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Counseling the Financially Distressed Corporation

By Philip D. Forlenza, Esq.

Counseling any corporation can often be a challenging endeavor. These challenges become more complex when the entity is financially distressed. To provide effective counsel, the business attorney must be able to explain to the corporation's board of directors the duties that the board has to various constituencies. Case law in the area has been emerging over the past few decades. This article examines some of this case law and how the duties of directors shift once a corporation nears insolvency or becomes insolvent.

What Duties Does the Board of Directors of an Insolvent Corporation Have?

Traditional Corporate Law Principles

Generally, directors of a corporation owe fiduciary duties only to the corporation's shareholders. These duties include the duties of due care, loyalty and good faith. Directors of a solvent corporation do not owe a fiduciary duty to creditors or other third parties. It is presumed that creditors are capable of protecting themselves through the contractual agreements that they enter into with the corporations with which they deal. As noted in Katz v. Oak Industries, Inc.,[1] "… the relationship between a corporation and the holders of its debt securities, even convertible debt securities is contractual in nature … (citations omitted) [a]rrangements among a corporation, the underwriters of its debt, trustees under its indentures and sometimes ultimate investors are typically thoroughly negotiated and massively documented, the rights and obligations of the various parties are or should be spelled out in that documentation." In examining the conduct of directors, courts employ the "business judgment rule." In New Jersey, the business judgment rule provides that in the absence of evidence of self-dealing, conflict of interest, bad faith or fraud, directors will be presumed to exercise their judgment in the best interests of the corporation, and their decision as to what constitutes that best interest will be respected by the courts.[2]

Insolvent Corporations

New Jersey law clearly provides that when a corporation becomes insolvent, the directors assume a fiduciary or quasi-trust duty to its creditors.[3] Under these circumstances, a director cannot "prefer one creditor over another, and they have a special duty not to prefer themselves…"[4] In Bank Leumi-Le-Israel v. Sunbelt Industries, Inc.,[5] the court stated "[i]n the case of an insolvent corporation, the directors and officers stand as trustees of corporate properties for the benefit of creditors first and stockholders second." The law of most states is clear that where a corporation becomes insolvent, the class of constituencies to whom directors owe duties expands to include creditors. This shift in duties presents challenges to directors that are more complex than those faced by directors of solvent corporations.

When is a Corporation Considered to be Insolvent?

In light of the fact that the duties of directors shift once a corporation becomes insolvent, it is important to be able to determine when a corporation has become "insolvent." In B.S. Livingston & Co., Inc. v. Stemcor USA, Inc.,[6] the Bankruptcy Court held that "insolvency means insolvency in fact rather than an insolvency due to a statutory filing." As a result, it is clear that it is not necessary for a corporation to file a bankruptcy or other insolvency petition to be considered insolvent. There is no case law in New Jersey which defines insolvency for these purposes; however, courts in other jurisdictions generally use two tests to determine whether a corporation is insolvent, including an analysis of whether:

- the corporation's liabilities exceed its assets; or
- the corporation is unable to pay its debts as they become due in the ordinary course of business.[7]

Section 14A:14.2(f) of the New Jersey Business Corporation Act provides a definition of "insolvent" which involves an analysis similar to the analysis discussed above. Section 14A:14-2(f) provides that:

> "a corporation shall be deemed to be insolvent for the purposes of this chapter (1) when the aggregate of its property, exclusive of any property which it may have conveyed, transferred, concealed, removed or permitted to be concealed or removed, with intent to defraud, hinder or delay its creditors, shall not at a fair valuation be sufficient in an amount to pay its debts; or (2) when the corporation is unable, by its available assets or the honest use of credit, to pay its debts as they become due."

The Zone of Insolvency

Certain courts have embraced the notion that the duties of directors shift to include creditors when a corporation is in the "zone of insolvency." In one of the first such cases, Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.,[8] the Delaware Chancery Court, in dicta, indicated that when a corporation is in the "vicinity of insolvency," directors' duties are expanded to include creditors and the corporate enterprise as a whole. In its opinion, the Court emphasized the duties of directors to the firm and their duty to responsibly maximize the value of the firm. The Court noted that such a strategy might require pursuing a course of action that neither the stockholders nor the creditors would prefer.

