

*So Where Exactly IS the
Vicinity of Insolvency?*

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The Winding Road To the Vicinity of Insolvency

In 1824, creditors of the Hallowell and Augusta Bank sued the bank's directors for making a distribution to shareholders, leaving the creditors high and dry. In *Wood v. Dummer*,¹ the court found that because the bank was insolvent, the act of making a distribution to the shareholders amounted to "misconduct" on the part of the bank's directors requiring the shareholders to return the distribution to the creditors. Indeed, the court noted that shareholders have an interest only in the "residuum" of the corporation, so when the corporation becomes insolvent, its assets are held in trust for the benefit of creditors.²

Over the years, case law on the extent to which corporate managers owed duties to creditors and the qualitative nature of those duties, ebbed and flowed.³ In *Curran v. Arkansas*,⁴ a creditor sued the State of Arkansas for having received priority in the distribution of the assets of an insolvent state-chartered bank. In finding for the creditor, the Supreme Court stated that a trust relationship between the managers of the bank and its creditors arose from the moment the bank was chartered:

The bank received this money from the State as the fund to meet its engagements with third persons which the State, by the charter, expressly authorized it to make for the profit of the State. Having thus set apart this fund in the hands of the bank,

¹3 Mason 308, 30 F. Cas. 435 (C.C.Me. 1824).

²*Id.* at 439.

³See Jonathan C. Lipson, *Directors' Duties to Creditors: Power Imbalance and the Financially Distressed Corporation*, 50 UCLA L. Rev. 1189, 1203-07 (2003).

⁴56 U.S. 304(1853).

and invited the public to give credit to it, under an assurance that it had been placed there for the purpose of paying the liabilities of the bank, whenever such credit was given, a contract between the State and the creditor not to withdraw that fund, to his injury, at once arose.⁵

Forty years later, in *Hollins v. Brierfield Coal & Iron Co.*,⁶ the Supreme Court again had occasion to consider the nature of the relationship between corporate managers and the corporation's creditors. In *Hollins*, the Court seemed to retreat from the notion that a constant trust relationship existed between a corporation and its creditors:

[T]he corporation is an entity, distinct from its stockholders as from its creditors. Solvent, it holds its property as any individual holds his, free from the touch of a creditor who has acquired no lien; free, also, from the touch of a stockholder who, though equitably interested in, has no legal right to, the property. Becoming insolvent, the equitable interest of the stockholders in the property, together with their conditional liability to the creditors, place the property in a condition of trust, first for the creditors, and then for the stockholders.⁷

At common law, corporate managers owe a duty of care, loyalty and good faith to the corporation.⁸ Generally, the beneficiaries of these duties are the corporation's shareholders.⁹

⁵*Id.*, at 314.

⁶150 U.S. 371 (1893).

⁷*Id.*, at 383.

⁸*See, generally*, WILLIAM A. KLEIN, J. MARK RAMSAYER & STEPHEN M. BAINBRIDGE, *BUSINESS ASSOCIATIONS CASES AND MATERIALS ON AGENCY, PARTNERSHIPS, AND CORPORATIONS* 328 (6th Ed. 2006). *See also*, Daniel B. Bogart, *Liability of Directors of Chapter 11 Debtors in Possession: "Don't Look Back, Something May*

Once, a corporation becomes insolvent, however, the prevailing view is that the beneficiaries of the managers' duties cease to be the shareholders and become instead the corporation's creditors.¹⁰

Presumably, the rationale behind the shift in the beneficiaries of the duties owed by corporate managers is the liquidation priority of the corporation's assets. In other words, when a corporation is insolvent, the liquidation value of the corporation will be distributed *pro rata* to the creditors. Shareholders, whose distribution rights are limited to the corporation's "residuum," would not share in the proceeds from the liquidation of an insolvent enterprise.¹¹

The duties corporate managers owe to the corporation are intended to provide operational guidelines for the conduct of those managers in running the corporation. The duties of care, loyalty and good faith should run to the corporation and not to any of its constituencies. Nevertheless, over the years, courts have created a great deal of confusion by redefining these operational guidelines to suggest that when a corporation becomes insolvent, the duties of corporate managers shift directly to the creditor constituency.¹²

Be Gaining On You," 68 Am. Bankr. L.J. 155, 168 (1994). "It is hornbook law that corporate directors owe the corporation they serve fiduciary duties of due care, loyalty and good faith." *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 367 (Del. Sup.Ct. 1993).

