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EXPERT ANALYSIS

Nearing the End Zone: Developments in The 'Zone of Insolvency'

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When a corporation collapses or encounters financial difficulty that impairs repayment of debt, corporate creditors often look for ways to hold corporate officers and directors — and their outside corporate advisers — responsible for their losses.

Over the past few decades, creditors have sought to expand their ability to bring such actions by arguing that fiduciary duties and/or derivative rights in their favor are triggered whenever a company enters the "vicinity" or "zone" of insolvency.

Such theories — if viable — could have significant consequences for these potential defendants, who are often involved in efforts to right the ship only to have those efforts second-guessed later.

While zone-of-insolvency theories had traction for a number of years, most courts now follow the lead of Delaware courts in rejecting them.

Under Delaware law it is now clear that:

- Directors do not owe direct fiduciary duties to creditors either before or after a company enters insolvency, although after a company becomes insolvent, creditors may pursue derivative actions to enforce fiduciary duties owed to the company.

- A company's entry into a mere "zone" or "vicinity" of insolvency does not create a freestanding fiduciary duty by officers to creditors; nor does that status afford creditors standing to pursue a derivative action for breach of fiduciary duty.

Put differently, under Delaware law, that a company is in the zone of insolvency is of no particular legal consequence from a fiduciary duty standpoint.

Some plaintiffs, however, continue to pursue claims based on zone-of-insolvency theories, and some courts outside of Delaware — generally without expressly considering Delaware law — have continued to assume or suggest that a company's presence in a zone of insolvency has some legal significance.

Officers, directors and their outside professionals should be aware that zone-of-insolvency theories continue to be pursued, while counsel defending against such theories should be aware of Delaware law's evolution on these issues, as Delaware law may prove persuasive to courts in other jurisdictions considering such theories.

THE ORIGIN OF ZONE-OF-INSOLVENCY THEORIES

As a general rule, corporations and their officers and directors do not owe direct fiduciary duties to corporate creditors.[1] However, a number of courts have found that where a corporation is insolvent, creditors join shareholders as stakeholders whose interests may be affected by corporate decision-making — and thus have standing to pursue officers and directors for alleged breach of fiduciary duty to the corporation.

Creditors may bring such actions either derivatively or, in some jurisdictions, on "constructive trust" or "trust fund" theories that corporate officers and directors owe a duty to creditors to avoid dissipation of the remaining assets.[2] These duties are sometimes described as limited and not generally intended to create a direct right of action for breach of fiduciary duty in favor of individual creditors.[3]

Against these general principles, the Delaware Chancery Court issued an opinion in 1991 called *Credit Lyonnais Bank Nederland v. Pathe Communications Corp.*, No. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991). The ruling was widely interpreted as suggesting that corporate directors owe fiduciary duties to creditors when a corporation is merely in the zone of insolvency rather than actually insolvent — and that such duties might be owed directly to creditors, rather than merely derivatively.

In language that has since been referred to as an "influential aside,"[4] the Delaware Chancery Court said, in part:

> At least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise. … The MGM board or its executive committee had an obligation to the community of interest that sustained the corporation, to exercise judgment in an informed, good faith effort to maximize the corporation's long-term wealth creating capacity.

Nationally, almost every court has rejected the notion that directors owe fiduciary duties to creditors while a company is in the "zone of insolvency."

The court further observed that when directors are "managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right … course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act."

Credit Lyonnais involved a dispute over the enforcement of a corporate governance agreement, not a determination of whether a direct tort claim for breach of fiduciary duty existed in favor of creditors.

Nevertheless, numerous courts around the country read the decision as support for the proposition that corporate directors and officers owed direct fiduciary duties to creditors if the company was within the nebulous vicinity or zone of insolvency, or that creditors might attain standing to bring a derivative claim for breach of fiduciary duty once a company entered a zone of insolvency.[5]

CLARIFICATION IN DELAWARE ON THE ZONE OF INSOLVENCY

As decisions recognizing a zone-of-insolvency fiduciary duty concept emerged around the country, another Delaware Chancery Court decision questioned the then-prevalent interpretation of *Credit Lyonnais*.

