KNOWING "WHEN TO HOLD THEM AND WHEN TO FOLD THEM": NEGOTIATING THE FIDUCIARY CHALLENGES FACING OFFICERS AND DIRECTORS POST-INSOLVENCY

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I. INTRODUCTION

Despite the apparent upturn in the United States' economy, challenges facing officers and directors of insolvent corporations are more relevant now than ever. In connection with the recent demise of several public companies, lawsuits against officers and directors (and accountants) have become increasingly more common.[2] Directors of financially healthy corporations are usually familiar with their fiduciary duties to shareholders. However, the expansion of those duties once the corporation enters the "zone of insolvency" can often place directors at an uncomfortable crossroads: should a director cut his or her losses, resign from the board, and face the likely blame from others, including the director's successors, for the corporation's financial troubles?[3] Or should the director remain on board to either right the ship or maximize recovery for creditors, at the risk of his or her own personal liability?[4] This decision to "hold them" or "fold them" may require more sophisticated officers and directors to evaluate what protections, if any, the corporation has in place to minimize these risks. This Memorandum summarizes the current rules regarding the "zone of insolvency" and the expanded fiduciary duties of officers and directors within the "zone." We also make certain recommendations regarding how corporate officers and directors may mitigate their risks post-insolvency. The prospect of liability to officers and directors makes an understanding of these concepts important to those who advise companies.

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[2] See, e.g., Richard B. Schmitt and Henny Sender, CEO's Wealth May Be at Stake in Investor Suits, WALL STREET JOURNAL, August 9, 2002 at B1, available in 2002 WL-WSJ 3403151; Carla J. Feldman, Suing the Boss: Suits Name Managers, Others in Current Crackdown on Corporate Responsibility, More Company Big Shots May Face Personal Liability, NATIONAL LAW JOURNAL, July 28, 2003, at 13, col. 2.

[3] The discussion in this Memorandum of the fiduciary duties of directors applies equally to non-director officers. Most courts do not distinguish between the fiduciary duties of directors and non-director officers. See J. Douglas Bacon and Jennifer A. Love, When Good Things Happen to Bad People: Practical Aspects of Holding Directors and Managers of Insolvent Corporations Accountable, 10 J. BANKR. L. & PRAC. 185, 187 (2001).

[4] In foreign jurisdictions, officers and directors can sometimes be subject to criminal sanctions, including imprisonment, for doing business with knowledge of the corporation's insolvency. While the penalties within the United States are certainly less severe, the risk of more serious liability for directors of foreign corporations raises several interesting issues which are not addressed by this Memorandum. For instance, could directors of an insolvent U.S. corporation be subject to criminal liability in jurisdictions where its foreign subsidiaries conducted business?

II.
DISCUSSION

A. When Do Fiduciary Duties to Creditors Arise?—Defining "Insolvency".

Typically, officers and directors of a solvent corporation owe fiduciary duties to the corporation and its shareholders, the violation of which may subject directors to personal liability. Under Delaware law, these duties include the duty of care, the duty of loyalty and the related duty of disclosure when seeking shareholder action.[5] When evaluating the conduct of directors in respect of their fiduciary duties, courts apply the "business judgment rule," an evidentiary presumption that business decisions are made by disinterested and independent directors on an informed basis with the good faith belief that the decisions are in the best interests of the corporation.[6]

During the last two decades, significant case law has developed holding that directors of an insolvent corporation owe fiduciary duties not only to the corporation and its shareholders, but also to the corporation's creditors. This theory has its roots in the "trust fund doctrine," an early equitable concept under which the directors of an insolvent corporation hold the corporation's property in trust for payment to creditors. The "trust fund doctrine" transforms the contractual relationship between an insolvent corporation and its creditors into that of a trustee and its beneficiaries.[7]

Unfortunately for those seeking predictability, the precise moment upon which these expanded duties arise may be difficult to pinpoint. While a formal filing of bankruptcy may be sufficient to trigger fiduciary duties to the corporation's creditors, it certainly is not necessary, and a corporation may have entered the "zone of insolvency" well before bankruptcy.[8] More recent developments in the case law would suggest that duties to creditors might arise at the point when the corporation becomes "insolvent in fact,"[9] or perhaps at an earlier point, when it enters the "vicinity of insolvency."[10] Furthermore, decisions relating to these issues are likely

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5 See Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156, 1163 (Del. 1995). This Memorandum does not attempt to address pre-insolvency fiduciary duties in detail. For an in depth discussion of the fiduciary duties of officers and directors of solvent corporations, see DENNIS J. BLOCK, NANCY E. BARTON & STEPHEN A. RADIN, THE BUSINESS JUDGMENT RULE (5th ed. 1998).

