

FINANCE & TRANSACTIONS GROUP

Directors' Duties in the Zone of Insolvency: A Practical Guide

This "white paper" addresses the change in directors' duties when a corporation enters the "zone of insolvency," when this change occurs, and what directors can do to mitigate the risks of breaching their fiduciary duties.

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Due to the recent increase in the number of corporate bankruptcies and scandals involving public companies, corporate managers are under intense scrutiny. At no time in recent history have directors' fiduciary duties been more important to understand and manage, particularly when a company is distressed.

In a solvent corporation, directors owe fiduciary duties to the corporation and its stockholders. When a financially distressed corporation enters the zone or vicinity of insolvency, the number of parties to whom the directors owe their fiduciary duties increases to include the corporation's creditors. As a result, the directors of a corporation in the zone of insolvency must balance the sometimes conflicting interests of the stockholders and creditors, elevating the directors' risk of personal liability.

This article addresses the change in directors' duties when a corporation enters the "zone of insolvency," when this change occurs, and what directors can do to mitigate the risks of breaching their fiduciary duties.

Directors' Fiduciary Duties Generally

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

In determining whether directors have fulfilled their fiduciary duties, courts generally apply the business judgment rule: A judicial presumption that in making business decisions, directors act on an informed basis, in good faith, and in the honest belief that the decision or action taken was in the best interests of the corporation. Proving that a director has breached a fiduciary duty

means first overcoming the business judgment rule by establishing that the director was grossly negligent in failing to inform himself or herself of the relevant facts, failed to act in good faith or had an improper self-interest.

Duties Owed to Creditors of an Insolvent Corporation

In a solvent corporation, directors generally owe no fiduciary duties to creditors. However, upon insolvency, the rights of creditors expand because the fiduciary duties of directors increase to include creditors.¹ Thus, directors owe a duty to act in the creditors' interests at the moment a corporation reaches insolvency. The change in the focus of directors' duties occurs because directors may take extreme risks in an attempt to improve stockholders' position to the detriment of the corporation's creditors.² Furthermore, when a corporation becomes insolvent, creditors become residual claimants (as opposed to the stockholders when a corporation is solvent) and therefore a part of the corporate enterprise.

When Does a Corporation Fall Within the Zone of Insolvency?

While the duties of directors of an insolvent corporation are relatively clear, the question of when a corporation becomes insolvent is often difficult to determine. Unless the corporation admits insolvency in writing or in a board meeting its directors and officers will not necessarily know, in real time, when insolvency actually begins. Accordingly, the term "zone of insolvency" has been used by courts to describe the uncertain period when a corporation is in financial distress, but it is unclear if it is actually insolvent.

Depending on the state where a court is located, the court may apply the Equity Test³ or the Balance Sheet Test⁴ in determining if a corporation is insolvent. Based on the facts of each case, the Delaware Chancery Court has applied either or both of the tests in determining the insolvency of a corporation. The Court noted that an insolvency test needs to take into account business realities, and that to define insolvency merely as a corporation's liabilities exceeding its assets fails to take into account emerging corporations that take advantage of business opportunities.⁵

Duties Owed to Creditors when a Corporation is in the Zone of Insolvency

The fiduciary duties owed by directors of a corporation to creditors of the corporation extends beyond insolvency to the "zone of insolvency."⁶ The Delaware courts have stated that when a corporation is merely the zone of insolvency the directors have an obligation not only to the stockholders, but rather an obligation to the community of interests that sustained the corporation's wealth-creating capacity, including the corporation's creditors.⁷ The court reasoned that expanding the directors' fiduciary duties in this situation also assists creditors by preventing them from having to prophesy when directors are entering into transactions that would render the entity insolvent and improperly prejudice creditors' interests. Furthermore, expanding the number of parties to whom fiduciary duties are owed is intended to encourage directors to choose a course of action that best serves the entire corporate enterprise rather than any single group at a point in time when stockholders' wishes should not be the directors' only concern. The more insolvent the corporation is or would become, the larger the group to whom the fiduciary duties are owed.

When a corporation is in the zone of insolvency, the directors' fiduciary duties expand to include creditors, but the duties do not shift entirely to creditors. In *Steinberg v. Kendig*,⁸ the Illinois Bankruptcy Court (interpreting Delaware law) stated that while directors' duties in the zone of insolvency may require the directors to take creditors' interests into account, they do not require the directors to make creditors' interests a priority. In other words, directors are not required to simply liquidate and pay creditors, provided that in the directors' informed good faith judgment, there is an alternative to liquidation. The appropriate scope of the duty of care owed to creditors of a corporation "near insolvency" is to "protect the contractual and priority rights of creditors."⁹

What Can a Director Do for Protection?

