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A Fresh Look into the Zone of Insolvency

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The existence of the zone of insolvency — that state of a corporation's being when the fiduciary responsibilities of officers and directors may expand to include other stakeholders — is well established in legal precedent. Less clear is how fiduciary obligations expand. This article focuses on issues governing that potential expansion in light of the decision in *N. Am. Cath. Educ. Programming Found., Inc. v. Gheewalla,* 930 A.2d 92 101-03 (Del. Sup. Ct. 2007).

While this article outlines sound management practices for officers and directors of a corporation in the zone and those who may be approaching the zone, recent court decisions out of Delaware may have caused some officers and directors to seek a potentially false "safe harbor" regarding these fiduciary obligations. Caution is advised. Given the Gheewalla decision and the current economic climate, many boards of directors controlled by financial sponsors may merit a re-examination of the zone, especially when looking into the future over the next 12 to 18 months.

According to VentureXpert, some 3,578 transactions were closed by financial sponsors

from January 1, 2004, to August 15, 2007. While many excesses may have been created during that go-go period, financial sponsors did many things right. To their credit, they established thoughtful and intentional corporate governance structures and practices that featured effectively designed boards to give guidance and counsel to officers and management. Those boards prominently feature independent directors.

Many of these corporations controlled by financial sponsors have not yet been through a restructuring, although many of them will need to in light of disappointing operating performance and other factors, includ ing the massive repricing of financial assets since August 2007 — an uncontrollable factor.

In a keynote presentation to the Association for Corporate Growth in June, the Parthenon Group's William Achtmeyer outlined $11 trillion in equity market value that vanished from the U.S. capital markets during 2008. Estimates of value that has eroded throughout the global financial systems go as high as $60 trillion. With the compression of multiples and valuations in the recalibrated world since September 2008, deals that made sense in the go-go times are way off market and out-of-whack in the new capital market realities of 2Q 2009.

Further, more than $1 trillion in debt is maturing over the next 18 months, and many boards controlled by financial sponsors are having tense and frank conversations about what to do next, as the soft broad economy, tight credit markets, and rapidly approaching debt maturities put many companies under pressure. While the credit markets have shown some modest signs of activity over the past few months, most of that activity has focused on the best and most creditworthy companies. Many enterprises continue to stare at grim prospects for refinancing debt as it comes due in a credit market that remains generally hostile to "story situations."

The fact is, given the 20-20 hindsight afforded later legal scrutiny to determine if a corporation was in the zone, if management and board members have questioned whether they are, the prudent course is to operate as if the company is in the zone. And given the realities of today's economy and the capital markets, a company that has debt

maturing in the next 18 months is likely to be at least approaching the zone. If its corporate debt is trading at a material discount (i.e., more than 20 percent discount to par), a company probably is well over that stark demarcation.

Independent directors especially need to use caution and seek guidance and protection in the zone, and corporate recovery professionals need to better understand the zone once again for two reasons: 1) to prepare prospective clients to "do the right thing," and 2) as an alternative strategy to enhance recoveries in a Chapter 11 proceeding.

Defining the Zone

Management and directors need to be aware if their company is approaching or crossing over into the zone of insolvency. Unfortunately, the very language used to describe this critical junction seems designed to foster uncertainty, if not litigation. Unlike Monday Night Football, there is no bright yellow line to measure progress toward the zone of insolvency. However, zone of insolvency obligations of management and directors were well established in *Credit Lyonnias Bank Nederland N.V. v. Pathe Communications Corp.,* No. 12150 Del.
Ch. Lexis 215 (Dec 30, 1991).

The two general tests for defining the zone of insolvency are more simply stated than applied and predate most of the zone of insolvency cases. One test asks whether a company's assets — "fairly valued" — exceed liabilities (note the valuation pitfall). The second test measures whether a company can meet its debt obligations as they become due in the ordinary course.

Before *Gheewalla,* some aggressive value investors attempted to leverage the zone of insolvency argument in situations in which bonds didn't mature for several years, arguing that the underlying business model that was used to secure the bond funding appeared to be faulting. Investors argued to "stop the madness" and turn over used cash. These efforts mostly failed.

Indeed, some issues surrounding the zone liabilities fell out of favor following a 2007

ruling by the Delaware Supreme Court that clarified and limited the scope of a director's duty when a corporation is operating in the zone. Specifically, in Gheewalla, the Supreme Court, in affirming the decision of the Delaware Chancery Court, held that regardless of whether a corporation is insolvent or operating in the zone of insolvency, creditors have no right, as a matter of law, to bring a direct claim for breach of fiduciary duty against the corporation's directors. The court reasoned as follows:

[T]he need for providing directors with definitive guidance compels us to hold that no direct claim for breach of fiduciary duties may be asserted by the creditors of a solvent corporation that is operating in the zone of insolvency. 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 their shareholders….

Gheewalla, 930 A.2d at 101.

Additionally, with regard to directors of a corporation that is insolvent, the court said:

Recognizing that directors of an insolvent corporation owe direct fiduciary duties to creditors, would create uncertainty for directors who have a fiduciary duty to exercise their business judgment in the best interest of the insolvent corporation. To recognize a new right for creditors to bring direct fiduciary claims against those directors would create a conflict between those directors' duty to maximize the value of the insolvent corporation for the benefit of all of those having an interest in it, and the newly recognized direct fiduciary duty to individual creditors. Directors of insolvent corporations must retain the freedom to engage in vigorous, good faith negotiations with individual creditors for the benefit of the corporation.

Gheewalla, 930 A2d at 103.