⁹See *Smith v. Van Gorkum*, 488 A.2d 858 (Del. Sup.Ct. 1985); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. Sup.Ct. 1985).

¹⁰Lipson, *supra* note 3, at 1201.

¹¹*Id.*, at 1203.

¹²See, e.g., *Kalb Voorhis & Co. v. American Financial Corp.*, 8 F.3d 130, 132 (2d Cir. 1993); *St. Paul Fire and Marine Ins. Co. v. PepsiCo, Inc.*, 884 F.2d 688, 701 (2d Cir. 1989); *DeNune v. Consolidated Capital of North America, Inc.*, 288 F.Supp.2d 844, 859 (N.D. Ohio 2003) *Pereira v. Cogan*, 2001 WL 243537 at *12 (S.D.N.Y. 2001); *In re Greater Southeast Community Hospital Corp.*, 353 B.R. 324 (Bankr. D. Dist. Col. 2006); *In re Ben Franklin*

The impact of this judicially-created shift in the application of the rules of corporate governance creates significant problems, particularly for corporations in some financial distress. They create equally thorny problems for the lawyers advising corporate managers.

It should not be difficult for conscientious corporate managers to understand that they must act with reasonable care in managing the corporation's affairs; that they owe a duty of loyalty to their employer; and, that they must act in good faith. These rules of conduct ought to apply consistently, irrespective of the corporation's financial condition at any point in time. For example, if corporate managers encounter a business opportunity which, in the exercise of their business judgment makes economic sense, what purpose is served by the added requirement that corporate managers must factor into their deliberations the financial condition of the corporation and whether or not the effect of the decision will be more or less beneficial to creditors versus shareholders? Since the interests of creditors and shareholders are not always in harmony, managers of corporations in financial distress may even be less inclined to make decisions that might benefit the corporation if they believed that the implementation of such a decision might create an excessive risk to creditors.

Even more difficult to navigate is the application of the duty of loyalty in the case of an insolvent corporation. In exercising the duty of care, corporate managers are protected by the business judgment rule:

Retail Stores, Inc., 225 B.R. 646, 653 (Bankr. N.D.Ill. 1998), *aff'd in part, reversed in part*, 2000 WL 28266 (N.D. Ill. 2000); *Weaver v. Kellog*, 216 B.R. 563, 583-84 (Bankr. S.D.Tex. 1997); *In re Folks*, 211 B.R. 378, 384, 387 (Bankr. 9th Cir. 1997); *In re Mortgage & Realty Trust*, 195 B.R. 740, 750-751 (Bankr. C.D.Cal. 1996); *Geyer v. Ingersoll Publications Co.*, 621 A.2d 784, 790 (Del. Chancery 1992).

It is a presumption that in making a business decision 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.... Absent an abuse of discretion, that judgment will be respected by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption.¹³

For obvious reasons, there is no business judgment rule that will insulate corporate managers from alleged violations of the duty of loyalty.¹⁴ So long as the beneficiary of the duty of loyalty remains the corporation, corporate managers should retain a modicum of comfort in the decision-making process, whether or not the corporation is insolvent. If, however the beneficiaries of the duty of loyalty for an insolvent corporation are its creditors, corporate managers may well find themselves in a virtually irreconcilable conflict situation. Does the duty of loyalty require managers to affirmatively advise creditors that the corporation has become insolvent? Are the managers of an insolvent company required to advise the corporation's vendors that any payments the vendors receive may be recoverable as a preferential transfer if the corporation files bankruptcy within 90 days,¹⁵ or that the corporation is even contemplating bankruptcy? If so, the imposition of these disclosure obligations as a component of a duty of loyalty to creditors will certainly hasten the corporation's demise. To date, there are not yet any reported cases that have gone quite so far.

