A Shift in Fiduciary Duties for Directors of Distressed Corporations

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It is generally agreed that the business marketplace is cyclical in nature.The rise of interest rates during the past few years has led experts to debate when we can expect to see increased numbers of distressed companies.We believe it is important that corporate directors understand their fiduciary duties to stockholders and creditors and how such duties may change as a business enters the "zone of insolvency."

Fiduciary Duties for Solvent Corporations

When a corporation is solvent, directors owe the corporation and its shareholders fiduciary duties of care, loyalty and good faith.A breach of these duties can result in personal liability for the director.In most situations, a director's actions are protected by the business judgment rule, which presumes that "the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[1] To overcome the business judgment rule and recover in a breach of fiduciary duty suit, the plaintiff must demonstrate that the director was self-interested or grossly negligent in making the decision in question.

Protecting Creditor Interests

While a company is solvent, its creditors are presumed to be protected by the terms of their contracts with the company.But, when a corporation becomes insolvent, a director's fiduciary duties of care, loyalty and good faith shift to include, and arguably favor, creditors of the corporation.It is well settled that directors must act to address creditor interests when making decisions upon the occurrence of insolvency.This shift is meant to discourage directors from taking unnecessary risks that would potentially benefit a company's shareholders but harm its creditors, such as selling company property at below-market prices.

Defining Insolvency

In the fiduciary duty context, a corporation's insolvency is not determined at the time it files for bankruptcy or receivership.Courts have used two tests to determine the time at which a company becomes insolvent.The "balance sheet" test states that a corporation is insolvent when the fair market value of total liabilities (including contingent liabilities and off-balance sheet losses) exceed the fair market value of total assets.Alternatively, under the "equitable insolvency" test, a corporation is insolvent when it becomes unable to pay debts in the ordinary course of business.It has been suggested that both tests are flawed.Applying a different valuation methodology may alter the results under the balance sheet test and temporary liquidity issues could result in triggering insolvency under the equitable insolvency test.In addition, some courts have attempted to account for business realities when determining whether a corporation is insolvent.

In the "Zone of Insolvency"

The 1991 Delaware Chancery court opinion in *Credit Lyonnais Bank Nederland N.V. v. Pathe Communications*,[2] is widely cited as first suggesting that director duties shift to creditors prior to actual insolvency and include the period of time when the corporation is in the "zone" or "vicinity" of insolvency.Since *Credit Lyonnais*, cases have defined the zone of insolvency to include the period of time leading up to actual insolvency and also those directorial actions that, once complete, will result in the insolvency of a company.

Balancing Constituency Interests

However, simply because directors are required to consider the interests of the corporation's creditors, does not mean that other constituencies may be ignored.Upon entering the zone of insolvency, "even though equity is junior to creditors, the views of equity cannot be ignored, but that principle cannot be stretchedto also prohibit debtors from giving considerable weight to the views of creditors."[3] The result of such reasoning is that corporations are not required to immediately liquidate assets and distribute profits based on priority upon entering the zone of insolvency. Instead, the standard requires that directors may not play favorites when deciding what is best for the corporation. When approaching insolvency, directors must make informed decisions after carefully considering the impact upon all relevant parties.

While it was initially unclear, recent cases have stated that the business judgment rule does protect directors who are making decisions for insolvent or near-insolvent corporations.However, in a case where the directors made a decision that resulted in the insolvency of the corporation based on the best interests of only the shareholders, without considering the best interests of creditors or the corporation, the business judgment rule did not apply and the directors were required to prove the entire fairness of the transaction.In general, the business judgment rule will protect directors when proper inquiry is made and consideration given to all appropriate parties during board deliberations.

Waiver of the Duty of Care

Another recent case provides that, under some circumstances, a director may be shielded from liability even when arguably violating certain fiduciary duties when the corporation was insolvent or near-insolvent.In *Production Resources Group, LLC v. NCT Group, Inc.*,[4] a creditor claimed that the directors of an arguably insolvent corporation breached their fiduciary duties.The court reasoned that while the creditor had standing to sue for several alleged breaches of fiduciary duties, the recovery should go to the corporation itself and not directly to the plaintiff creditor.In other words, the claim was derivative in nature.As a result, the court ruled that the director was protected from liability for breaches of the duty of care *owed to the corporation* under a provision in the corporation's articles of incorporation waving liability for duty of care violations in accordance with Delaware General Corporation Law Section 102(b)(7).If future courts follow this decision, directors in states with similar statutes to DGCL § 102(b)(7) will be able to avoid liability for duty of care violations if the corporation's articles include similar exculpatory language.

