In The Zone: New Insolvency Rules

by Michael Foreman, Eric Lopez Schnabel and Jordan Brackett

A few years back, directors faced real legal uncertainty when their companies were "in the zone" of insolvency. To whom did the board owe its loyalty—shareholders or creditors? What if board turnaround efforts added to the debts? Recent legal cases have given boards added powers to make the tough choices needed for a restructuring or turnaround.

In the current economic climate, directors are venturing into the brave new world of restructuring and workouts. These newly traveled roads bring issues of fiduciary duties and responsibilities that many may not have seen before.

In preparing for a restructuring, directors must be mindful of the company's changing economics, for the status of a corporation's solvency will determine what type of lawsuit may be brought against the corporation and by whom. Accordingly, to whom the directors of a corporation owe duties and the consequences of potential failings are not static, and directors must keep a watchful eye on the solvency of the corporation to which they owe a fiduciary duty.

Much has been written about directors' duties and responsibilities during two seemingly distinct circumstances:

☐ The "zone of insolvency," when a company is on the brink of becoming insolvent.

☐ "Deepening insolvency," when an already insolvent company becomes more insolvent.

Perhaps the concern for directors should be less about whether the company is more or less insolvent and more about whether the company actually is insolvent. Nonetheless, because of the murkiness of definitions, when a company may be approaching insolvency or is already in its throes, directors must be mindful of not only what is best for the corporation and its shareholders, but also all of its creditors.

Normally, directors owe duties of care and loyalty to the corporation. The "duty of care" has been defined as "that degree of skill, diligence, and care that a reasonably prudent person would exercise in similar circumstances." The duty of loyalty "prohibits the fiduciaries from taking advantage of their beneficiaries by means of fraudulent or unfair transactions." If directors breach either of these duties, a derivative suit (for an injury to the corporation) may be brought against the corporation by its shareholders. In contrast, if the alleged wrong is not to the corporation, but to its shareholders, a direct suit may be brought against individual directors.

Director duties in a restructuring are more complicated than just solvency/insolvency. A turnaround strategy that requires "deepening" the insolvency could lead to lawsuits.

The action to which directors may be disposed—direct or derivative—is determined by a corporation's solvency. A Delaware court has noted, "When a corporation is *solvent,* [shareholders] have standing to bring derivative actions on behalf of the corporation because they are the ultimate beneficiaries of the corporation's growth and increased value… When a corporation is *insolvent,* however, its creditors [come before] shareholders as the…principal constituency injured by any fiduciary breaches that diminish the firm's value."

The extent of directors' duties in a restructuring is more complicated than just solvency/insolvency. Indeed, many courts have suggested that fiduciary duties are owed to creditors before a company reaches insolvency—when it is in the "zone" of insolvency. Furthermore, some courts have concluded that once a company is insolvent, acts causing a company to assume greater debt and become more insolvent (or entering "deepening insolvency") are justification

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for a derivative suit.

To provide guidance for board members, recent Court decisions will help to answer the following questions: What parties may pursue actions against directors when a company is moving towards insolvency? Can creditors sue when an insolvent company becomes "more" insolvent, or is in the midst of "deepening insolvency?" When a company is insolvent, what kind of suits by creditors may directors be exposed to?

The short answers are that:

☐ When a company is in the "zone of insolvency," only shareholders may bring suits.

☐ "Deepening insolvency" is losing support as a claim and has been invalidated by the influential Delaware Supreme Court.

☐ Creditors may bring derivative suits only against a corporation when a corporation is insolvent. They generally cannot bring direct suits against individual board members.

In an era of tightening credit, where creditors are more likely to be hostile and litigious, directors must be aware of the current dangers regarding derivative suits.

It now appears that creditors may assert direct claims against directors only on very rare occasions—when directors show a "marked degree of animus toward a particular creditor" as cited in a 2004 Delaware case. For a director of an insolvent company, therefore, there is little risk of direct personal liability claims.

There is a good deal of risk, however, that directors' actions may lead to a derivative suit against the company. In an era of tightening credit, where creditors may be more likely to be hostile and litigious, directors must be aware of the current dangers regarding derivative suits.

The concept of the "zone of insolvency" likely started with a footnote to a 1991 Delaware Court of Chancery case that stated:

"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.'

According to a subsequent case in the same court, "To the extent that a firm is in the zone of insolvency, some read this case as authorizing creditors to challenge directors' business judgments as breaches of a fiduciary duty owed to them."

The notion that, in Delaware, directors of a not-yet-insolvent company owed a duty both to shareholders and to creditors was finally put to rest by the Delaware Supreme Court in the 2007 *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla* case.

The *Gheewalla* court concluded first, that creditors may not assert direct claims against directors for breach of fiduciary duties (they may only assert derivative claims). Second, even when a company is operating in the "zone of insolvency," directors owe their fiduciary duties to a corporation and its shareholders and not to creditors.

In other words, if a corporation is approaching insolvency, under current Delaware law, the fiduciary duties of directors do not shift from shareholders to creditors. Indeed, directors must continue to make decisions of business judgment based on what is best for the corporation overall and its shareholders, and not necessarily what is best for the creditors.

Still, we recommend that restructuring corporations approaching insolvency be mindful of potential duties owed to creditors.

