

## Client Alert

North America

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### **Fiduciary duties and the “zone of insolvency”**

The recent crisis in the global credit markets will undoubtedly strain the financial resources of US corporations, leading to an increase in debt defaults and formal insolvencies. Managing the affairs of a corporation that is in or close to insolvency demands that the corporation’s board of directors delicately balance its competing responsibilities of wealth creation and capital preservation. In turn, the tension between these two responsibilities may present complex fiduciary issues, particularly when different corporate constituencies – often, creditors and stockholders – advocate competing business strategies. In this Client Alert, we briefly explore the fiduciary duties of directors of an insolvent or nearly insolvent corporation, and offer practical considerations to directors of such a distressed business enterprise. Our focus is on Delaware law as it is followed, directly or by example, in most US jurisdictions.

### **When does a corporation enter into the “zone of insolvency”?**

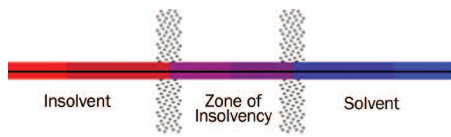
This Client Alert discusses fiduciary duty issues that arise when Delaware corporations become insolvent or merely enter the “zone of insolvency.” Delaware courts have expressly refused to define precisely when a corporation becomes insolvent for purposes of determining when more expansive fiduciary duties arise. Insolvency is determined on the facts and not solely by whether statutory (bankruptcy) proceedings have been initiated. A corporation may thus be deemed insolvent under traditional equity and balance sheet tests when, respectively:

- the corporation cannot pay its debts as they come due in the usual course of business; or
- the value of the corporation’s debts or liabilities exceeds the reasonable market value of the corporation’s assets.

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Apart from actual insolvency, the corporation may also operate in the “zone of insolvency” – a more nebulous and even less clearly-defined state of affairs that a corporation enters into short of insolvency in fact.

A critical consequence of the corporation becoming insolvent is that the creditors become the principal residual bearers of economic risk. In the solvent corporation, the principal residual risk bearers are the corporation’s stockholders – that class of corporate constituents which, after the payment in full of the corporation’s creditors by the solvent corporation, will reap any excess gains or suffer any losses arising from the business decisions of the board of directors. In contrast, when the corporation is insolvent, the corporation cannot pay the higher-priority debts of the creditors, and thus creditors surpass stockholders and become the principal residual risk bearers. The potential for this shifting of residual risk from stockholders to creditors similarly exists in the zone of insolvency. As explained below, this change in the relative economic status of creditors vis-à-vis stockholders underlies the unique fiduciary duty analysis applicable to directors of insolvent or nearly insolvent Delaware corporations.

## What is the nature of the fiduciary duties owed by directors?

The fiduciary duties of directors in managing the affairs of a solvent Delaware corporation are well settled. Directors are required at all times to comport with their fiduciary duties of due care, loyalty and good faith. In other words, directors must always act: (i) in an informed manner and with the proper level of care in light of all relevant circumstances; (ii) unselfishly and in the best interests of the corporation and its stockholders; and (iii) without intentional dereliction of their duties or conscious disregard for their responsibilities.

These fiduciary duties continue to govern the directors in their role as corporate fiduciaries after the corporation enters the zone of insolvency or becomes insolvent. Accordingly, the directors are still charged with the responsibility of attempting to maximize the economic value of the firm. The fact of insolvency, though, broadens the constituency on whose behalf the directors are pursuing that end.

## To whom do directors owe fiduciary duties?

When a corporation is solvent, directors owe their fiduciary duties to the corporation and, derivatively, to the corporation’s stockholders – the residual risk bearers of economic consequences of the board’s decisions. Creditors are not the beneficiaries of these fiduciary duties. Instead, creditors may protect their interests through their contracts with the corporation or the legal rights typically afforded to creditors, such as fraudulent conveyance laws, bankruptcy laws and liens. Thus, as a general principle, directors do not owe duties to creditors beyond applicable contractual terms.

That said, the scope of the directors' fiduciary duties expands once a corporation enters the zone of insolvency. As noted above, the corporation's creditors replace its stockholders as the principal residual risk bearers when the corporation enters the zone of insolvency. The general legal paradigm that excluded creditors (formerly non-residual risk bearers) from the fiduciary analysis thus no longer applies. Rather, when a corporation is in the zone of insolvency, directors no longer remain agents of only the ultimate residual risk bearers, and owe fiduciary duties to the corporate enterprise, including its creditors.

- *Not just for the benefit of creditors.* To be clear, creditors are but one group in the community of interests that comprise the corporate enterprise, and fiduciary duties in the insolvency context neither run solely in favor of the creditors, nor require that the interests of creditors necessarily supersede those of other corporate constituencies, such as the stockholders. Even while the corporation operates in the zone of insolvency, directors must continue to fulfill their fiduciary duties to the corporation and its stockholders and seek to maximize the corporation's long-term wealth. It is thus incorrect to say that fiduciary duties change when a corporation enters the zone of insolvency such that directors then owe fiduciary duties exclusively to the creditors and at the expense of the stockholders.
- *Not just for the benefit of stockholders.* Simultaneously, when the corporation enters the zone of insolvency, stockholders no longer remain the sole beneficiary (beyond the corporation itself) of the directors' fiduciary duties. Stockholders, like creditors, are but one constituency in the corporate enterprise. Directors are therefore prohibited from undertaking excessive risks that compromise the corporation's ability to pay its legal obligations to the creditors yet would benefit the stockholders. This restriction on assuming risk differs from the relative freedom afforded directors of solvent corporations – and counteracts any increase in the stockholders' appetite for risk-taking to the detriment principally of the creditors.
- *A balancing of interests.* Instead, when the corporation enters the zone of insolvency, directors are obligated to balance the interests of all corporate constituencies – including both creditors and stockholders – when formulating and adopting corporate policies and strategies. In this regard, it is imperative that directors undertake and memorialize appropriately a deliberative process that recognizes the impacts that a particular business decision will have on the creditors and stockholders. Directors may confront specific situations in which the divergent interests of creditors and stockholders create a “zero sum game” and benefits to one group come at the cost of risks to the other group. Directors are not required to prefer creditors completely, but they must keep in mind the creditors' payment priority when balancing these interests. Case law, however, provides scant guidance on these thorny issues, which require contextual legal advice and analysis. Directors are thus well served by premising their decision on a broader review of and concern for both the corporation's creditors and stockholders in this regard.