6 See BLOCK, et al., supra note 5.

7 See, e.g., Bovay v. H. M. Byllesby & Co., 38 A.2d 808 (Del. 1944)

8 See Pepper v. Litton, 308 U.S. 295, 307, 60 S.Ct. 238, 245 (1939).

9 See, e.g., Geyer v. Ingersoll Publ'ns Co., 621 A.2d 784, 787-90 (Del. Ch. 1992); Value Property Trust v. Zim Co. (In re Mortgage & Realty Trust), 195 B.R. 740, 751 (Bankr. C.D. Cal. 1996) ("It is the time of insolvency, not the time of the filing of a bankruptcy case, that determines the ripening of these additional fiduciary duties."); Clarkson Co. v. Shaheen, 660 F.2d 506, 512 (2d Cir. 1981) (rejecting claim under New York law that duties do not arise until "liquidation is 'imminent and foreseeable'"). But see Tigrett v. Pointer, 580 S.W.2d 375, 386 (Tex. Civ. App. 1978) (opining that fiduciary duties owed to creditors are not triggered until pre-bankruptcy insolvency is coupled with the cessation of business by the insolvent).

10 See Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications. Corp., No. CIV.A.12150, 1991 WL 277613, at *34 (Del. Ch. Dec. 30, 1991) [hereinafter "Credit Lyonnais"]. See also Brandt v. Hicks, Muse & Co. (In re Healthco Int'l, Inc.), 208 B.R. 288, 300 (Bankr. D. Mass. 1997) ("[W]hen a transaction renders

to be made in 20/20 hindsight well after the fact and may be heavily influenced by an assessment of the parties' motives.

Competing definitions of the "zone of insolvency" may make it difficult "to confidently predict which insolvency definition a court will use in a creditor's suit for breach of fiduciary duty."[11] To illustrate, the Delaware Chancery Court in Geyer v. Ingersoll Publications Co. held that directors' duties to creditors arise upon "insolvency in fact," but in an unpublished, though widely cited, opinion, Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., the same court held that the duties arise in the "vicinity of insolvency."[12]

To further complicate the issue, there are no bright-line standards for determining when a corporation becomes insolvent under any of these definitions. And regardless of which test or definition a court adopts, "application of these definitions in a particular factual pattern may be difficult, and reasonable individuals may reach different conclusions."[13] Several of the financial tests used by courts to define the zone of insolvency and its parameters are discussed below.

1. "Insolvency in Fact"—Balance-Sheet Test and/or Cash-Flow Test.

Courts which have tied fiduciary duties to creditors upon "insolvency in fact" have typically done so using one of two tests: the balance-sheet test (liabilities in excess of assets)[14] and the cash-flow test (an inability to pay debts as they become due).[15] Some courts have embraced both tests.[16] In Geyer v. Ingersoll Publications Co., the Delaware Chancery Court relied on Webster's Dictionary for the ordinary meaning of the term "insolvency," concluding that an entity is insolvent when it is unable to pay its debts as they become due in the usual course of business (cash-flow test), or when the entity's liabilities are in excess of a reasonable market value of its assets (balance-sheet test).[17] Similarly, in A.R. Teeters &

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a corporation insolvent, or brings it to the brink of insolvency, the rights of the creditors become paramount").

11 Andrew D. Shaffer, Corporate Fiduciary—Insolvent: The Fiduciary Relationship Your Corporate Law Professor (Should Have) Warned You About, 8 AM. BANKR. INST. L. REV. 479, 515 (2000).