In *Production Resources Group LLC v. NCT Group Inc.*, 863 A.2d 772, 789 (Del. Ch. 2004), then-Vice Chancellor Leo Strine observed that there was no evidence the *Credit Lyonnais* decision was intended to create new fiduciary duties to creditors, and he expressed skepticism about whether creditors should be permitted to bring even derivative claims if a company is merely in the zone of insolvency.

That skepticism was validated by the 2007 Delaware Supreme Court decision in *North American Catholic Educational Programming Foundation Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007).

In *Gheewalla*, Delaware's highest court rejected the concept of zone-of-insolvency duties many courts believed *Credit Lyonnais* had recognized. Instead, it made clear that under Delaware law, directors do not owe a fiduciary duty to creditors based on a company's entrance into the zone of insolvency, adding that creditors would have only a derivative claim — not a direct right of action — for breach of fiduciary duty even if the corporation were actually insolvent.

The court explained, "When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: Directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners."

The Delaware Chancery Court has applied *Gheewalla* to reject claims based on zone-of-insolvency theories, stating that it is not "accurate any longer to say that the directors of an insolvent corporation owe fiduciary duties to creditors." *Quadrant Structured Prods. Co. v. Vertin*, 102 A.3d 155, 176 (Del. Ch. 2014). The court also said "there is no legally recognized 'zone of insolvency' with implications for fiduciary duty claims." *Quadrant Structured Prods. Co. v. Vertin*, 115 A.3d 535, 546 (Del. Ch. 2015).

CONTINUING UNCERTAINTY AND ITS CONSEQUENCES

Nationally, almost every court to consider zone-of-insolvency theories in light of *Gheewalla* has followed its reasoning and rejected the notion that directors owe fiduciary duties to creditors while a company is in the zone of insolvency.[6]

Despite this clear trend, some plaintiffs have continued to pursue claims based on such theories. These efforts continue — at least in part — because some courts have not yet revisited their pre-*Gheewalla* zone-of-insolvency case law.

While "zone of insolvency" theories had traction for a number of years, most courts now follow the lead of Delaware courts in rejecting them.

Further, since *Gheewalla*, some courts have continued to use the phrase in dicta, either as a synonym for "insolvency" or without express consideration of the changes in Delaware's case law.[7]

For example, an Arizona appeals court held that officer and director "fiduciary obligations can apply even to creditors when a corporation enters the zone of insolvency, without regard to the terms in the underlying contracts." *Dooley v. O'Brien*, 244 P.3d 586, 591 (Ariz. Ct. App. 2010).[8]

Other courts simply may be outliers in recognizing pre-insolvency duties. *Snyder Elec. Co. v. Fleming*, 305 N.W.2d 863, 869 (Minn. 1981) (pre-*Credit Lyonnais* case finding duty to creditors when company is on the "verge of insolvency").

For corporate officers and directors, the fact that some courts continue to invoke the phrase "zone of insolvency" may create continuing uncertainty.

The prospect that this phrase may have some significance can make it difficult for managers of a financially troubled company to predict to whom they owe duties, by whom they may be sued, and how competing duties should be balanced if a possible restructuring alternative could benefit shareholders but not creditors.

Those uncertainties may be compounded by what one federal court has described as the lack of precision and accepted definition for the term "zone of insolvency." *Kipperman v. Onex Corp.*, 411 B.R. 805, 844-45 (N.D. Ga. 2009).

These problems may also exist for outside professional advisers working with a financially troubled company in jurisdictions that recognize a tort for aiding and abetting a breach of fiduciary duty.

