



Directors' Duties in the Zone of Insolvency and Corporate Governance Issues in Chapter 11 Bankruptcies

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PART I – Fiduciary Duties of Directors/ Impact of Gheewalla



Fiduciary Duties of Directors to the Corporation They Control

- Duties are to the corporation. Del. Code Ann. Tit.8, §141(a).
- Fiduciary duties of care and loyalty
- Directors are protected by the business judgment rule

Duty of Care

- Duty of care governs a director's decisions in managing the corporation
- Focus of this duty is the process by which decisions are made rather than the substance of the decision or its eventual outcome

Duty of Loyalty

- Requires that directors act in the best interests of the corporation subordinating other interests to that of the corporation
- Requires good faith belief that actions taken are in the corporation's best interests
- Duty implicated where there is conflict of interest or by the corporate opportunity doctrine

The Business Judgment Rule

- The Business Judgment Rule provides an important protection to corporate directors. The Rule 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. *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984).
- A director is entitled to the protection of the rule unless it is demonstrated that the director breached his or her fiduciary duties.
- If a court decides not to apply the Business Judgment Rule to a corporate decision, the directors have the burden of demonstrating “entire fairness” of the transaction.

Derivative Action By Shareholders Against Directors

- While directors owe their fiduciary duties to the corporation, shareholders may bring a derivative action whereby the shareholder is suing directors on behalf of the corporation
- Directors and officers of solvent corporations do not owe fiduciary duties to the creditors of the corporation

Directors of Insolvent Corporations Owe Their Fiduciary Duties to Creditors

- When a corporation becomes insolvent, creditors take the place of shareholders as the residual beneficiaries of any increase in value
- As a result, creditors of an insolvent corporation have standing to maintain derivative claims against directors on behalf of the corporation for breaches of fiduciary duties

Zone of Insolvency

- Expands situation where directors owe creditors a fiduciary duty beyond those where corporation is actually insolvent, to situations where the corporation was operating “in the zone of insolvency.”
- TEST: insolvent in fact v. legally insolvent

New Rules Apply

- Heightened scrutiny of directors' actions when corporation is insolvent or in the zone of insolvency
- Business judgment rule may not apply
- Higher standard should be assumed
- THE MORAL: Directors must do all they can to comply with their fiduciary duties

Direct v. Derivative Claims By Creditors

- Previous cases left the door open for direct claims by creditors but the Delaware Supreme Court closed that door in *North American Catholic Educational Programming Foundation, Inc. (NACEPF) v. Gheewalla*, 930 A. 2d 92 (Del. Supr. 2007).

GHEEWALLA Decision

- In *Gheewalla*, certain creditors brought a direct action against directors of a Delaware corporation for breach of fiduciary duty. The Court of Chancery dismissed the action for failure to state a claim. The Delaware Supreme Court affirmed. The Court held definitely held that creditors of a Delaware Corporation that is either insolvent or in the zone of insolvency have no right to assert direct claims for breach of fiduciary duty against corporation's directors.
- The Court noted that creditors may nevertheless protect their interests by asserting derivative claims on behalf of the insolvent corporation but not direct claims for breach of fiduciary duty. *Gheewalla* holds that: (1) creditors may not assert *direct* claims for breach of fiduciary duty against directors of a solvent corporation, whether or not it is operating in the "zone of insolvency"; and (2) creditors may not assert *direct* claims for breach of fiduciary duty against directors of an insolvency corporation.
- Since *Gheewalla*, a few courts have discussed its impact. In the *Vartec Telecom* case, *Mims v. Fail*, 2007 Bankr. LEXIS 3240 (N.D. Tex. Sept. 18, 2007), the District Court for the Northern District of Texas applied the decision of *Gheewalla* in holding that a Chapter 7 trustee could only bring a derivative, but not direct, action against directors of the debtor.



PART II – Deepening Insolvency

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Other Causes of Action or Damage Theories: “Deepening Insolvency”

- First endorsed by Third Circuit in 2001 decision, *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc.*, 267 F.3d 340 (3d Cir. 2001) (“Lafferty”).
- Recent decisions show deepening insolvency, whether articulated as cause of action or theory of damages quickly eroding as independent means of recovery.

Lafferty Decision

- Committee brought action on behalf of debtors against debtors' lawyers, accounts, and independent underwriters, alleging conspiracy with debtors' management to fraudulently issue debt securities as part of "Ponzi scheme."
- Third Circuit held "deepening insolvency" constituted valid cause of action under Pennsylvania law.
- Holding despite absence of any breach of a legal duty.
- Ultimate decision recognized deepening insolvency as a claim but barred committee's complaint under doctrine of *in pari delicto*.