12 See supra notes 9 and 10.

13 Royce de R. Barondes, Fiduciary Duties of Officers and Directors of Distressed Corporations, 7 GEO. MASON L. REV. 45, 71 (1998).

14 See, e.g., Official Comm. of Unsecured Creds. v. Toy King Distribs., Inc. (In re Toy King Distribs., Inc, 256 B.R. 1, 57 (Bankr. M.D. Fla. 2000); Barrett v. Commonwealth Fed. Savings and Loan Assn. (In re Barett), 104 B.R. 688, 693 (Bankr. E.D. Pa. 1989); LaSalle Nat'l Bank v. Perelman, 82 F. Supp. 2d 279, 291-92 (D. Del. 2000).

15 The "cash flow" test is also referred to as the "equitable" insolvency test. See, e.g., Geyer, 621 A.2d at 789; Credit Lyonnais, 1991 WL 277613; Shakey's, Inc. v. Caple, 855 F. Supp. 1035, 1042-43 (E.D. Ark. 1994); Parkway/Lamar Partners, L.P. v. Tom Thumb Stores, Inc., 877 S.W.2d 848, 850 (Tex. Ct. App. 1994).

16 See, e.g., Geyer, 621 A.2d at 789, Brandt v. Hicks, Muse & Co. (In re Healthco International, Inc.), 208 B.R. 288, 301-02 (Bankr. D. Mass. 1997) (Stating that both the "balance-sheet test" or the "cash-flow test" are equally applicable to determine the point at which directors begin to owe fiduciary duties to creditors.)

17 See Geyer, 621 A.2d at 789.

Associates, Inc. v. Eastman Kodak Co., the Arizona Appeals Court applied multiple tests when it held that a corporation is insolvent when: (1) it has ceased to pay its debts in the ordinary course of business, (2) it cannot pay its debts as they become due, or (3) its liabilities are greater than its assets.[18]

2. "Vicinity of Insolvency" and "Unreasonably Small Capital"—Insolvency Before "Insolvency in Fact".

"Insolvency in fact" is ultimately a snapshot analysis of a corporation's viability, measuring a company's present ability to pay its debts. Therefore, under the balance-sheet and cash-flow tests, directors of a corporation that is "technically solvent but doomed to fail" would owe no duties to creditors.[19] Likewise, a corporation could be "solvent in fact," notwithstanding presently disputed claims or liabilities which could arise far into the future.[20] In consideration of these limitations, some courts have held that directors' duties to creditors are triggered within the "vicinity of insolvency" or when a corporation has "unreasonably small capital."[21] Under these standards, liability to creditors would arise before a corporation is actually insolvent, but when insolvency is reasonably foreseeable, or when a transaction creates an unreasonable risk of insolvency.[22]

B. Fiduciary Duties to Owing to Creditors, Shareholders, and Other Constituencies of An Insolvent Corporation.

Once a corporation is within the zone of insolvency (whether that "zone" is defined by the corporation's "insolvency in fact" or the corporation being within the "vicinity of insolvency"), the officers and directors owe fiduciary duties to the corporation's creditors and may be sued by creditors for violation of those duties. What is not as clear is whether the fiduciary duties to creditors replace the duties owed to shareholders, or whether the directors owe concurrent duties to both constituencies. Some courts have concluded that directors of an insolvent corporation owe fiduciary duties to both creditors and shareholders, while providing little guidance as to the relative priority of those duties or how they should be carried out.[23]

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[18] See A.R. Teeters & Assocs., Inc. v. Eastman Kodak Co., 836 P.2d 1034, 1041 (Ariz. Ct. App. 1992).

[19] Pereira v. Cogan, 294 B.R. 449, 521 (S.D.N.Y. 2003) (quoting Geron v. Schulman (In re Manshul Const. Corp.), 2000 WL 1228866, at *54 (S.D.N.Y. Aug. 30, 2000).

[20] See Ann E. Conaway Stilson, Reexamining the Fiduciary Paradigm at Corporate Insolvency and Dissolution: Defining Directors' Duties to Creditors, 20 DEL. J. CORP. L. 1, 14 (1995).