While *Gheewalla* holds that creditors do not have the right to pursue direct breach of fiduciary duty claims against directors of a corporation operating in the zone of

insolvency or actually insolvent, directors are not completely absolved from potential liability. Indeed, *Gheewalla* confirms that shareholders of a corporation in the zone of insolvency (thus “solvent”) have standing to prosecute derivative claims against directors for breach of fiduciary duty, among other claims. Further, when a corporation is insolvent, directors’ duties shift to the creditors, who then have standing to prosecute derivative claims against directors for breach of fiduciary duty.

Duty of Directors and Officers

Corporate directors and officers owe fiduciary duties to shareholders at all times, including the duty of care, the duty of loyalty, and the duty of good faith. The duty of care requires decision makers to act with the care that an ordinarily prudent person in a like position would exercise under the circumstances. The duty of loyalty requires management and directors to put the interests of the corporation above personal interests, and the duty of good faith requires directors and officers to deliberate the potential risk of harm to the corporation.

Directors and officers rely heavily on the business judgment rule to protect themselves in fulfilling their fiduciary obligations. Courts generally have been supportive of directors when decisions were made on a well-informed basis, in good faith, without self-interest, and in the honest belief that a decision was in the best interest of the corporation, its shareholders, and perhaps its other stakeholders (e.g. senior lenders, vendor creditors, leaseholders, other creditor constituencies, employees, unions, pensioners, customers, etc.).

A challenge facing many of these companies backed by financial sponsors is that their boards feature designees of the financial sponsors, and it may be difficult for many board members to overcome denial before it’s too late. If directors and officers are discussing “optionally value” for common equity, then one should bet that the corporation has crossed over the line and should be acting in a full zone of insolvency mode. In 20-20 litigation hindsight, it’s a safe bet that those discussions will be under attack at least by testing the duty of loyalty and good faith.

The U.S. Bankruptcy Court for the District of Delaware recently addressed issues surrounding a director's duty of care, loyalty, and good faith in its decision in *In re Bridgeport Holdings, Inc.,* 388 B.R. 548 (Del. Bankr. 2008). In *Bridgeport,* the Bankruptcy Court refused to dismiss a complaint filed by a liquidating trustee against the corporation's former directors and officers that alleged, among other things, that the directors and officers, including a corporate recovery professional retained by the board, breached their duty to the corporation when they approved a sale of a substantial portion of the corporation's assets prior to a Chapter 11 filing.

The court reasoned that the complaint sufficiently pled a number of causes of action against the directors and officers, because, among other things, rather than commencing a competitive bidding process for the assets prior to the petition date, the board simply permitted the corporate recovery professional to conduct a "fire sale" of the corporation's core business. See *id.* at 563-565.

Indeed, the court stated, "Taking the facts alleged as true and viewing all inferences in the light most favorable to the trust, the allegations support the claim that the D&O Defendants breached their fiduciary duty of loyalty and failed to act in good faith by abdicating crucial decision-making authority to (the corporate recovery professional) and then failing adequately to monitor his execution of a 'sell strategy' resulting in an abbreviated and uninformed sale process...."

The *Bridgeport* decision confirms that directors and officers remain vulnerable when making decisions for corporations in precarious financial condition, whether the companies are in the zone or actually insolvent.

Protecting Directors and Officers

The following are steps that corporate officers and directors can take to help protect themselves in the zone of insolvency.

Get Outside Perspective. Despite the obvious potential self-serving nature of this recommendation, the need for advice from outside professionals has never been greater

during the last quarter century. These are trying times, and in many ways financial sponsored enterprises are facing unprecedented challenges in unchartered territory. Pulling together a seasoned team of lawyers, financial advisors, interim managers, investment bankers, and communication specialists is prudent for managing the perils of the zone.

Increase Transparency. The very ability to survive an unexpected negative development may depend on the credibility a company preserves with senior lenders. Too often management and the directors are worried about "spinning" bad news to the lender group, as if theirs were the only entity in peril. "Sunlight is the best disinfectant," U.S. Supreme Court Justice Louis Brandeis said famously, and it refers to the benefits of openness and transparency that may be critical in preserving value and allowing time with senior lenders.

Document, Document, Document. The business judgment rule can protect officers and directors, but they must be careful to build a complete paper trail. Again, collecting materials from well credentialed third parties that directors considered in making their decisions in the zone will be useful.

Focus on Cash Flow. Cash is king is a sublimely obvious statement often seen in discussions involving Chapter 11 in *The Journal of Corporate Renewal.* But well before a formal filing for protection, a renewed vigor and discipline on the cash flow exercise may pay huge dividends for financial sponsors. Often corporate recovery professionals face situations in which a vexing combination of unfounded optimism and stubborn denial has forced companies down less attractive paths because they lacked sufficient liquidity to run an effective restructuring process.

Share the Bad News. Officers and directors should think about how to communicate with valuable employees, critical vendors, and top customers as they operate in the zone of insolvency. Understanding the interrelation between the business and the rest of the stakeholders will lower risk and improve survival prospects.

Proceed with Caution

In many ways, zone of insolvency issues are interrelated to the strict priority rule and who are, in fact, the "owners" of a corporation. Where grey areas exist in determining the ultimate outcome of a process, officers and directors may rely on the business judgment rule for comfort and solace, but they should be careful not to rely too heavily on *Gheewalla* for safe harbor.

When boards have conflicting and alternative agendas, officers and directors should be aware that bankruptcy courts may be more aggressive in applying zone of insolvency rules in a manner more directly detrimental to the financial sponsor.

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