Aftermath of Lafferty

- Some courts construed Lafferty to create both “deepening insolvency” cause of action and theory of damages that can be pursued upon establishing another cause of action.
- For example, *Bookland of Maine v. Baker, Newman & Noyes, LLC*, 271 F. Supp. 2d 324 (D. Maine 2003) held plaintiff can recover difference between value of company upon insolvency and value at date of bankruptcy filing.
- Other courts accept deepening insolvency as cause of action but limit application to breach of duty owed to company or other actionable tort. *Adelphia Communications Corp.*, 2006 WL 687153 (Bankr. S.D.N.Y. 2006).
- Deepening insolvency claims dismissed as duplicative. *In re Verestar, Inc.*, 343 B.R. 444 (S.D.N.Y. 2006).
- Granting motion to dismiss deepening insolvency claim as subsumed within breach of fiduciary duty claims. *Boles v. Filipowski (In re Enivid, Inc.)*, 345 B.R. 426, 453 (Bankr. D. Mass. 2006)
- Deepening insolvency action requires showing of breach of established legal duty. *In re VarTec Telecom, Inc.*, 335 B.R. 631, 645-46 (Bankr. N.D. Tex. 2005).

Third Circuit's Subsequent Limitations on Deepening Insolvency

- *In re CitX Corp.*, 448 F.3d 672 (3d Cir. 2006) – Third Circuit denied applicability of deepening insolvency as “theory of injury” and held that deepening insolvency could not be used as theory of damages for trustee’s malpractice claims against debtor’s auditor.
- Third Circuit focused on evidence relating to causation of damages, non-existence of fraud.
- Opinion contained limiting language regarding application of *Lafferty* --- the Court “cannot revisit the correctness” of its decision in *Lafferty* and that nothing in *Lafferty* “compels any extension of the doctrine beyond Pennsylvania.”

Continued Erosion of Deepening Insolvency Theory

- Delaware Chancery Court decision *Trenwick America Litigation Trust v. Ernst & Young LLP*, 906 A.2d 168 (Del. Ch. 2006) (later affirmed by Delaware Supreme Court) held that deepening insolvency is not supported by Delaware law.
- *Trenwick* Court required allegations of self-dealing or gross negligence at a minimum to sustain plaintiff's claims.
- *Trenwick* reaffirmed application of business judgment rule to directors' conduct.
- Plaintiff must rely on "the contents of their traditional toolkit" i.e., breach of fiduciary duty, fraud, etc.

Recent Cases – Further Limitations

- *Miller v. McCown De Leeuw & Co. (In re Brown Sch.)*, 2008 Bankr. LEXIS 1226 (Bankr. D. Del. Apr. 24, 2008) (state law did not recognize deepening insolvency cause of action but traditional theories of breach of fiduciary duty, corporate waste, civil conspiracy, etc., still available).
- *Miller v. Dutil (In re Total Containment, Inc.)*, 2008 Bankr. LEXIS 681 (Bankr. E.D. Pa. March 5, 2008) (deepening insolvency nothing more than breach of fiduciary duty).



PART III - Corporate Governance Issues in Chapter 11 Bankruptcies



Shareholder Meetings While in Bankruptcy

- Does an order directing the scheduling of a shareholder meeting of a chapter 11 debtor violate the automatic stay?
- In *Asher E. Fogel v. U.S. Energy Systems, Inc. et al.*, the Delaware Chancery Court held that the automatic stay did not apply to the scheduling or holding of a shareholder meeting of the debtor.
- The Chancery Court held a trial to determine whether U.S. Energy had terminated the plaintiff, the former CEO, pursuant to a valid board meeting.
- In determining that the purported termination was ineffective, the Chancery Court issued an order directing U.S. Energy to schedule a shareholder meeting.
- After the ruling, the plaintiff sought to modify the ruling and moved for reconsideration.
- However, in the interim, U.S. Energy filed a voluntary chapter 11 case in the U.S. Bankruptcy Court, Southern District of New York before the Chancery Court could rule on the motion.
- The debtor argued that the automatic stay barred the holding of the meeting. The plaintiff argued that the meeting should proceed. The court agreed with the plaintiff.