[21] See, e.g., Pereira v. Cogan, 294 B.R. 449, 521 (S.D.N.Y. 2003).

[22] See, e.g., Miramar Resources, Inc. v. Shultz (In re Shultz), 208 B.R. 723, 729 (Bankr. M.D. Fla. 1997) (holding that fiduciary duties to creditors arise upon the "brink of insolvency," where an impending transaction will render the corporation insolvent); Brandt v. Hicks, Muse & Co. (In re Healthco Int'l, Inc.), 208 B.R. 288, 302 (Bankr. D. Mass. 1997) (finding a breach of fiduciary duties to creditors on the part of the directors occurs when the directors voted in favor of a transaction that leaves the corporation insolvent or with unreasonably small capital).

[23] See, e.g., Credit Lyonnais, 1991 WL 277613, at *34 n.55 (speaking in terms of a duty to the "corporate enterprise," which encompasses shareholders and creditors); LaSalle Nat'l Bank v. Perelman, 82 F. Supp. 2d 279, 290 (D. Del. 2000) ("Under Delaware law, officers and directors of a corporation generally do not owe a fiduciary duty to the creditors of the corporation unless the corporation is insolvent.") (citing Credit

Other courts have held that the fiduciary obligations of directors "shift from the stockholders to the creditors,"[24] upon entering the zone of insolvency, implying that the directors no longer owe shareholders any fiduciary duties. There is little case law discussing what duties, if any, are owed to other corporate constituencies upon insolvency.

It is unclear whether courts will draw upon the business judgment rule in evaluating the directors' business decisions within the zone of insolvency.[25] For instance, the Credit Lyonnais court, in imposing a duty upon directors to maximize a near insolvent corporation's "community of interest," did not mention the availability of the business judgment rule for the protection of business decisions in light of that duty.[26] However, since Credit Lyonnais, at least one Delaware case, Angelo, Gordon & Co. v. Allied Riser Communications Corp., has specifically applied the presumption of the business judgment rule in a breach of fiduciary duty action by creditors.[27] Those courts applying the business judgment presumption to directorial conduct are likely to uphold the directors' decisions "unless those seeking damages can show that such actions are venal."[28] Moreover, courts are likely to apply the most weight to the business judgment rule where directors' decisions are focused on maximizing the enterprise value of the company for all constituencies as opposed to using control to leverage advantage for management or for junior interests.

Irrespective of whether continuing duties may be owed to shareholders within the zone of insolvency, corporate governance principles may dictate that directors still consider the views of shareholders. Delaware recognizes the continuing right of shareholders to elect directors after the corporation has become insolvent.[29] Therefore, while directors may not be personally liable to shareholders for failure to optimize shareholder's return post-insolvency, shareholders who would like to pursue different policies could simply remove the directors.[30]

Lyonnais, 1991 WL 277613, at *34); Bank Leumi-Le-Israel, B.M. v. Sunbelt Indus. Inc., 485 F. Supp. 556, 559 (S.D. Ga. 1980) ("In the case of an insolvent corporation, the directors and officers stand as trustees for the benefit of creditors first and stockholders second."); Value Property Trust v. Zim Co. (In re Mortgage & Realty Trust), 195 B.R. 740, 750 (Bankr. C.D. Cal. 1996).

24 See, e.g., FDIC v. Sea Pines Co., 692 F.2d 973, 977 (4th Cir. 1982); Official Comm. of Unsecured Creds. v. Toy King Distribs., Inc. (In re Toy King Distribs., Inc.), 256 B.R. 1, 57, 166-67 (Bankr. M.D. Fla. 2000) (holding that director's fiduciary duty shifts from shareholders exclusively to creditors exclusively).

25 See, e.g., Creditors Comm. v. Haverty (In re Xonics, Inc.), 99 B.R. 870, 876 (Bankr. N.D. Ill. 1989) (stating that actions of the board "must suffice unless [creditors] can show that the conduct … offends accepted notions of fiduciary duties"); Devereux v. Berger, 284 A.2d 605, 612 (Md. 1971) (applying business judgment rule in the context of insolvency).