The language in Credit Lyonnais was interpreted by some courts as exposing directors to a new set of fiduciary duty claims from creditors, rather than creating a shield for directors from stockholder claims.[9] The difficulty in applying this premise to real world facts is that courts have provided little guidance as to when a corporation is deemed in the zone or vicinity of insolvency. In discussing this issue, the Delaware Chancery Court, in Production Resources, supra, stated:

> The "zone" issue is an admittedly confusing one. For example, once a firm becomes insolvent, there is little doubt that creditors can press derivative claims arguing that directors' pre-insolvency conduct injured the firm, which makes some of the Bankruptcy Court decisions discussing the zone interesting dictum. The more difficult issue is whether there is a zone in which the directors' duties to the firm fundamentally change and whether creditors can assert fiduciary claims (e.g. for injunctive relief) before the firm becomes insolvent. If creditors having standing to bring derivative claims in the "zone of insolvency," they will share that standing with stockholders, leading to the possibility of derivative suits with starkly different conceptions of what is best for that firm.

The Court in Production Resources Group L.L.C. v. NCT Group, Inc.[10] went on to say that the expansion of a director's fiduciary duties when a corporation is insolvent or in the zone of insolvency does not create a new body of creditor's rights law. Instead, the Court instructed that the Credit Lyonnais decision was intended to be a shield to protect directors from claims by shareholders that they acted too conservatively in managing the corporation's affairs. The Court in Production Resources emphasized that the fact that the duties of directors are expanded when a corporation is insolvent or in the zone of insolvency gives creditors standing to assert a claim for a director's breach of duty, but those claims are derivative claims owned by the corporation, not a direct claim owned by a particular creditor. In other words, although directors of an insolvent corporation owe fiduciary duties to creditors, claims for breach of duty belong to the corporation, and not to any creditor individually. As a result, under Delaware law, a creditor who wishes to pursue a breach of fiduciary duty claim against directors must do so by way of a derivative action on behalf of the corporation.

Deepening Insolvency: Rejection of Cause of Action

Following the Credit Lyonnais decision, federal courts began to recognize causes of action brought by creditors and bankruptcy trustees for "deepening insolvency." Deepening insolvency has been described as the "fraudulent prolongation of a corporation's life beyond solvency, resulting in damage to the corporation by increased debt."[11] Deepening insolvency claims against directors typically involve allegations that the directors have negligently or fraudulently prolonged the life of a corporation, resulting in increased debt or a greater level of insolvency than if they liquidated or sought a bankruptcy restructuring of the company. Plaintiffs argue that if the directors had liquidated the company or sought bankruptcy relief earlier, greater value would have been preserved for creditors. Deepening insolvency cases made it more difficult to recommend a course of action that, if not successful, could leave creditors in a worse position.

In August 2006, the Delaware Court of Chancery rejected the notion that a cause of action for deepening insolvency exists under Delaware law. In Trenwick America Litigation Trust v. Ernst & Young, LLP,[12] the Court, in analyzing a "deepening insolvency" claim held as follows:

> "Delaware law does not recognize this catchy term as a cause of action, because catchy though the term may be, it does not express a coherent concept. Even when a firm is insolvent, its directors may, in the appropriate exercise of their business judgment, take action that might, if it does not pan out, result in the firm being painted in a deeper hue of red. The fact that the residual claimants of the firm at that time are creditors does not mean that the directors cannot choose to continue the firm's operations in the hope that they can expand the inadequate pie such that the firm's creditors get a greater recovery. By doing so, the directors do not become a guarantor of success. Put simply, under Delaware law, "deepening insolvency" is no more of a cause of action when a firm is insolvent than a cause of action for "shallowing profitability" would be when a firm is solvent. Existing equitable causes of action for breach of fiduciary duty, and existing legal causes of action for fraud, fraudulent conveyance, and breach of contract are the appropriate means by which to challenge the actions of boards of insolvent corporations.
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> Refusal to embrace deepening insolvency as a cause of action is required by settled principles of Delaware law. So, too, is a refusal to extend to creditors a solicitude not given to equityholders. Creditors are better placed than equityholders and other corporate constituencies (think employees) to protect themselves against the risk of firm failure.
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> The incantation of the word insolvency, or even more amorphously, the words zone of insolvency should not declare open season on corporate fiduciaries. Directors are expected to seek profit for stockholders, even at risk of failure. With the prospect of profit often comes the potential for defeat.
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> The general rule embraced by Delaware is the sound one. So long as directors are respectful of the corporation's obligation to honor the legal rights of its creditors, they should be free to pursue in good faith profit for the corporation's equityholders. Even when the firm is insolvent, directors are free to pursue value maximizing strategies, while recognizing that the firm's creditors have become its residual claimants and the advancement of their best interests has become the firm's principal objective."