In performing their fiduciary duties, directors of a corporation in the zone of insolvency should make a good faith balancing of benefits and losses, recognizing that any loss to creditors may well be more significant than the corresponding benefit derived by stockholders. Directors of a corporation in the zone of insolvency should note the following suggestions:

- Actions that increase stockholder return by impairing creditors' claims should be thoroughly scrutinized.
- Stockholders should not be given preferential treatment at the expense of creditors (e.g., directors should not authorize and fund a dividend or a stock redemption at such time).
- One creditor or one class of creditors should not be given preference over another.

- A reasonable effort should be made to learn all the facts before taking a specific course of action; directors should genuinely believe that any decisions made are in the best interests of the corporation in its entirety (i.e., their decisions will be reviewed in hindsight in light of the effect of such actions on the corporation).
- Transactions that would constitute a fraudulent conveyance (i.e., a transfer for less than fair value) or a preferential payment to one creditor should not be approved.
- Directors should propose at each annual stockholder meeting a resolution affirming that all business decisions and actions taken by the directors and officers of the corporation were taken in good faith after an exercise of reasonable care.
- To avoid appearances of violating their duty of loyalty, directors should not engage in any self-dealing.
- To avoid the appearance of a conflict of interest, directors should fully disclose any personal or business relationships with parties on the other side of transactions involving the corporation.
- In evaluating potential fund raising transactions or a sale of assets of the troubled corporation, directors should be aware that these transactions may be scrutinized later in light of the expansion of directors' fiduciary duties to include creditors.
- While a director is always free to resign under state law and under the corporation's charter and by-laws, **resignation does not provide total protection. A director will continue to have liability for pre-resignation acts and omissions.** Also, a director has a duty not to resign if resignation will cause immediate harm, allow harm to occur, or leave corporate assets unprotected. Liability may be deemed continuing even where the director resigned before the improper or illegal action was taken if the improper or illegal action had its inception prior to the director's resignation.
- The traditional purpose of a Director and Officer Liability Policy ("D&O Policy") is to insure against financial losses, including the costs of litigation incurred by the insured. A typical D&O Policy contains two parts. The first part directly reimburses the corporation for any amounts that it pays to indemnify its officers and directors for covered losses, and the second part directly insures the officers and directors to the extent that there is no corporate indemnification or the available corporate indemnification does not cover the loss incurred. Directors should familiarize themselves with the terms of coverage and exclusions of coverage of such policies before the corporation enters the zone of insolvency. In addition, a director contemplating resignation should review the D&O Policy for the effect of resignation on such coverage. The director should also determine if the policy covers acts that occurred during his tenure, even though such acts were not determined to be in violation of fiduciary duties at the time of occurrence.

Conclusion

There is no bright-line test used by courts to determine if a corporation is in the zone of insolvency. In general, if a corporation is in dire financial straits, a court will likely find that the corporation is in the zone of insolvency.

Accordingly, when a corporation is in financial distress, its directors and officers should assume that they are in the zone of insolvency, and should be making decisions and taking actions on the basis that they owe fiduciary duties to creditors as well as stockholders.

However, by ensuring that all transactions involving the corporation are entered into in good faith, are fair and reasonable, and without self-dealing or favoritism toward any group of stakeholders, directors should be able to navigate their duties in the zone of insolvency with few difficulties.

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Endnotes

¹ *Geyer v. Ingersoll*, 621 A.2d 784, 787 (Del. Ch. 1992).

² *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications, Corp.*, No. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991).

³ A corporation is deemed insolvent when it is unable to pay its debts in the ordinary course of business.

⁴ A corporation is deemed insolvent when its liabilities exceed the reasonable market value of its assets.

⁵ *Francotyp-Postalia AG & Co. v. On Target Tech., Inc.*, Del. Ch., C.A. No. 16330 (December 24, 1998); *see also Angelo, Gordon & Co., L.P. et al. v. Allied Riser*, Del. Ch., C.A. No. 19298 (January 31, 2002) (determining the issue of insolvency by applying the Balance Sheet Test).

⁶ *Credit Lyonnaise Bank Nederland, N.V. v. Pathe Communications, Corp.*, No. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991). Although the Court extended the standard to the zone or vicinity of insolvency, it did not provide guidance as to exactly what constitutes such zone or vicinity of insolvency. As mentioned above, directors and officers of financially distressed corporations should assume that they are in the zone or vicinity of insolvency.

⁷ *Credit Lyonnaise Bank Nederland, N.V. v. Pathe Communications, Corp.*, No. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991).

⁸ 225 B.R. 646, 655 (Bankr. N.D. Ill. 1998), *aff'd* in *Jackson*, U.S. Dist. LEXIS 16645.

⁹ *Id.*

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