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## Expanded Protections for Directors Navigating the "Zone of Insolvency"

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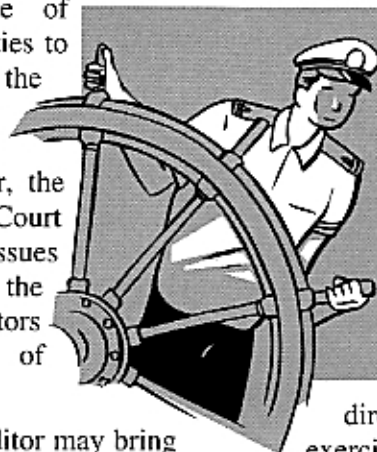
In 1991, a decision of the Delaware Chancery Court helped popularize the term "zone of insolvency."<sup>1</sup> In the intervening 16 years, numerous courts and commentators have cited this decision as standing for the proposition that the directors of a Delaware corporation that is either insolvent or in the zone of insolvency owe fiduciary duties to the creditors, as well as to the shareholders, of the corporation. In a pair of landmark decisions this year, the Delaware Supreme Court addressed two fundamental issues and, thereby, expanded the protections available to directors navigating the zone of insolvency:

- ◆ the extent to which a creditor may bring a claim against the directors of a corporation that is insolvent or operating in the zone of insolvency; and
- ◆ the extent to which a creditor may bring a claim against the directors of a corporation for "deepening insolvency."

### North American Catholic

In May 2007, the Delaware Supreme Court<sup>2</sup> held that:

- ◆ a creditor may not bring a direct claim for breach of fiduciary duties against the directors of a corporation that is either insolvent or operating in the zone of insolvency; and
- ◆ a creditor has standing to bring a derivative claim for breach of fiduciary duties against the directors of an insolvent corporation.



Although the Court did not expressly address whether a creditor may bring a derivative claim against the directors of a corporation operating in the zone of insolvency, the opinion appears to suggest that the right to enforce the directors' fiduciary duties may be exercised only by the shareholders so long as the corporation is actually solvent.

Holding that a creditor may not bring a direct claim against the directors of a solvent corporation operating in the zone of insolvency, the Court noted:

When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary



duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners.<sup>37</sup>

When the corporation slides from the zone of insolvency into actual insolvency, the Court held that a creditor may bring a derivative action against the directors, saying:

It is well settled that directors owe fiduciary duties to the corporation. When

a corporation is *solvent*, those duties may be enforced by its shareholders, who 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 take the place of the shareholders as the residual beneficiaries of any increase in value.

Consequently, the creditors of an *insolvent*

corporation have standing to maintain derivative claims against directors on behalf of the corporation for breaches of fiduciary duties. The corporation's insolvency "makes the creditors the principal constituency injured by any fiduciary breaches that diminish the firm's value." Therefore, equitable considerations give creditors standing to pursue derivative claims against the directors of an insolvent corporation.

Individual creditors of an insolvent corporation have the same incentive to pursue valid derivative claims on its behalf that shareholders have when the corporation is solvent.<sup>38</sup>

However, even when the corporation is insolvent, the Court held that a creditor has no right to assert a direct claim against the directors, reasoning:

Recognizing that directors of an insolvent corporation owe direct fiduciary duties to creditors, would create uncertainty for directors who have a fiduciary duty to exercise their business judgment in the best interest of the insolvent corporation. To recognize a new right for creditors to bring direct fiduciary claims against those directors would create a conflict between those directors' duty to maximize the value of the insolvent corporation for the benefit of all those having an interest in it, and the newly recognized direct fiduciary duty to individual creditors. Directors of insolvent corporations must retain the freedom to engage in vigorous, good faith negotiations with individual creditors for the benefit of the corporation. Accordingly, we hold that individual creditors of an *insolvent* corporation have *no right to assert direct* claims for breach of fiduciary duty against corporate directors.<sup>39</sup>

Instead of a direct cause of action, the Court noted that, unlike stockholders who rely on directors to protect their interests, "creditors are afforded protection through contractual agreements, fraud and fraudulent conveyance law, implied covenants of good faith and fair dealing, bankruptcy law, general commercial law and other sources of creditor rights."<sup>40</sup>

### *Trenwick America*

In August 2007, the Delaware Supreme Court affirmed the decision of the Chancery Court that there is no cause of action under Delaware law for "deepening insolvency."<sup>41</sup>