Impact of U.S. Energy

- Important principles resulting from *U.S. Energy* include: (i) the Chancery Court is the proper forum to address corporate governance issues as they may be impacted by the automatic stay; (ii) the filing of the chapter 11 case does not, on its own, divest shareholders of their right to "exercise their rights of corporate democracy," and (iii) absent some clear showing of abuse, which need likely rise to such a level as to "seriously threaten the rehabilitation of the debtor," the rights of the shareholders in respect of shareholder meetings will not be disturbed.
- *U.S. Energy* ruling will invite additional litigation on the issue. After the Delaware Chancery Court's ruling, the debtor filed a motion in bankruptcy court seeking a declaration that the shareholder meeting is effectively enjoined by the automatic stay and that the mandate of the Chancery Court was void. The parties ultimately settled on the matter, permitting the meeting and re-constitution of the board of directors so the bankruptcy court never ruled on the dispute.

Solidus Networks Case

- Noteholders (composed of private equity funds) exercised contractual right to replace the board and management of Solidus. After taking such action, the Noteholders immediately petitioned the Delaware Chancery Court to ratify their conduct and the composition of the board. Vice Chancellor Strine entered a status quo order, which detailed what Solidus and the parties could/not do. The order specifically prohibited any attempt by former management to commence a bankruptcy case.
- After entry of the status quo order, an involuntary bankruptcy was commenced by relatives of the former owner of the company (who were former employees and technically creditors). The former owner also commenced a personal voluntary chapter 11 proceeding.
- On behalf of the Noteholders, we had to immediately address the following issues:
 1. Does the stay apply to the Chancery Court action, which involved a purely corporate governance dispute to be determined by the Vice Chancellor in accordance with Delaware corporate law?
 2. Upon commencement of the involuntary proceeding, who was in control of Solidus?
 3. Was the status quo order still enforceable?
 4. Should the Noteholders proceed with the Chancery Court action without regard to the involuntary or seek stay relief from the Bankruptcy Court, which may have implicitly conceded that the Bankruptcy Court would have jurisdiction over the issues that were the subject of the Chancery Court action?
 5. If the Noteholders decided to seek stay relief, need they also seek stay relief in the chapter 11 case of the former owner?

Riverstone Networks Case

- Due to substantial and incurable accounting irregularities, Riverstone was prohibited by the SEC from soliciting its shareholders in connection with a sale of the company.
- As a result, it had no choice but to commence a voluntary chapter 11 case in order to consummate the transaction because a bankruptcy case overrides the need for a shareholder vote under Delaware corporate law.
- Prior to the petition date, a shareholder had petitioned the Delaware Chancery Court to order a shareholder meeting, which order had been granted. The petitioning shareholder was intent on supplanting the board and destroying the proposed transaction (which paid all claims in full and provided a distribution of \$220,000,000 to equity). However, due to the aforementioned accounting irregularities, Riverstone was prohibited from sending any solicitations, proxies or other materials to its shareholders.
- On behalf of Riverstone, we had to immediately address the following issues:
 1. Did the chapter 11 stay the Chancery Court order?
 2. What strategy could be employed to preserve the sale (which paid all creditors in full and \$220,000,000 to equity)?
 3. Was there any way for the company to utilize the Bankruptcy Court to sanction a communication to Riverstone's shareholders?

Removal of Debtor's Officers After Commencement of Chapter 11

- Creditors always have the option to appoint Chapter 11 Trustee but what if grounds do not exist and other strategies are pursued?
- In *In re Hutchinson*, a case out of the Northern District of Texas, a creditor took possession of a debtor's shares of stock and held a meeting pursuant to a voting trust agreement executed by the debtor and the creditor. When the creditor voted the shares to remove the debtor as the corporate president and sole director, the debtor filed a motion seeking enforcement of the automatic stay and damages for violation of the stay.
- Court held in favor of the debtor that the shares were property of the estate because they were never transferred to the name of the creditor.
- The court reasoned that the automatic stay protected the debtor from removal as the controlling officer of the corporation absent a lifting of the automatic stay or the appointment of a chapter 11 trustee
- Notwithstanding the contractual right provided by the voting trust agreement, Texas corporate law required that the shares be transferred into the trustee's name before the right to vote was exercisable.
- While the creditor contended that the debtor breached his contracts by refusing to transfer the shares into the creditor's name, the fact remained that as of the date of the shareholder's meeting, the shares remained in the debtor's name and the creditor's acts were attempts to exercise control over property of the estate under Section 362(a)(3).