"Deepening insolvency" was defined as "an injury to the debtors' corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life." It gained steam after the Third Circuit's 2001 decision in *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc.* In *Lafferty,* the court held that deepening insolvency constituted a valid cause of action under Pennsylvania law.

Deepening insolvency could harm a corporation in several ways. The incurrence of additional debt could force a company into bankruptcy, thereby creating additional administrative costs. Bankruptcy stemming from deepening insolvency would destroy a corporation's ability to conduct business in a profitable manner. It could harm relationships with and credibility with customers, suppliers, and employees.

Lastly, "prolonging an insolvent corporation's life through bad debt may simply cause the dissipation of corporate assets." According to the *Lafferty* court, the "harms [stemming from deepening insolvency] can be averted, and the value within an insolvent corporation salvaged, if the corporation is dissolved in a timely manner, rather than kept afloat with spurious debt."

The popularity of the theory of "deepening insolvency" began to erode when the Third Circuit considered the issue for the first time since *Lafferty* in the 2006 *Seitz* case. In this, "[a]n insolvent internet company involved in an illegal Ponzi scheme used its financial statements, compiled by its accounting firm, to attract investors."

The new Delaware view—the "fact of insolvency does not render the concept of 'deepening insolvency' a more logical one than the concept of 'shallowing profitability.'"

The court concluded that "deepening insolvency" could be a valid cause of action but does not "create a novel theory of damages for an independent cause of action like malpractice." Insolvency beyond the *Lafferty* holding was determined to be limited, and would not sustain a claim of negligence or support a deepening-insolvency cause of action.

The Delaware courts may have dealt a fatal blow to the concept by holding that Delaware law does not recognize an "independent cause of action for deepening insolvency" in *Trenwick America Litigation Trust v. Ernst & Young, L.L.P* (2007). According to the court in *Trenwick,* the board of even an insolvent company "may pursue, in good faith, strategies to maximize the value of the firm." Even if a strategy incurs additional debt, "an even more insolvent entity does not in itself give rise to a cause of action."

In such circumstances, the directors will be protected by the business judgment rule because the "fact of insolvency does not render the concept of 'deepening insolvency' a more logical one than the concept of 'shallowing profitability.'"

Deepening insolvency is also becoming less and less a valid cause of action throughout the rest of the country. Because both federal and state courts often follow Delaware's lead on such creditor issues, it is likely that deepening insolvency will no longer be a credible alternative for plaintiffs elsewhere.

Insolvency remains a fairly gray legal area. The board should still be mindful of creditors when the company approaches insolvency, but is not there yet.

Because the concepts of the "zone of insolvency" and "deepening insolvency" have diminishing value, the real test for determining director responsibility and liability is whether or not a corporation is solvent. However, the test for insolvency lies in a fairly gray area. Directors should be mindful of creditors when they think a company is approaching insolvency but is not there yet.

Under Delaware law, a corporation is insolvent if it has either: a deficiency of assets below liabilities with no reasonable prospect that the business can be successfully continued, or; an inability to meet maturing obligations as they fall due in the ordinary course of business."

As noted earlier, once a company reaches the point of insolvency, however measured, directors' fiduciary duties transfer from the shareholders to creditors. As the Delaware court observed, "The directors continue to have the task of attempting to maximize the economic value of the firm. But the fact of insolvency does necessarily affect the constituency on whose behalf the directors are pursuing that end. By definition, the fact of insolvency places the creditors in the shoes normally occupied by the shareholders—that of residual risk-bearers."

Because creditors are placed in the shoes of shareholders once the firm is insolvent, in theory, they may assert any of the same claims that previously belonged to shareholders. In practice, however, at least in Delaware, creditor suits against an insolvent corporation are generally limited to derivative suits. Claims against individual directors could only arise in very narrow and unique circumstances, if such directors display such a marked degree of animus towards a particular creditor with a proven entitlement to payment that they expose themselves to a direct fiduciary duty.

While immunity from direct suits during insolvency should be a relief for directors, some cause for concern remains because of the potential for derivative suits. At least in Delaware, the test for insolvency is more complicated than liabilities exceeding assets. There must also be "no reasonable prospect that the business can be successfully continued." Shareholders and creditors may both file derivative suits at the same time, given the same financial circumstances.

Thus, even though the "zone of insolvency" idea is in decline (or already extinguished), the question of whether a company is insolvent can be fought over in a derivative suit. Directors may not simultaneously owe duties to creditors and shareholders, but must be mindful that both groups could bring simultaneous suits.

If a company is solvent, shareholders can bring suit, and this right transfers to creditors during a time of insolvency. While there no longer appears to be a "zone of insolvency" as an independent cause of action, the period when a corporation is at the edge of insolvency is dangerous because creditors and shareholders may take different positions on whether the corporation is solvent and may both sue. Although only one suit at most could stand, to avoid needless litigation, directors should be mindful of duties to both groups. Be aware of the fact that the "zone of insolvency" can transform into insolvency rapidly.

Once a company hits the point of insolvency, directors no longer need to have the same worries about accumulating greater corporate debt and deepening the insolvency. Nonetheless, directors should continue to exert the degree of "skill, diligence, and care" that their constituents would demand. ■

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