"Deepening insolvency" has been defined as the "fraudulent expansion of corporate debt and prolongation of corporate life."<sup>42</sup>

In *Trenwick America*, the Chancery Court held that the directors of a subsidiary did not

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breach a fiduciary duty to its creditors by incurring debt for the benefit of the parent company. The Court reasoned as follows:

Delaware law imposes no absolute obligation on the board of a company that is unable to pay its bills to cease operations and to liquidate. Even when the company is insolvent, the board may pursue, in good faith, strategies to maximize the value of the firm . . . . If the board of an insolvent corporation, acting with due diligence and good faith, pursues a business strategy that it believes will increase the corporation's value, but that also involves the incurrence of additional debt, it does not become a guarantor of that strategy's success. That the strategy results in continued insolvency and an even more insolvent entity does not in itself give rise to a cause of action. Rather, in such a scenario the directors are protected by the business judgment rule . . . . If a plaintiff cannot state a claim that the directors of an insolvent corporation acted disloyally or without due care in implementing a business strategy, it may not cure that deficiency simply by alleging that the corporation became more insolvent as a result of the failed strategy.<sup>109</sup>

### Potential Pitfalls

The Court in *North American Catholic* predicated their holding that no direct claim may be asserted by a creditor of a solvent corporation operating in the zone of insolvency upon "the need for providing directors with definitive guidance."<sup>111</sup> However, the very issue of whether the corporation is in fact insolvent is subject to considerable uncertainty. Under Delaware law, a corporation is insolvent if either (1) "it is unable to pay its debts as they become due in the usual course of business" (the "cash flow test"), or (2) "it has liabilities in excess of a reasonable market value of assets held" (the "balance sheet test"), or (3) both.<sup>121</sup> Not only is it uncertain which test a court may adopt, but "application of these definitions in a particular factual pattern may be difficult, and reasonable individuals may reach different conclusions."<sup>131</sup>

As the Court emphasized in *Trenwick America*, "[t]he rejection of an independent cause of action for deepening insolvency does not absolve directors of insolvent corporations of responsibility."<sup>124</sup> They are still subject to causes of action for breach of fiduciary duties and for fraud. The board must act "with fidelity and care in deciding to undertake more

debt to continue the company's operations."<sup>135</sup> The fact of insolvency will be a factor in the court's analysis of whether the board has fulfilled these duties.

### Conclusion

Notwithstanding the continued existence of unsettled issues, the decisions of the Delaware Supreme Court in *North American Catholic* and *Trenwick America* provide much needed guidance to directors and courts alike on the contours of directors' fiduciary duties in the zone of insolvency.

<sup>111</sup> *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, 1991 WL 277613 (Del. Ch. 1991).

<sup>121</sup> *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla et al.*, 2007 WL 1453705 (Del. Supr. 2007).

<sup>122</sup> *Id.* at 7.

<sup>123</sup> *Id.*

<sup>124</sup> Prior to *North American Catholic*, the Chancery Court had suggested that a creditor could bring a direct claim for breach of fiduciary duties during insolvency. See *Big Lots Stores, Inc. v. Bain Capital Fund VII, L.L.C.*, 922 A.2d 1169 (Del. Ch. 2006); *Production Resources Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772 (Del.Ch. 2004).

<sup>125</sup> *North American Catholic* at 8.

<sup>126</sup> *Id.* at 6.

<sup>127</sup> The Delaware Supreme Court affirmed the Chancery Court's decision "on the basis of and for the reasons assigned" therein. See *Trenwick America Litigation Trust v. Ernst & Young LLP, et al.*, 906 A.2d 168 (Del. Ch. 2006).

<sup>128</sup> *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc.*, 267 F.3d 340, 347 (3d Cir. 2001).

<sup>129</sup> *Trenwick America* at 204.

<sup>130</sup> *North American Catholic* at 7.

<sup>131</sup> *Geyer v. Ingersoll Publications Co.*, 621 A.2d 784, 789 (Del. Ch. 1992). See also *LaSalle National Bank v. Perelman*, 82 F.Supp.2d 279, 291 (D. Del. 2000)

<sup>132</sup> Royce de R. Barondes, *Fiduciary Duties of Officers and Directors of Distressed Corporations*, 7 GEO. MASON L. REV. 45, 71 (1998).

<sup>133</sup> *Trenwick America* at 205.

<sup>134</sup> *Id.*



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