Consulting Creditors Early

It may also be possible to stop a creditor, or trustee acting on behalf of creditors, from asserting a breach of fiduciary duty claim by advising the creditor of the financial situation before authorizing the transaction. *In re Brentwood Lexford Partners, LLC*,[5] presents a case where a Texas corporation approached its primary creditor to inform it of the company's possible insolvency, but the creditor

agreed to allow the company to continue operating as if it was solvent and therefore effectively approved of the corporation's distributions to shareholders.The court reasoned that in this situation, a trustee was estopped from later asserting breach of fiduciary duty claims on behalf of creditors once the corporation filed for bankruptcy.This case suggests that one strategy that directors may take to avoid future liability is to contact creditors regarding key decisions when a corporation is nearing insolvency.

Ohio Judicial Decisions

As with most corporate law issues, the vast majority of cases dealing with directors' fiduciary duties in insolvent and near-insolvent corporations have involved the application of Delaware law.Some Ohio cases have adopted the Delaware standard, stating that "a corporation that is insolvent or is on the brink of insolvency owe[s] a fiduciary duty to the corporation itself and to its creditors not to waste corporate assets which otherwise could be used to paycorporate debts."[6] However, in *Official Committee of Unsecured Creditors of PHD, Inc. v. Bank One, NA*,[7] the court determined that because Ohio Revised Code Section 1701.59 provides that directors are permitted but not required to evaluate the interests of creditors, that there is no duty for directors to consider creditors when making decisions.As a result, the court dismissed creditor committee claims against a director who did not consider creditor interests while the corporation was insolvent.These conflicting cases make it difficult to determine what legal standard should be applied for Ohio corporations.Given the nationwide acceptance of the principle that fiduciary duties shift to include creditors when a corporation approaches bankruptcy, it would be wise for directors of Ohio companies to continue considering the interests of all relevant parties when making decisions for insolvent or near-insolvent corporations - at least until the Ohio legislature or Supreme Court clarify the issue.

Best Practices for Insolvent and Near Insolvent Boards

Once in the zone of insolvency, directors will reduce the risk of breaching fiduciary duties by:

1. Learning all the facts about the proposed issue before the board and the effects of the decision on creditors and shareholders;

2. Carefully scrutinizing transactions that could be deemed preferential to shareholders, including share redemptions and payment of dividends;

3. Avoiding any appearance of self-dealing, including providing full disclosure of any interest the director may have in a transaction with the corporation;

4. Not taking actions that prefer any one class of creditors over others;

5. Not undertaking transfers for less than fair value; and

6. Reaffirming by resolution that all actions have been taken in good faith after exercising reasonable care.

Summary

As indicated by the preceding discussion, the law defining the responsibilities of directors of corporations that are either insolvent or in the zone of insolvency is constantly evolving.There is no universal test to determine when a director must start considering the interests of creditors, but directors should assume when a company becomes financially distressed that courts will deem it in the zone of insolvency.Personal liability for breach of fiduciary duties is avoidable.Directors merely need to be aware of the fact that fiduciary obligations shift when a company becomes distressed and take precautions to act reasonably and in the best interests of the corporation after considering the implications of a transaction on the relevant parties.

To learn more, please contact Jacob Derenthal at 216.363.4642 or jderenthal@bfca.com.As a reminder, this Bulletin is being produced to draw the reader's attention to the issues being discussed and is not intended to replace legal counseling.

[1] *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971).
[2] 1991 WL 277613 (Del. Ch. 1991).
[3] *In re Adelphia Communications Corp.*, 2003 WL 22316543, *32 (Bankr. S.D.N.Y. 2003).
[4] 863 A.2d 772 (Del. Ch. 2004).
[5] 292 B.R. 225 (N.D. Tex. 2003).
[6] *DeNune v. Consolidated Capital of North America, Inc.*, 288 F.Supp.2d 844, 859 (N.D. Ohio 2003); *See also In re National Century Financial Enterprises, Inc., Investment Litigation*, 2006 WL 469468 (S.D. Ohio 2006).
[7] 2004 WL 3721325 (N.D. Ohio 2004).