UPDATE ON FIDUCIARIES AND ZONE OF INSOLVENCY
SATURDAY, MARCH 20, 2010 AT 10:40

A. Duties of directors and officers of insolvent corporations under Delaware and other state law

1. Generally corporate directors and officers of a solvent corporation owe fiduciary duties to the corporation and to shareholders, but not to creditors.

a. Duty of Care – Directors and officers must exercise the amount of care that an ordinary prudent businessperson would exercise under similar situations and must consider all available material information in making business decisions.

b. Duty of Loyalty – Directors and officers must act in the best interests of the corporation and must not engage in self dealing or usurp corporate opportunities.

c. Business Judgment Rule – Presumption that directors and officers act in good faith and in the honest belief that their actions are in the best interests of the corporation.

2. When a corporation is insolvent, or enters the "zone of insolvency," the fiduciary duties normally owed to shareholders may shift to creditors as the residual stakeholders. *See, e.g., Unsecured Creditors Comm. of Debtor STN Enters., Inc. v. Noyes (In re STN Enters.)*, 779 F.2d 901, 904 (2d Cir. 1985); *FDIC v. Sea Pines Co.*, 692 F.2d 973, 976-77 (4th Cir. 1982); *Credit Lyonnais Bank Nederland v. Pathe Communications Corp.*, 17 Del. J. Corp. L. 1099. 1155 n.55, 1991 WL 277613 (Del. Ch. 1991)

a. Determining insolvency

i. Balance sheet insolvency – A corporation is insolvent under the balance sheet test when its liabilities exceed the value of its assets.

ii. Equitable/cash flow insolvency – A corporation is insolvent under the equitable insolvency test when it is unable to pay its debts as they come due in the ordinary course of business.

B. Recent developments in case law have limited the scope of fiduciary duties owed to Creditors

1. *Production Resources Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772 (Del. Ch. 2004)

a. Creditor claims for breach of fiduciary duty based upon alleged mismanagement or lack of oversight resulting in a loss of value to the

corporation are derivative claims asserted on behalf of all creditors, not direct claims of particularized injury to a single creditor. As such, statutorily authorized exculpation provisions in a corporate charter may prevent creditors from asserting such claims.

b. Unlike shareholders, creditors do not have a direct claim for breach of the fiduciary duty of loyalty simply because the actions of directors ultimately favor one creditor or group of creditors over others. Corporate directors must retain the ability to engage in "vigorous, good-faith negotiations with [creditors]" in balancing the interests of all those with a claim to the firm's inadequate assets.

2. *Trenwick America Litigation Trust v. Ernst & Young L.L.P.*, 906 A.2d 168 n. 75 (Del. Ch. 2006) judgment aff'd 931 A.2d 438 (Del. 2007)

a. Directors of an insolvent corporation have a duty to "manage the enterprise to maximize its value so that the firm can meet as many of its obligations to creditors as possible," however, "insolvencey does not suddenly turn directors into mere collection agents." Upon insolvency, creditors simply "become the enforcement agents of fiduciary duties because the corporation's wallet cannot handle the legal obligations owed."

b. Whether a corporation is solvent or insolvent, the notion that the directors should pursue the best interests of residual stakeholders (shareholders when solvent, creditors when insolvent) "does not prevent them from making a myriad of judgments about how generous or stingy to be to other corporate constituencies in areas where there is no precise legal obligation to those constituencies."

c. "[T]he business judgment rule protects the directors of solvent, barely solvent, and insolvent corporations, and [ ] the creditors of an insolvent firm have no greater right to challenge a disinterested, good faith business decision than the stockholders of a solvent firm."

3. *North American Catholic Educational Programming Found., Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007)

a. Creditors have no direct claims as a matter of Delaware law for breach of fiduciary duty, even when corporation is insolvent.

b. Creditors cannot assert derivative claims for breach of fiduciary duty unless the corporation is insolvent.

4. *Berg & Berg Enter., LLC v. Boyle*, 178 Cal. App. 4th 1020 (Cal. App. 2009)

a. Under California law, "there is no broad, paramount fiduciary duty of due care or loyalty that directors of an insolvent corporation owe the

corporation's creditors solely because of a state of insolvency." Instead, "the scope of any extracontractual duty owed by corporate directors to the insolvent corporation's creditors is limited in California . . . *to the avoidance of actions that divert, dissipate, or unduly risk corporate assets that might otherwise be used to pay creditors claims*" (emphasis in original).

b. Because the existence of a zone or vicinity of insolvency is difficult to objectively determine, "there is no fiduciary duty prescribed under California law that is owed to creditors by directors of a corporation solely by virtue of its operating in the 'zone' or 'vincinity' of insolvency."

C. Claims against director's and officer's ("D&O") liability policies:

1. Are insurance policies property of the estate and subject to the automatic stay?

a. Courts generally hold that D&O insurance policies themselves are assets of the estate. However, they are divided on whether the proceeds from D&O policies are property of the estate.

i. D&O policies often contain three separate types of coverage:

(A) "Side A" coverage provides direct coverage to directors and officers where the corporation has not or will not indemnify them.