26 See Stilson, supra note 20, at 63.

27 See Angelo, Gordon & Co. v. Allied Riser Communications Corp., 805 A.2d 221, 229 (Del. Ch. 2002).

28 Creditors Comm. v. Haverty (In re Xonics, Inc.), 99 B.R. 870, 876 (Bankr. N.D. Ill. 1989).

29 See Saxon Indus., Inc. v. NKFW Partners, 488 A.2d 1298, 1300 (Del. 1985) ("Insolvency alone, irrespective of degree, does not divest the stockholders of a Delaware corporation of their right to exercise the powers of corporate democracy.")

30 See Barondes, supra note 13, at 70.

C. Liability for Breach of Fiduciary Duties to Creditors.

In the United States, directors are generally not subject to criminal penalties in connection with an alleged breach of their fiduciary duties; allegations of criminal fraud, securities fraud, embezzlement, perjury and the like are often joined in allegations in complaints filed by plaintiffs against officers and directors. Directors may face significant monetary liability as a result of civil lawsuits by aggrieved creditors (or by bankruptcy trustees acting on their behalf), which are becoming more and more common as this area of law develops.[31] Recent high profile corporate scandals in cases such as Enron, Global Crossing and WorldCom have fueled the fervor against officers and directors, and creditors have joined with shareholders in pursuing claims against departed executives.[32] In cases involving such high levels of corporate misconduct, liability to creditors can be staggering.[33]

D. Protective Measures Available to Directors.

What can directors do to fulfill their expanded fiduciary duties post-insolvency? The simple answer is for directors to first identify whether the corporation is within the "zone," recognizing that fiduciary duties to creditors may arise well before the corporation's liabilities exceed its assets. Directors must then act on an informed basis, in such a way that considers the interests of the corporate enterprise, not just the corporation's shareholders. We believe that critical decisions should be driven by the goal of maximizing corporate value. Moreover, directors should avoid allegations that the company was run without the expectation that creditors could be paid.[34] Once the corporation is within the "zone of insolvency", the option of

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[31] See Patrick Danner, Mortgage.com Suit Ends in Settlement, MIAMI HERALD, July 26, 2003, at 1, available in 2003 WL 60040494 (referencing $130,000 to be paid by insurer to settle $3,000,000 lawsuit brought by creditors of Mortgage.com against the company's principal); Report Brings Closure to Lomas, MORTGAGE SERVICING NEWS, April 19, 2002, available in 2002 WL 10922629 (discussing actions brought by bankruptcy trustee on behalf of creditors against former officers and directors of Lomas Mortgage for negligence, fraud, corporate waste and breach of fiduciary duty).

[32] See Carla J. Feldman, Suing the Boss: Suits Name Managers, Others in Current Crackdown on Corporate Responsibility, More Company Big Shots May Face Personal Liability, NATIONAL LAW JOURNAL, July 28, 2003, at 13, col. 2 ("Recent corporate scandals have also produced a flurry of lawsuits by shareholders, pension fund managers and creditors against directors, officers and executives. Officers and directors of companies such as Enron Corp., Global Crossing and WorldCom have been named in suits for breach of fiduciary obligation; misrepresentation; and stock, securities and pension fraud.") See also Stephen Taub, Lenders Want $70 million From Former Enron CEO and His Wife – Meanwhile, Enron Wants Customers to Pay . . . , CFO.COM, February 4, 2003, available in 2003 WL 9773337; Final Report of Neal Batson, Court-Appointed Examiner, Appendix D, In re Enron Corp., (Bankr S.D.N.Y. Case No. 01-16034 (ALG)). (While the Examiner's report in Enron makes specific reference only to the directors' breaches of fiduciary duties to shareholders, claims by creditors could arise under the same analysis.)

[33] See Citigroup to Pay $2.65 Billion to Settle WorldCom-Related Suit, WSJ.COM, May 10, 2004.