¹³*Aronson v. Lewis*, 473 A.2d 805, 812 (Del.1984).

¹⁴*See Bogart, supra* note 8, at 173-74.

¹⁵11 U.S.C. §547.

Navigating Through the Vicinity of Insolvency

Even though the state of existing case law has blurred the lines concerning the shift in direction for duties owed by corporate managers, one could argue that the trigger mechanism for this shift – the insolvency of the corporation, remains constant and somewhat easily discernible. In other words, even though the law is murky on who precisely are the beneficiaries of the duties of corporate managers, at least the managers know that the change occurs when the corporation becomes insolvent and, therefore, they ought to be able to function in the “normal mode” up to that point. Well, maybe not.

In recent years there has emerged a line of cases suggesting that creditors may become the beneficiaries of the duties imposed on corporate managers before the corporation ever becomes insolvent. Incredibly, the source of the concept of the “zone of insolvency” was a 1991 decision of the Delaware Chancery Court which never even made the official reports.

*Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*¹⁶ involved a contentious dispute over the control of MGM-Pathe Communications Co., between Credit Lyonnais Bank, its major creditor and Giancarlo Parretti, who controlled the stock of MGM. The issue was whether or not MGM’s management committee, created pursuant to an agreement between Credit Lyonnais and Parretti, breached its duties by taking (or refraining from taking) actions which were allegedly beneficial to the bank and detrimental to shareholders.

For the most part, the opinion reads like the script of a soap opera and it soon becomes apparent that the Chancellor had significant problems with the conduct of the shareholders, particularly Mr. Parretti. In the end, the court concluded that the conduct of

¹⁶1991 WL 277613 (Del.Ch. Dec. 30, 1991).

MGM's management committee was entirely consistent with the terms of the agreement between the bank and Parretti, an agreement the court found Parretti had repeatedly breached.

Yet the opinion went far beyond the mere analysis of the conduct of the management committee under the agreement. It proceeded to measure that conduct under traditional rules of corporate governance. The court used the hypothetical example of a solvent corporation whose only asset was a judgment against a solvent defendant. The judgment was on appeal and the defendant has made an offer to compromise the litigation at approximately 25 percent of the amount judgment. The offer is for an amount sufficient to pay all creditors of the corporation in full (\$12 million), but if accepted by the board there would be very little left for shareholders. On the other hand, there is a significant risk that the judgment would be modified on appeal to an amount that would render the corporation insolvent. The court described the optimal response of the corporation's managers as follows:

But if we consider the community of interests that the corporation represents it seems apparent that one should in this hypothetical accept the best settlement offer available providing it is greater than \$15.55 million, and one below that amount should be rejected. But that result will not be reached by a director who thinks he owes duties directly to shareholders only. It will be reached by directors who are capable of conceiving of the corporation as a legal and economic entity. *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.*¹⁷

As a practical matter, there is not a great deal to criticize about the manner in which Chancellor Allen describes the way in which corporate managers ought to do their jobs. What is intriguing, however, is the implication that directors are specially constrained to follow the “efficient and fair” course for the corporation only when it is in the vicinity of insolvency.

Where Do We Go From Here?

In *Floyd v. Hefner*¹⁸ a Chapter 11 trustee sued the debtor’s directors and its pre-bankruptcy counsel for, among other things, taking actions contrary to the interests of creditors while the corporation was in the vicinity of insolvency. The district court found, rather summarily, that the vicinity of insolvency is not to be found in the State of Texas.¹⁹

In re Unifi Communications, Inc.,²⁰ was a case in which the creditors committee sued several members of the debtor’s board of directors on behalf of the Chapter 11 trustee, alleging that their conduct had prolonged the debtor’s existence and depleted its assets in a vain and ill-advised effort to create value for the corporation’s shareholders. This theory of liability is an extension of the vicinity of insolvency known as “deepening insolvency.”