(B) "Side B" coverage provides covers the corporation for payments it makes to indemnify directors and officers.

(C) "Entity" or "Side C" coverage covers losses resulting from direct claims against the corporation on the basis of director and officer conduct (i.e. claims for violation of securities laws).

ii. It is not uncommon for Side A, Side B and Entity Coverage to be subject to a single policy limit.

b. Where an action threatens only that portion of the D&O policy that provides direct coverage to directors and officers (Side A) and does not threaten to exhaust Side B or Entity coverage to which the debtor may be entitled (based upon a reasonable expectation of loss rather than a hypothetical contingency), courts have found that D&O insurance proceeds are not property of the bankruptcy estate because they are payable to (and owned by) the directors and officers themselves, rather than the corporation. *See In re Louisiana World Exposition, Inc.*, 832 F.2d 1391, 1399 (5th Cir. 1987); *In re Allied Digital Technologies Corp.*, 306 B.R. 505, 512-13; *In re Adelphia Comm. Corp.*, 298 B.R. 49, 53-54 (S.D.N.Y. 2003).

c. Conversely, where a D&O policy provides direct coverage to the debtor as well as directors and officers, the general rule is that the insurance proceeds are property of the estate where they may be payable to the debtor. *Allied Digital*, 306 B.R. at 511 ("A debtor's interest in the proceeds requires protection from depletion and overrides the interest of the directors and officers.") (citing *In re Sacred Heart Hosp. of Norristown*, 182 B.R. 413, 419-420 (Bankr. E.D. Pa. 1995)); *see also In re Vitek, Inc.*, 51 F.3d 530, 534-35 (5th Cir. 1995) ("Faced with the typical situation in which a debtor corporation's liability policies provided the debtor and thus the estate with direct coverage against third party claims, virtually every court to have considered the issue has concluded that the policies-and clearly the proceeds of those policies-are part of the debtor's bankruptcy estate, irrespective of whether those policies also provide liability coverage for the debtors directors and officers").

2. Lifting the automatic stay so that directors and officers can access policy proceeds

a. Even where D&O policy proceeds are found to be property of the estate, courts have shown a willingness to lift the automatic stay to allow directors and officers access to coverage in order to avoid inequitable results. *See In re Cybermedica, Inc.*, 280 B.R. 12, 17-18 (Bankr. D. Mass. 2002) (lifting stay to avoid substantial and irreparable harm that would otherwise occur if directors could not exercise their rights to defense payments and where debtor had no pending claims for indemnification or entity coverage).

b. Courts have also lifted the automatic stay based upon priority of payment provisions in some D&O policies which provide that, if claims are likely to exceed the policy limit, proceeds are to be paid in satisfaction of claims for Side A coverage prior to claims for Side B or Entity coverage. *See In Re Refco Inc.*, No 05-60006 (Bankr. S.D.N.Y. March 27, 2006) (order granting relief from automatic stay, Docket No. 1567).

3. Courts have reached differing results on the question of whether they may use their equitable powers under section 105 of the Bankruptcy Code to extend the automatic stay in order to preserve access to a D&O policy for the benefit of the debtor's estate.

a. Injunction not available

i. Courts finding that a section 105 injunction is unavailable have done so in cases where a third party's claims against directors or officers are separate and distinct from the injury suffered by the debtor corporation. *See In re Reliance Acceptance Group, Inc.*, 235 B.R. 548 (D. Del. 1999) (finding shareholder claims against directors for securities law violations were fundamentally different from the debtor estate's claims for breaches of fiduciary duty based

on mismanagement and declining to issue an injunction under section 105 on the basis that no legal principal supported the estate's position that its claims against the directors should take precedence over the shareholders' claims with respect to the insurance proceeds); *In re Enivid, Inc.*, 364 B.R. 139 (D. Mass. 2007)(same).

b. Injunction available

i. Alternatively, courts finding that a section 105 injunction is available have reasoned that, although D&O proceeds may not be property of the estate, the distribution of those proceeds may have the affect of reducing assets available to the estate and thus a third party proceeding which threatens the proceeds is sufficiently "related to" the bankruptcy case to allow the court to issue the injunction. *See Megliola v. Maxwell*, 293 B.R. 443 (N.D. Ill. 2003); Courts have also enjoined third party actions where the policy itself provides a necessary benefit to the estate. *See In re Adelphia Comm. Corp.*, 302 B.R. 439 (Bankr. S.D.N.Y. 2003) (enjoining insurers from proceeding with declaratory action seeking a determination that policies were rescinded).

D. Tips for advising boards

1. Goals

a. Maintain optionality

b. Continuous evaluation of options

c. Simultaneous pursuit of as many options as possible so as to maximize value

2. Means of implementation

a. Regular meetings

b. Diligent inquiry

c. Retain professional advisors to assist in evaluating options and their impact with respect to various constituencies

d. Maintain documentation of decision making process