## What fiduciary claims may creditors assert against the directors of an insolvent or nearly insolvent corporation?

As the principal residual risk bearers once the corporation enters the zone of insolvency, creditors gain standing to pursue derivative claims against the directors for breaches of fiduciary duties. Creditors, however, cannot assert direct claims against directors of a corporation in the zone of insolvency. Directors of insolvent corporations remain obligated to maximize the value of the corporation for all constituents of the corporate enterprise. Those directors therefore may engage in good faith negotiations with creditors in satisfaction of those duties.

Restricting the nature of the fiduciary claims that may be pursued by creditors to that of derivative claims, creditors – like stockholders in a solvent corporation – can bring fiduciary claims to advance the interests and value of the corporation, and not solely to further their own interests at the expense of other corporate constituencies. Typically, such claims will be asserted by the estate in the context of bankruptcy proceedings involving the insolvent corporation. Directors still will have available to them the panoply of protections and defenses that exist in litigating fiduciary claims in the context of solvent corporations including, among others, the presumptions of the business judgment rule, the ability to rely upon the reports of management and experts and the effect of exculpatory provisions in the corporation’s certificate of incorporation.

## Practical considerations for directors

Most US businesses should not expect to remain isolated from the continuing global credit crisis. More than ever, directors of Delaware corporations must understand their fiduciary duties, their role in fostering wealth creation and their significant obligation to monitor corporate risk. While the contextual nature of fiduciary duties, as well as the innumerable variety of challenges facing different businesses, precludes any simplistic, universal guidance in dealing with the issues confronting corporate directors, some helpful practices include the following:

- *Understand the corporation’s level of exposure.* Directors should periodically review the corporation’s capital structure, major loan agreements and cash-flow needs. The results of that examination should be evaluated in comparison to the corporation’s projected performance, including cash flows, in light of the current business environment. Because Delaware applies the “equity” test to determine whether a corporation is, in fact, insolvent, directors should work with the corporation’s management to identify in advance any liabilities that the corporation will not be able to

pay as they come due in the ordinary course of business. In light of recent volatility and developments, directors should prepare to revisit, redo and revise their analysis as appropriate.

- *Review the corporation's accounting policies and financial statements.* As noted above, one method of deciding whether a corporation is insolvent is the "balance sheet" test. Directors, particularly those who serve on audit committees, should work with the corporation's management, accountants and auditors to determine the impact that any accounting practices, such as "marking to market," may have on the corporation's balance sheet and financial statements. Moreover, any such review should also take into account (i) any accounting principles or practices that have a disparate impact on the corporation itself or the corporation's industry sector; and (ii) the anticipated effect of the current credit crisis on the magnitude of the corporation's short-term and long-term liabilities.
- *Identify the corporation's constituencies.* Directors should identify the corporation's creditors and major stockholders. To the extent possible, directors should recognize the motivations of these constituencies, including whether a particular creditor or stockholder has adopted a short-term or a long-term strategy to its relationship with and/or stockholdings in the corporation.
- *Plan for emergencies.* The board of directors, working with the corporation's management, should consult with experts, including legal counsel and public relations firms, and develop a strategy to respond to liquidity and other crises. In particular, directors and officers of publicly traded corporations should prepare contingency plans to meet and attempt to neutralize unfounded rumors that can adversely impact the value of the corporation's securities.
- *Establish flexible board processes.* The board of directors should establish and implement board processes that impart flexibility to board decision making, thereby enabling the board of directors to react dynamically to business developments. More frequent meetings, longer deliberations on risk management, greater involvement of expert advisers (see below) and increased delegation to committees – to bring potentially greater expertise to bear on a decision as well as to appropriately protect privileged communications – all can be used to achieve these ends.
- *Review the corporation's governing documents and insurance policies.* Directors should review the corporation's certificate of incorporation and bylaws in order to determine whether appropriate provisions are in place in the event of a derivative lawsuit by the corporation's stockholders. In particular, directors should consider any exculpatory, advancement and indemnification provisions in the corporation's governing documents. Directors should also determine whether adequate insurance coverage exists under the corporation's directors and officers liability policies.

- *Consult more frequently with management and experts.* Under Delaware law, directors are protected in performing their duties in their good faith reliance on the opinions and reports of management and experts. Directors are thus entitled to rely in good faith upon the advice and analyses provided by the corporation's accountants, auditors and attorneys. Directors are well-advised to avail themselves of this statutory protection. Indeed, the increased risk to businesses arising from the present economic conditions may necessitate more frequent consultation by directors with corporate management as well as outside professionals.
- *Continue to implement best corporate practices.* In this difficult business environment, an old adage remains true: "An ounce of prevention is worth a pound of cure." By implementing best corporate practices, beyond the minimum required under Delaware corporate law, directors – protected by the presumptions of the business judgment rule – may reduce the likelihood that plaintiffs will successfully challenge the decisions of the board of directors through derivative litigation.

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