¹⁷*Id.*, at fn. 55. *Emphasis added.*

¹⁸2006 WL 2844245 (S.D. Tex. 2006).

¹⁹*Id.*, at 10, *citing Conway v. Bonner*, 100 F.2d 786, 787 (5th Cir.1939).

²⁰317 B.R. 13 (D. Mass.2004).

The court found that the allegations raised in the complaint were sufficient to raise a triable issue of material fact. In doing so, the court chastised the directors for arguing that the complaint failed to allege that they breached their fiduciary duties to creditors:

For reasons not apparent to the Court, the Defendant-Appellant's brief does not address the question of whether the Board has breached any fiduciary duty owed to Unifi. This is particularly puzzling in light of Defendants' initial argument that the Trustee has standing to bring only claims involving duties owed to the Debtor corporation. In a motion for summary judgment, the burden is on the moving party to show "that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law."

Because the members of the Board have plainly not met their burden, summary judgment is inappropriate and the motion filed in the Bankruptcy Court was properly denied....

Finally, Defendants have moved, in the alternative, for partial summary judgment limiting the claims against them to damages resulting from the actions of Board members occurring after August 31, 1998. Defendants argue that, before that date, the members of the Board owed no fiduciary duty to creditors because the Debtor was not insolvent. That argument, however, as did the Defendants' previous argument, overlooks the possibility that Board members breached a fiduciary duty to the Debtor itself before August 31, 1998. Because the Defendants fail to address that possibility, a genuine issue of material fact

remains and their motion for partial summary judgment was properly denied as well.²¹

In another unpublished opinion of the Delaware Chancery Court, a putative creditor of the corporation brought “derivative” breach of duty claims against corporation’s directors, alleging that while the corporation was in the vicinity of insolvency, the directors had done precisely what footnote 55 of the *Credit Lyonnais* decision stated directors were not supposed to do.²² The court dismissed the complaint for lack of standing.

In *Trenwick America Litigation Trust v. Ernst & Young*,²³ the court again dismissed an action against the directors of a corporation which alleged a violation of their duties in the vicinity of insolvency. In doing so, the Chancellor expressed an interesting view of the meaning of the *Credit Lyonnais* holding:

The judicial decisions indicating that directors owe fiduciary duties to the firm when it is insolvent are not, in my view, at odds with Bainbridge's fundamental perspective: indeed, they seem to me more a judicial method of attempting to reinforce the idea that the business judgment rule protects the directors of solvent, barely solvent, and insolvent corporations, and that the creditors of an insolvent firm have no greater right to challenge a disinterested, good faith business decision than the stockholders of a solvent firm. To this point, many firm life

²¹*Id.*, at 19.

²²See *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 2006 WL 2588971 (Del.Ch. Sept. 1, 2006).

²³906 A.2d 168 (Del.Ch. 2006)

cycles have involved an emergence from bankruptcy with the firms' former creditors emerging in the form of the firms' new equityholders.²⁴

Finally, in *U.S. Bank Nat. Ass'n v. U.S. Timberlands Klamath Falls, L.L.C.*²⁵ the court refused to dismiss a complaint by a creditor against the members of a limited liability company which alleged that the members breached their duties to the creditor while the company was in the vicinity of insolvency. The court held that, under *Credit Lyonnais*, the complaint raised triable issues of material fact.

If anything, the foregoing cases make it clear that there is neither a cogent nor consistent roadmap to navigate through the vicinity of insolvency. This places corporate managers in a difficult predicament as courts find newer and more interesting ways to recharacterize and redefine their corporate responsibilities.

²⁴*Id.*, at fn 75, *citing* Stephen M. Bainbridge, The Board of Directors as a Nexus of Contracts, 88 Iowa L. Rev. 1 (2002).

²⁵864 A.2d 930 (Del.Ch.2004).