For example, in *Mukamal v. Bakes*, 383 B.R. 798 (S.D. Fla. 2007), a bankruptcy trustee sought to assert creditors' claims against the company's outside auditor on a theory that it aided and abetted breaches of fiduciary duty to creditors while the company was "insolvent and/or operating in the zone of insolvency."

The court in *Mukamal* rejected those claims relying in part on *Gheewalla*, but creditors might seek to pursue similarly framed aiding-and-abetting claims in jurisdictions that have not clearly rejected the zone-of-insolvency concept.[9]

CONCLUSION

Gheewalla dramatically reduced the prospect for successful litigation based on zone-of-insolvency theories, but corporate officers and directors as well as their outside professionals should be aware that not all courts have shut the door on such liability.

Likewise, counsel representing defendants against breach of fiduciary duty claims of this type would be well-advised to familiarize themselves with Delaware's case law on these issues, which they can cite as persuasive authority that the zone-of-insolvency concept should not be accorded legal significance.

NOTES

[1] *See Guth v. Loft Inc.*, 5 A.2d 503, 510 (Del. 1939) (such duties are owed to the corporation and to shareholders); *Geyer v. Ingersoll Publ'ns Co.*, 621 A.2d 784, 787 (Del. Ch. 1992); 18B Am. Jur. 2d Corporations § 1568 (West 2d ed. 2016) ("The statement that an officer or director is a fiduciary for the corporation's creditors is not true in a technical or general and unlimited sense.").

[2] *See, e.g., Musicland Holding Corp. v. Best Buy Co. (In re Musicland Holding Corp.),* 424 B.R. 95, 101 (Bankr. S.D.N.Y. 2010); *Claybrook v. Morris (In re Scott Acquisition Corp.),* 344 B.R. 283, 288-89 (Bankr. D. Del. 2006) (fiduciary duties owed to creditors during insolvency are typically "derivative of the duties owed" to the corporation itself); *Newsome v. Gallacher*, 722 F.3d 1257, 1266 (10th Cir. 2013); *FDIC v. Sea Pines Co.,* 692 F.2d 973, 976-77 (4th Cir. 1982); *Prod. Res. Grp. LLC v. NCT Grp.,* 863 A.2d 772, 790-91 (Del. Ch. 2004); *Baldi v. Lynch (In re McCook Metals LLC),* 319 B.R. 570, 595 (Bankr. N.D. Ill. 2005).

[3] William Meade Fletcher, Fletcher Cyclopedia Corporations § 1015 (Thomson Reuters 2015) ("Under the common law, a director of an insolvent corporation is deemed to be a trustee for it and its creditors."); *see also In re Ben Franklin Retail Stores Inc.*, 225 B.R. 646, 655 (Bankr. N.D. Ill. 1998) (explaining narrow scope of duty owed to creditors during insolvency).

[4] *Quadrant Structured Prods. Co. v. Vertin,* 102 A.3d 155, 173 (Del. Ch. 2014) (Laster, V.C.).

[5] *See, e.g., Carrieri v. Jobs.com Inc.,* 393 F.3d 508, 534 n.24 (5th Cir. 2004); *Kittay v. Flutie N.Y. Corp. (In re Flutie N.Y. Corp.),* 310 B.R. 31, 57 (Bankr. S.D.N.Y. 2004); *Gladstone v. Stuart Cinemas Inc.,* 878 A.2d 214 (Vt. 2005); *MC Asset Recovery LLC v. Southern Co.,* No. 06-cv-417, 2006 WL 5112612, at *7 (N.D. Ga. Dec. 11, 2006); *see also In re Healthco Int'l Inc.,* 208 B.R. 288 (Bankr. D. Mass. 1997) (describing duties at the "brink" of insolvency); *Official Comm. of Unsecured Creditors v. Fleet Retail Fin. Grp. (In re Hechinger Inv. Co.),* 274 B.R. 71, 89 (D. Del. 2002); *see also Bennett Restructuring Fund LP v. Hamburg*, No. X02CV010167682S, 2003 WL 178753, at *20 (Conn. Super. Ct. Jan. 2, 2003) (suggesting creditors might have standing to pursue a derivative action when company is in the zone of insolvency).

