

Directors' Duties in the Zone of Insolvency



DIRECTORS' DUTIES IN THE ZONE OF INSOLVENCY

At Foley's sixth annual National Directors Institute on March 8, 2007 in Chicago, "Directors' Duties in the Zone of Insolvency" was a featured breakout session. The panel was moderated by Foley & Lardner partners, Judy O'Neill and Michael Richman. Panel participants included Andrew Kramer, managing director, Restructuring and Growth Capital Group, UBS Securities LLC; Julia Darlow, former board member, Internet Corporation; and Keith Marchiando, former chief financial officer, DURA Automotive.

Panelists for this session fielded questions related to their own experiences with companies that were in the zone of insolvency. They focused on what signs to watch for to determine if a company might be in the "zone," how their decision processes were impacted once the company was in the zone, and what kind of legal or other independent expert advice they sought while in the zone. Discussions surfaced on the fiduciary duties of directors and officers, how those duties changed during the zone of insolvency, and how to ensure that they upheld their duties during the zone of insolvency.

Fiduciary Duty of Directors

Boards of directors and officers owe fiduciary duties to the shareholders of a corporation. There are three duties a board and officers always have: 1) the duty of care, 2) the duty of loyalty, and 3) the duty of good faith. The duty of care requires that directors and officers act with the care an ordinarily prudent person in a like position would exercise under the circumstances. The duty of loyalty requires directors and officers to put the interests of the corporation above their own personal interests. Finally, the duty of good faith requires that directors and officers not make "ostrich like" decisions that demonstrate a deliberate indifference to a potential risk of harm to the corporation.

When Does a Corporation Enter the Zone of Insolvency?

While courts use legal tests, in hindsight, to determine if a corporation was in the zone of insolvency at a specific point in time, practically speaking, if a board is even raising questions about possibly being in the zone of insolvency, the most prudent course of action is to begin acting like the corporation is in the zone of insolvency. It also is important for a board to recognize when it is in "debtor denial" before it is too late. In other words, boards should not continue with business as usual when there are indications that the company may be insolvent. A corporation breaching covenants that were made in its agreements or its officers raising questions regarding the company's cash flow, are all practical markers that could indicate that the corporation might be headed towards the zone of insolvency.

Additionally, three financial tests for being in the zone of insolvency include: 1) balance sheet test — whether the value of the assets or the enterprise value of the corporation exceeds the liabilities; 2) cash flow test — whether the corporation has sufficient cash flow to meet its fixed financial obligations as they become due; and 3) unreasonably small capital test—whether the company has sufficient capital to obtain or support financing for future operations.



Changing Duties

Some courts have held that when a company enters the zone of insolvency, the directors' duties expand to include creditors of the corporation, in addition to the shareholders and the corporation itself. Other courts have compared directors to trustees administering the assets of the corporation for the benefit of creditors. In either scenario, directors of the insolvent corporation must maximize the value of the assets for payment of creditors. If a board always acted in order to maximize the enterprise value of the company, and so long as it did nothing to favor equity over creditors, the board would be satisfying its duties.

When a company is in the zone of insolvency, the absolute priority rule also comes into play. Under this rule, applicable in bankruptcy and imbedded in the expansion of duty cases, the claims of the equity holders would always be below secured and unsecured creditors of the corporation. If value is not sufficient to pay equity, the creditors essentially become the new stakeholders in the company.

Companies should discuss requirements for disclosing financial statements or filings with the Securities and Exchange Commission (SEC) with SEC counsel involvement, but the expansion of the board's fiduciary duties may not, in itself, be a material event requiring filing of an 8K statement. However, other things that trigger that expansion, such as a default in a material loan agreement, may be material events required to be disclosed.

In some instances, stating that the company was in the zone of insolvency might work *against* the board's duty to maximize the corporation's enterprise value. Therefore, counsel with restructuring and SEC expertise must work together to navigate these disclosure issues and the potentially competing concerns.

Retaining Independent Counsel for the Board

Retention of independent counsel to the board (as opposed to the company) is necessary when the interests of the board and the company may be in conflict, or in certain other instances, but that, with respect to the duties imposed on the officers and directors, in the zone, the interests of the corporation and the officers and directors are the same

Resignation of Board Members

Many experts believe that resigning when a corporation is in distress is a complete derogation of a board member's obligations. While there is no law that prohibits a board member from resigning, it is not common practice for a board member to do so. In some cases, board members and officers may be able to obtain a release from liability through a plan of reorganization. As these releases are difficult to obtain in some jurisdictions for active board members, they are even harder to obtain for a former board member. Therefore, resigning while a company is in the zone of insolvency might be an impediment to a board member ultimately obtaining a release for actions or omissions while on the board.

Retention of Outside Experts

To meet the officers' and directors' duties in the zone, companies should retain outside legal counsel and financial advisors that interact with the board in order to ensure the board is given objective advice about how to conduct business during the zone of



insolvency. Companies also can create a committee to handle these types of issues, and during the zone of insolvency, a company's board should be taking a much more active role in seeking advice from outside experts.

The Business Judgment Rule

Under the business judgment rule, a board of directors' business decision will be respected by the courts if the decision was made on a fully informed basis, without self-interest, in good faith, and in the honest belief that the decision was in the best interests of the corporation and its stockholders/creditors. In certain circumstances (e.g., a transaction that contemplates a change of control), a board's duties may be heightened, in order to ensure that it is obtaining the best transaction that is reasonably available.

Deepening Insolvency

Courts recently have begun to recognize a theory of liability, termed "deepening insolvency." Under this theory, liability may be imposed for fraudulently or even negligently prolonging the life of a corporation and increasing the corporation's debt, and exposure to creditors, directors, and officers may be targets of deepening insolvency claims.

The following are examples of scenarios in which courts recognized deepening insolvency claims:

- Directors used fraudulent financial statements to increase capital and shareholder investments, deepening the company's insolvency and causing bankruptcy
- Parent company and directors continued to operate an insolvent company by fraudulently concealing the company's insolvency
- Negligent preparation of financial statements which caused the corporation to incur unmanageable debts and file for bankruptcy
- Negligent preparation of valuation reports which induced the corporation to continue to make corporate acquisitions and borrow additional funds, which resulted in financial deterioration

Thus far, there has not been a single finding of liability solely under a theory of deepening insolvency. Rather, liability has been found only in cases where deepening insolvency is a claim in conjunction with a claim of self-dealing or fraud.



For More Information

For more information on this session or the sixth annual National Directors Institute, visit Foley.com/ndi2007 or contact the panelists directly.

Julia Darlow
Former board member, Internet Corporation
jdarlow@sbcglobal.net

Andrew Kramer
UBS Securities LLC
andrew.kramer@ubs.com

Keith Marchiando
Former CFO, DURA Automotive
kmarchiando@comcast.net

Judy O'Neill
Foley & Lardner LLP
joneill@foley.com

Michael Richman
Foley & Lardner LLP
mrichman@foley.com

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Save the date! The 7th Annual National Directors Institute will be held on March 6, 2008 in Chicago. Learn more at Foley.com/ndi.