# Avoiding Personal Liability When The Corporation Is In the "Zone of Insolvency": A Guide for Directors and Officers

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Who owns a corporation? When the corporation is in the black, the shareholders own it and it is the duty of the directors to manage the company in the best interests of the shareholders. By contrast, once a corporation becomes insolvent or approaches insolvency, the ownership interest and the duties of directors are radically altered.

As long as a corporation is financially sound, its creditors have no additional protection beyond legal enforceability of the terms of their contracts with the corporation. As a corporation approaches insolvency, however, the shareholders' equity interests decline in value and may eventually become worthless. As this happens, creditors obtain an equitable interest in the corporation's assets as the ultimate source of the recovery of the debt owed to them.

At the same time, with insolvency looming, corporate officers may feel there is little incentive to protect corporate assets for shareholders, because the assets are likely to go to creditors. Directors and officers may be tempted to use the creditors' money either for their own advantage or in drastic efforts to save the enterprise. For the most part, these temptations must be avoided, because yielding to them can expose directors and officers to personal liability. As explained by a Delaware court in a seminal case, once a corporation is in the "vicinity of insolvency," directors have an obligation not only to the stockholders but also to the "community of interests that sustained the corporation's wealth creating capacity, including the corporation creditors." *[Credit Lyonnais Bank Nederland N.V. v. Pathe Communications Corp. 1191 WL 277613 (Del. Ch. Dec. 30, 1991)]*

What is the nature of that obligation? While the corporation is in the black, directors owe a fiduciary duty to shareholders. Once it approaches insolvency, however, the duty is owed not only to shareholders but also to creditors. There are three elements of directors' fiduciary duties, all of which may be subject to review in 20/20 hindsight should the corporation become insolvent:

(1) Due Care – Did the directors make a reasonable effort to familiarize themselves with the facts sufficiently to make an informed decision? In this regard, directors may rely on reports prepared by corporate officers or outside experts.

(2) Good Faith/Loyalty – Was the action taken by directors based on a reasonable belief that such action was in the best interests of those to whom the directors owed a duty, and in particular the creditors if the enterprise is in the zone of insolvency?

(3) Disinterestedness – Did the directors engage in self-dealing?

Illustrating how these duties may be evaluated, in one case, a corporation's bankruptcy trustee challenged transactions involving a stock redemption, excessive compensation to a company official, insider loans, and the payment of non-business expenses. The court found that during a four-year period when the company was in the zone of insolvency the directors had, among other mistakes, failed to discuss, investigate, and approve the loans made to the corporate official; failed to set up a procedures by which loans would be approved or to require the pledge of adequate collateral; and failed to investigate or determine whether the loans were fair to the corporation. For failure in the

fiduciary duties of good/loyalty to the general creditors and due care to protect the general creditors, the directors and officers were held liable for more than $20 million. *[Pereira v. Cogan, 294 B.R. 449 (S.D.N.Y. (2003)]*

***Where is the Zone of Insolvency?***

Significantly, directors' fiduciary duties to creditors do not arise at the institution of statutory proceedings, such as the filing of a bankruptcy petition. Rather, they arise when a corporation operates in the zone of insolvency. This is the period – which can last for years – when the corporation is in financial distress, but may or may not be actually insolvent. There is no bright line rule for determining the exact point at which a corporation enters into the zone, thus triggering a change in the directors' fiduciary duties. Courts have used several approaches. It may be based on the period before insolvency in fact – also called balance sheet insolvency – which occurs when a corporation's liabilities exceed its assets. Another approach is equitable insolvency, that is, an inability to pay debts as they come due. Even these tests may not be exhaustive, since another case warns that officers and directors may need to consider the interests of creditors even when the corporation is not in the zone of insolvency if the directors are presented with a decision – such as whether to approve a leveraged buyout – the effect of which would be to move it into the zone and beyond. [(In re Healthco International, Inc.), 208 B.R. 288 (Bankr. D. Mass. 1997)]

***A Checklist for Avoiding Personal Liability***

The following precautions can help directors avoid any risk of personal liability to creditors for their actions when the corporation is or may be in the zone of insolvency:

- If the corporation is encountering significant fluctuations in asset values, be apprised of its net worth based upon realistic market values, rather than inflated cost or outdated goodwill.

- Monitor cash flow to make sure that all current liabilities are timely paid.

- If a decision would pose a substantial risk to corporate assets, it may be prudent to consult with and/or obtain the consent of major creditors before implementing the decision.

- Seek expert legal and financial advice about the likely effects for major stockholders and creditors when considering a financially significant transaction such as sale of a major asset, spin-off of a subsidiary, incurring significant debt, or issuance of a dividend.

- Consider alternative courses of action before approving any transaction, such as a financial restructuring, that may have the effect of placing the corporation in the zone of insolvency.

- Recognize the parties to whom fiduciary duties are owed and the nature of those duties and strictly adhere to those duties.

- Consider retaining financial advisors to evaluate whether contemplated transactions are fair to the creditors of the corporation.

- Prohibit the corporation from continuing to purchase goods and services on credit if the enterprise will be unable to pay these debts as they become due.

- Maintain neutrality with respect to preserving corporate value for the community of the corporation's interests when it is in the zone of insolvency; avoid preferring one constituency (stockholders, creditors, officers) over another.

- Assure that decisions are defensible on the basis of good faith judgment, taking into account the whole community of interests, and particularly any action that increases stockholder returns by impairing creditors' claims; generally, it is prudent to avoid

dividends or stock redemptions in the zone of insolvency.

- Remember that transactions with insiders may come under special scrutiny; any actions benefiting directors could be subject to avoidance as fraudulent or preferential payments, or breach of fiduciary duty.

- Be prepared to demonstrate based on reports of outside advisors, which are reflected in the records of the board's deliberations that any awards of executive compensation were reasonable and necessary.

- Do not approve any transactions or other actions that are unlikely to result in reasonably equivalent value to the corporation.

- Avoid any action that prefers one creditor over another.

Many corporate charters contain exculpatory language, which protects directors from personal liability for breaches of their duty of care. According to the decision of at least one federal court, these provisions may not apply to a breach of a duty to a creditor *(Pereira v. Cogan)*. A breach of duty to creditors may or may not be covered by officer's and director's insurance depending on the policy language. While directors may be personally liable for a failure in their duty of care toward creditors, the duty is not directly enforceable by a creditor. A claim for breach of this duty can be made only after a bankruptcy case is filed. The breach is considered an injury to the entire class of creditors and may be prosecuted by either a Chapter 7 Trustee, a Debtor-in-Possession (DIP) under Chapter 11, or Creditors Committee. Any proceeds would be distributed pro rata or in full pursuant to the Bankruptcy Code or the terms of the plan of Reorganization.

It is not the duty of courts to second-guess the decisions of corporate directors. Under the "business judgment rule" courts presume that in making business decisions corporate directors act in good faith and the honest belief that their decisions are in the best interests of the company. To overcome this presumption, a challenger, such as a trustee in bankruptcy, the DIP or Creditors Committee must present evidence that directors failed in their fiduciary duties and thus deserve to be stripped of the protection of the business judgment rule. So long as directors understand their duties, act in good faith, and practice informed, rational decision making, the business judgment rule will continue to protect them from personal liability exposure when the corporation is in the zone of insolvency.

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