[6] *See, e.g., Tow v. Bulmahn*, No. 15-cv-3141, 2016 WL 1722246, at *8 (E.D. La. Apr. 29, 2016); *In re Bridgeview Aerosol LLC*, 538 B.R. 477, 502 (Bankr. N.D. Ill. 2015); *In re Tsai*, No. 13–bk–27391, 2014 WL 1154032, at *6 (Bankr. C.D. Cal. Mar. 19, 2014); *Newsome*, 722 F.3d at 1270; *Goodman v. H.I.G. Capital LLC (In re Gulf Fleet Holdings Inc.)*, 491 B.R. 747, 780 (Bankr. W.D. La. 2013); *In re Nat'l Century Fin. Enters.*, 846 F. Supp. 2d 828, 895 (S.D. Ohio 2012); *Sanford v. Waugh & Co.*, 328 S.W.3d 836, 844 (Tenn. 2010); *Master-Halco Inc. v. Scillia, Dowling & Natarelli LLC*, 739 F. Supp. 2d 100, 103-04 (D. Conn. 2010); *RSL Commc'ns PLC v. Bildirici*, 649 F. Supp. 2d 184 (S.D.N.Y. 2009); *In re Gen. Growth Props.*, 409 B.R. 43, 64 (Bankr. S.D.N.Y. 2009); *Milbank v. Holmes (In re TOCFHBI Inc.)*, 413 B.R. 523, 539 (Bankr. N.D. Tex. 2009) (officers and directors owe no duty to creditors in the "zone of insolvency"); *Berg & Berg Enters. LLC v. Boyle*, 178 Cal. App. 4th 1020, 1041 (Cal. Ct. App., 6th Dist. 2009); *Metcoff v. Lebovics*, 977 A.2d 285, 290 (Conn. Super. Ct. 2007).

[7] *Estate of Jackson v. Gen. Elec. Capital Corp. (In re Fundamental Long Term Care Inc.)*, 507 B.R. 359, 380-81 (Bankr. M.D. Fla. 2014); *Tow v. Amegy Bank*, 976 F. Supp. 2d 889, 904 (S.D. Tex. 2013) (suggesting either "zone of insolvency" or insolvency may suffice to trigger duties); *In re Rama Grp. of Cos.*, 496 B.R. 307, 314 (Bankr. W.D.N.Y. 2013); *Bachrach Clothing Inc. v. Bachrach (In re Bachrach Clothing Inc.)*, 480 B.R. 820, 828 (Bankr. N.D. Ill. 2012) (using "zone of insolvency" and "insolvent" interchangeably); *see also In re Sabine Oil & Gas Corp.*, 547 B.R. 503, 556-57 (Bankr. S.D.N.Y. 2016) (appearing to use "zone of insolvency" as synonym for insolvency); *N. Beacon 155 Assocs. LLC v. Mesirow Fin. Interim Mgmt. LLC*, 135 F. Supp. 3d 1, 6-7 (D. Mass. 2015) (citing *Quadrant* to describe a "zone of insolvency" theory of duty that appears to rely on actual insolvency).

[8] The case *Dooley* cited for this proposition spoke only of "insolvency," not a "zone of insolvency," *see Dawson v. Withycombe*, 163 P.3d 1034, 1057-58 (Ariz. Ct. App. 2007), and the court in *Dooley* did not suggest a deliberate intent to expand the scope of duties owed.

[9] At least one court has suggested that aiding-and-abetting claims against outside professionals on a "zone of insolvency" theory should not be permitted. *In re Rama Grp.*, 496 B.R. at 314 ("Activity within a zone of insolvency will impose special obligations upon corporate management, but not upon corporate counsel.")

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