[34] In many non U.S. jurisdictions, "trading" while insolvent is prohibited. The underlying rationale for this concept is that company officers who continue to "trade" with creditors when they know or should know that the company cannot pay the resulting debts are engaging in a species of fraudulent conduct. These concepts may migrate to the U.S. just as other U.S. legal concepts have migrated abroad.

resigning one's position to avoid liability is somewhat unsatisfactory. The "Geronimo Defense" has been rejected.[35]

Directors seeking more comfort may consider adopting the following measures to minimize their liability to creditors.

1. Filing for Bankruptcy.

A bankruptcy filing is a clear hallmark of insolvency and, consequently, that the directors thereafter owe duties to the corporation's creditors. Thereafter, directors can seek bankruptcy court approval for business decisions made post-filing, which may insulate officers and directors from attack by creditors. In essence, the filing of bankruptcy allows directors to have the bankruptcy court validate the directors' exercise of business judgment. A possible risk of filing for bankruptcy for non-business reasons is to expose directors to liability to shareholders, whose recovery through the bankruptcy process will be subordinated to that of creditors.

2. Obtaining Professional Advisors.

Hiring professional advisors or investment bankers to help steward directors through the zone of insolvency is another way directors can limit liability. Obtaining an outside financial advisor to evaluate the condition and prospects of the corporation could help define whether the corporation is within the vicinity of insolvency or identify whether directors have a reasonable chance of averting insolvency. Moreover, getting an impartial opinion that business decisions contemplated by the board are reasonable or even advisable might dissuade a court from finding that the directors breached their fiduciary duties to creditors when those measures fail. While engaging financial advisors may present a short term cost to the corporation (unless the retention is based on a success-fee arrangement), directors can assert that the retention inures to the benefit of the corporate enterprise.

3. Exculpation by Corporate Charter.

Delaware law is ambiguous as to whether fiduciary duties to creditors can be abrogated by corporate charter. Delaware's General Corporation Law provides that a corporation's certificate of incorporation may contain a provision "eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders . . . ."[36] A corporation may consider adopting an exculpatory corporate charter to bind both creditors and shareholders. However, the Delaware General Corporation Law

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[35] See Xerox Corp. v. Genmoora Corp., et al., 888 F.2d 345, 355 (5th Cir. 1989).

[36] DEL. CODE ANN. tit. 8, § 102(b) (2000).

makes no reference to exculpation of post-insolvency fiduciary duties, and the enforceability of such a provision with respect to creditors is questionable.[37]

4. Insurance or Indemnity Funds.

Directors can request that the corporation purchase a directors and officers liability policy, establish an indemnity fund, or provide a combination of the two to reduce the exposure to directors in the event of a creditor lawsuit. It is now a common practice for public corporations to purchase insurance for liabilities resulted from shareholder derivative actions. However, at least one commentator suggests that D&O insurance against liability to creditors may be prohibitively expensive.[38] Unlike lawsuits brought by shareholders, many of whom may have little personal interest in the litigation, creditors claims may be more contentious and less likely to settle.[39] Insurers who are aware of the potential cost of litigating creditor suits are likely to pass these costs on to the corporation in the form of higher premiums.

Directors relying on a combination of D&O insurance and the proceeds of an indemnity fund should also be aware that both sources may not be available in their entirety to indemnify directors. Insurance policies may provide, under a single liability limit, both direct coverage to directors and officers as well as coverage to the corporation for funds expended indemnifying the officers and directors.[40] Contributions by the corporation pursuant to an indemnity fund may ultimately reduce the coverage available to directors under the D&O policy.

III.
CONCLUSION

Directors and officers of corporations within the "zone of insolvency" are confronted with significant challenges above and beyond those facing their counterparts at solvent corporations. The zone of insolvency brings with it a new set of fiduciary of duties, the onset of which may be difficult to determine. However, with foresight and proper planning, officers and directors can successfully negotiate the obstacles in this developing area of law.

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[37] See Geyer v. Ingersoll Publ'ns Co., 621 A.2d 784, 789 (Del. Ch. 1992).

[38] See Barondes, supra note 13, at 80.

[39] See id. at 81.

[40] See In re Allied Digital Technologies Corp., 306 B.R. 505 (Bankr. D. Del. 2004).