In essence, the Trenwick America decision indicates that even in a situation where a corporation is insolvent or in the vicinity of insolvency, the directors of a corporation continue to have discretion under the business judgment rule to enter into transactions for the benefit of its shareholders even if that strategy is ultimately unsuccessful and worsens the situation for creditors.

Statutory Considerations in New Jersey

The New Jersey Business Corporation Act contains certain provisions which impose personal liability on directors in instances where actions are taken by a corporation in violation of the Act. Generally, these provisions are intended to benefit creditors by restricting distributions to shareholders when a corporation is insolvent. For example, N.J.S.A. 14A:7-14.1 provides that a corporation may not make a distribution (which includes a dividend, repurchase or redemption of shares or incurrence of indebtedness to or for the benefit of shareholders in respect of any of its shares) if after giving effect to the distribution:

(a) the corporation would be unable to pay its debts as they become due in the usual course of its business; or

(b) the corporation's assets would be less than its total liabilities.

N.J.S.A. 14A:6-12 provides that in addition to any other liabilities imposed by law upon directors of a corporation, directors shall have personal liability to the corporation for the benefit of its creditors or shareholders if they vote for or concur in, among others, any of the following corporate actions:

(a) the declaration of any dividend or other distribution of assets to the shareholders contrary to the provisions of the Business Corporation Act or contrary to any restrictions contained in the certificate of incorporation;

(b) the purchase of the shares of the corporation contrary to the provisions of the Business Corporation Act or contrary to any restrictions contained in the certificate of incorporation;

(c) the distribution of assets to shareholders during or after dissolution of the corporation without paying, or adequately providing for, all known debts, obligations and liabilities of the corporation, except that the directors shall be liable only to the extent of the value of assets so distributed and to the extent that such debts, obligations and liabilities of the corporation are not thereafter paid, discharged or barred by statute or otherwise;

(d) the completion liquidation of the corporation and distribution of all of its assets to its shareholders without dissolving or providing for the dissolution of the corporation and the payment of all fees, taxes, and other expenses incidental

> thereto, except that the directors shall be liable only to the extent of the value of assets so distributed and to the extent that such fees, taxes, and other expenses incidental to dissolution are not thereafter paid.

These statutory provisions must be kept in mind when counseling management of a financially distress corporation.

Conclusion

When counseling a financially distressed company and its directors, attorneys must navigate complex issues and be mindful of the shifting duties of directors when the corporation is insolvent or approaching insolvency and the "normal" corporate governance principles no longer apply. The law in this area is constantly evolving and practitioners are well advised to monitor developments in the growing body of case law which addresses these issues. In addition, New Jersey lawyers must keep in mind the specific statutory provisions of the New Jersey Business Corporation Act which restrict corporate actions that can be taken by an insolvent corporation.

Endnotes

1. 508 A.2d 873 (Del. Ch. 1986)

2. See In re: PSE&G Shareholder Litigation, 173 NJ 258, 277 (2002)

3. Portage Insulated Pipe Co. v. Costanzo, 114 N.J. Super 164, 166, 275 A.2d 452 (App. Div. 1971) and Board of Trustees of Teamsters, Local 863 Pension Fund v. Foodtown, Inc., 296 F.3d 164 (3rd Cir. 2002)

4. Matter of Stevens, 476 F.Supp. 147, 153 n. 5 (D.N.J. 1979)

5. 485 F.Supp. 556 (S.D. Ga 1980) at 559

6. 186 B.R. 841 (D. NJ 1995)

7. See Geyer v. Ingersoll Publications, 621 A.2d 784, 787 (Del. Ch. 1992) and Production Resources Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772 (Del. Ch. 2004).

8. 1991 WL 277613 (Del. Ch., December 30, 1991) (No. CIV. A 12150)

9. See Weaver v. Kellogg, 216 B.R. 563, 582-84 (S.D. Tex. (1997)

10. 863 A 2.d 772 (Del. Ch. 2004)

11. In re Global Service Group, LLC, 316 B.R. 451, 456 (S.D. N.Y. 2004)

12. C.A. No. 1571-N, 2006 WL 2333201 (Del. Ch. Aug. 10, 2006)