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Clarifying Fiduciary Duty For Distressed Calif. Cos.

Law360, New York (January 26, 2010) -- Directors of California corporations have, for years, struggled to understand the scope of their fiduciary duties when a corporation is insolvent versus when a corporation is in the "zone of insolvency."

While other states (particularly Delaware) have provided some recent guidance in this area[1], the California Court of Appeal recently provided some much needed clarification — including providing comfort to the decision-making processes of directors who are considering various alternatives when a corporation enters into a zone of insolvency.

In Berg & Berg Enterprises LLC v. Boyle, 2009 Cal. App. LEXIS 1740 (Cal. App. 6th Dist. Oct. 29, 2009), the Court of Appeal of California, Sixth Appellate District, delineated the narrow scope of fiduciary duty owed by corporate directors to creditors by ruling that:

1) upon actual insolvency, corporate directors continue to owe fiduciary duties to the shareholders of the corporation and additionally owe a fiduciary duty to creditors of the corporation to avoid diversion, dissipation or undue risk to assets that could be used to satisfy the creditors' claims; and

2) a corporation being in the zone or vicinity of insolvency does not, in and of itself, provide a reason for corporate directors to owe a fiduciary duty to creditors.

Importantly, the court also ruled that the action of approving an assignment for the benefit of creditors (an "ABC") by the corporate directors, even in cases in which the corporate directors failed to pursue other alternatives, does not, as a matter of law:

1) establish a violation of a fiduciary duty;

2) show a failure to have exercised judgment with reasonable care, skill and diligence; or

3) establish an unreasonable failure to have investigated so as to rebut or allege exceptions to the business judgment rule.

In this case, Berg & Berg Enterprises LLC was the largest creditor of Pluris Inc. When Pluris began to experience serious financial difficulties, Berg & Berg's principal, Carl Berg, allegedly informed Pluris' board of directors that he wanted to pursue ways to derive value from Pluris beyond its obvious hard and soft assets, and sought to explore the possibility of obtaining value from the net operating losses that Pluris had accumulated.

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However, to obtain the value of Pluris' net operating losses, Pluris would have had to have been reorganized under federal bankruptcy laws. The board of directors of Pluris did not pursue Berg's plan (i.e. seeking a reorganization under federal bankruptcy laws) and instead completed an ABC transaction.

Berg & Berg filed a complaint against the former directors of Pluris which contained a single cause of action, alleging that the board of directors of Pluris breached the fiduciary duty that it owed to Berg & Berg as a creditor.

The complaint alleged that the board of directors owed a fiduciary duty to Pluris' creditors (including Berg & Berg) to protect all of the assets of Pluris and to affirmatively examine a range of possible courses of action to maximize the value of Pluris' remaining assets.

The complaint further alleged that the board of directors owed this duty to Pluris' creditors not only upon insolvency, but merely by entering the zone or vicinity of insolvency.

The directors demurred to the complaint for its failure to state facts sufficient to constitute a cause of action. The trial court sustained the demurrer without leave to amend.

The trial court relied upon CarrAmerica Realty Corp. v. nVIDIA Corp., Mo. 05-00428, 2006 U.S. Dist. LEXIS 75399 (N.D. Cal. Sept. 29, 2006), which determined that California follows the "trust fund doctrine" with respect to duties owed by corporate directors to creditors that arise upon the corporation's insolvency.

The trial court cited CarrAmerica for the rule that "the scope of this duty is to avoid 'diverting, dissipating, or unduly risking assets necessary to satisfy' creditors' claims."

This interpretation is critical to understanding the duty of directors of an insolvent entity and to appropriately advising them in this circumstance — the court's ruling effectively limits the fiduciary duty owed to creditors by corporate directors of insolvent companies to the prohibition of self-dealing or the preferential treatment of creditors.

The Court of Appeal agreed with the trial court that California applies the trust fund doctrine whereby all assets of a corporation, immediately upon becoming insolvent, become a trust fund for the benefit of all creditors in order to satisfy their claims.

The Court of Appeal further held that director liability would require engagement by the directors in conduct that diverted, dissipated or unduly risked corporate assets that might otherwise have been used to satisfy creditors' claims. This would most obviously include acts involving self-dealing or the preferential treatment of creditors.

The Court of Appeal stated that Berg & Berg's claim was essentially that Pluris' directors effected an assignment for the benefit of creditors rather than exploring a possible reorganization which could theoretically have maximized (or at least preserved) the value of Pluris' net operating losses.

The court further stated that those facts did not involve self-dealing or preferential treatment of creditors. Thus, the alleged actions could not legally constitute a diversion, dissipation or undue risk of corporate assets. The Court of Appeal affirmed the trial court's order sustaining the directors' demurrer to Berg & Berg's complaint.

This case is beneficial to boards of directors of companies in or near financial distress.

In cases in which shareholders or creditors sue the board of directors for breach of fiduciary duty in relation to the board's actions during or immediately prior to financial distress, the inquiry should be limited to whether the

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board engaged in self-dealing, preferential treatment of certain creditors, dissipation of company assets or other wrongful conduct.

The California Court of Appeal appears to have rejected any requirement that corporate directors establish, as a defense, that they considered all of the benefits of various courses of action before pursuing one.

This gives directors of companies in or near financial distress more flexibility in determining which actions they believe to be in the best interests of the relevant constituencies (i.e. shareholders and creditors).

In California, an ABC is typically cheaper and faster for a company than pursuing a Chapter 11 bankruptcy which, in this case, might have allowed for the orderly distribution of assets that could have resulted in a transfer of net operating losses to a potential buyer.

However, the Chapter 11 bankruptcy would have also required the company to engage professionals to market the company, to draft the requisite sale motion or plan and to investigate the tax implications of transferring net operating losses, and to pay for the professionals hired by the committee of unsecured creditors largely to mirror the work performed by the company.

Nonetheless, a board should not view this decision as allowing it to ignore the benefits and detriments of various courses of action before selling the assets of a company or shutting its doors.

Rather, this decision should be viewed as another step in the direction of giving back to directors, when the corporation is insolvent or near insolvency, the right to make reasonable business judgments as to how to proceed.

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[1] See NACEPF v. Gheewalla, 930 A.2d 92, 103 (Del. 2007) and Production Resources v. NCT Group, 863 A.2d 772, 791 (Del.Ch. 2004). In NACEPF, the court bluntly concluded that “creditors of a Delaware corporation that is either insolvent or in the zone of insolvency have no right, as a matter of law, to assert direct claims for breach of fiduciary duty against the corporation's directors.”

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