolvency

During insolvency, the fiduciary duties of directors and officers extend to the company's creditors and continue to the corporation itself. *Gheewalla*, 930 A.2d at 101. Courts appear divided on whether the directors and officers' duties to shareholders continue during insolvency or whether the duty to shareholders simply becomes subordinate to that of the creditors.

There are five general tests to determine if the company is solvent:

(1) the equity test – the corporation cannot meet its debts as they mature;

(2) the balance sheet test – the fair market value of the corporation's assets is less than the corporation's liabilities. This test involves a modified balance-sheet test – GAAP does NOT control. Balance sheet assets and liabilities must be adjusted to reflect "fair valuation";

(3) the future options test;

(4) the insolvency in fact test; and

(5) the bankruptcy test.

James F. Hart, *Solvency Determination*, Ass'n of Insolvency and Restructuring Advisors J., Jun./Jul. 2007.

The extension of a director's fiduciary duty to creditors is based on the trust fund doctrine. Under the trust fund doctrine, the trustee directors owe the duty to protect the insolvent corporation's assets that they hold in trust for distribution to the beneficiary creditors. Michael A. Bloom, Justice Randy J. Holland, Ann B. Laupheimer & Mark J. Sonnenfield*, The Fiduciary Duties of Officers and Directors*, Pa. B. Inst. Apr. 2, 2009 at 23.

Bankruptcy

When a company files for Chapter 11 bankruptcy protection, the directors and officers of a company owe duties to the corporation, creditors and shareholders. In bankruptcy, creditors become active participants in all corporate affairs, negotiations and reorganization. As a debtor in possession, the directors and officers' duty of care is to maximize and protect estate's assets, abstain from wasting assets, furnish information about the estate and its administration and exercise reasonable diligence and care in instituting a reorganization plan. The directors and officers' duty of loyalty remains the same as it was while the company was solvent, i.e. to refrain from self dealing, steer clear of conflicts of interest and avoid the appearance of impropriety.

III. COUNSELING D&O'S IN THE ZONE OF INSOLVENCY

While Courts continue to attempt to clarify the issues that arose from the original extension of creditors claims through the zone of insolvency theory, directors and officers should nevertheless be cognizant of their ever changing roles and duties and companies go through the transition from solvent to insolvent. In counseling clients, it is important to provide them with the following guidance.

- Get a Realistic Financial Picture
- Hire a Professional
- Budget for Future Payables
- Beware of Personal Guarantees
- Notice Where Priorities Lie
- Pay Attention to Regulatory Issues
- Get Backing from Secured Creditors
- Keep Records Orderly and Safeguarded

Directors and officers of an insolvent corporation may be personally liable for many specific actions such as:

- Unpaid Wages and Compensation Owed to Employees
- Failure to Withhold and Pay Federal Employee Tax
- Willful Failure to Pay Contribution or Withholding for Unemployment, Workers' Compensation and Disability Taxes/Contributions
- Failure to Maintain Workers' Compensation Insurance
- Willful Failure to Pay Sales and Use Taxes
- Issuance of "Bad" Checks
- Unlawful Payment of Dividends
- Plan Contribution Under ERISA Plans
- Termination of a Single-Employer Plan Under ERISA
- CERCLA Responsible Party Liability
- Securities Law
- Trade Creditors
- Guaranty of Corporate Obligations
- ADA

IV. POTENTIAL LIABILITIES FOR PROFESSIONALS COUNSELING COMPANIES IN THE ZONE OF INSOLVENCY

These problems may also exist for outside professional advisers working with a financially troubled company in jurisdictions that recognize a tort for aiding and abetting a breach of fiduciary duty.

While it established (at least in Delaware) that deepening insolvency is not a cause of action, *Trenwick* expressly left the door open for claims based on existing causes of action such as breach of fiduciary duty, fraud, fraudulent conveyance and breach of contract. Creditors looking for other ways to satisfy their claims have attempted to plead their claims relating to actions by directors, officers and professionals that, while attempting to save the business, only prolonged its agony and delayed its demise to fit the opening left by *Trenwick*. These attempts have met with mixed results. In Radnor Holdings, a Bankruptcy Court in Delaware dismissed claims that directors had breached their fiduciary duties to the company by authorizing it to borrow to "swing for the fences" in an aggressive new venture as no more than a "disguised" deepening insolvency claim. *Official Comm. of Unsecured Creditors of Radnor Holdings Corp. v. Tennenbaum Capital Partners LLC (In re Radnor Holdings Corp.*), 353 B.R. 820 (Bankr. D. Del. 2006).

Then in Brown Schools, another Bankruptcy Court in Delaware dismissed a cause of action for deepening insolvency based on Trenwick, but declined to dismiss duty of loyalty claims for self-dealing against a controlling stockholder/creditor and its representatives in causing the company to take actions intended to elevate their claims as creditors. *Miller v. McCown De Leeuw & Co*. (*In re Brown Schools*), 386 B.R. 37 (Bankr. D. Del. Apr. 24, 2008).

The elements of such a claim are: "(1) a fiduciary relationship; (2) a breach of that relationship; (3) that the alleged aider and abettor knowingly participated in the fiduciary's breach of duty; and (4) damages proximately caused by the breach." *Gatz v. Ponsoldt*, 925 A.2d 1265, 1275 (Del. 2007).

For example, in *Mukamal v. Bakes*, 383 B.R. 798 (S.D. Fla. 2007), a bankruptcy trustee sought to assert creditors' claims against the company's outside auditor on a theory that it aided and abetted breaches of fiduciary duty to creditors while the company was "insolvent and/or operating in the zone of insolvency." The court in *Mukamal* rejected those claims relying in part on *Gheewalla*, but creditors might seek to pursue similarly framed aiding-and-abetting claims in jurisdictions that have not clearly rejected the zone-of-insolvency concept.

In addition, under Delaware law, financial advisors and investment bankers may be held liable for aiding and abetting directors' breaches of fiduciary duties. *RBC Capital Markets, LLC v. Jervis*, 129 A.3d 816, 861-63 and 873-75 (Del. 2015).

Similarly, Creditors of an insolvent corporation may be liable for aiding and abetting a board's breach of fiduciary duties if they knowingly participated in the board's breaches, for example by intentionally capitalizing on directors' self-interest.69 Under Delaware law, a third party may be liable for aiding and abetting a breach of fiduciary duty.

Claims for aiding and abetting have been leveled against creditors at least twice, although the plaintiff was not successful in either case. *See Radnor Holdings Corp. v. Tennenbaum Capital Partners*, 353 B.R. 820 (D. Del. 2006) (rejecting claim that creditor aided and abetted a breach of fiduciary duties by advancing funds to an insolvent corporation on the grounds that borrowing funds was not a breach of fiduciary duty by the board under *Trenwick Am. Litig. Trust v. Ernst & Young, LLP*, 906 A.2d 168, 204 (Del. Ch. 2006)); *Official Comm. of Unsecured Creditors v. CIT Group/Business Credit, Inc. (In re Jevic Holding Corp.)*, 2011 Bankr. LEXIS 3553 (D. Del. 2011) (dismissing claim for aiding and abetting a breach of fiduciary duty).