

CAUTION: ARE YOU APPROACHING THE ZONE OF INSOLVENCY?

Inquiry: In the Ninth Circuit and under the laws of the State of Nevada, what, if any, fiduciary duties do corporate directors owe to a corporation's creditors in the "zone," or "vicinity," of insolvency?

Summary: In all probability, Nevada law would recognize that, when a corporation is in the "zone," or "vicinity," of insolvency, a director owes the same fiduciary duties to the corporate creditors as he does to corporate shareholders when the corporation is solvent. Reviewing case law to determine when the transition from solvency to "zone," or "vicinity," of insolvency, is merited.

Please note, at the outset, that directors for a debtor in possession owe the same fiduciary duties to a corporation's creditors in bankruptcy as does a trustee for a debtor out of possession. *See Wolf v. Weinstein*, 372 U.S. 633, 649-50 (1963); *see also Pepper v. Litton*, 308 U.S. 295, 306-07 (1939) (noting that, in bankruptcy, a director carries a fiduciary obligation "designed for the protection of the entire community of interests in the corporation – creditors as well as stockholders") (internal citation omitted); *Smith v. Arthur Andersen LLP*, 421 F.3d 989, 1005-06 (9th Cir. 2005) (discussing the "insolvency exception" under which directors of an insolvent corporation owe fiduciary duties to the corporation's creditors, thereby affording creditors standing to pursue derivative claims for a breach thereof, causing economic harm to the corporation, leading to a loss of corporate assets and diminishing of corporate value); *In re JTS Corp.*, 305 B.R. 529, 538-40 (Bankr. N.D. Cal. 2003) (discussing how, under Delaware law, the insolvency exception is in place because creditors need protection where the risk of loss shifts from the shareholders to the creditors upon insolvency, and that a directors' decisions during insolvency can affect the corporation's ability to make good on its debt).

The Court of Chancery of Delaware first recognized the concept of the "zone," or "vicinity," of insolvency in *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, Civ. A. No. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991), explaining that

directors will recognize that in[,] managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right (both the efficient and the fair) 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 [based on the "community of interests that the corporation represents."]

Id. at * 34 n.55 (emphasis added).

Unfortunately, Nevada state courts have yet to recognize this concept (or, for that matter, adjudicate any claims involving a director's fiduciary duties owed to the corporation and its creditors/shareholders in bankruptcy). However, courts within the jurisdictional

boundaries of the Ninth Circuit have made passing reference to, and in certain instances, shed light upon, the concept of the “zone,” or “vicinity,” of insolvency relative to a director’s fiduciary duties owed to a corporation’s creditors. The following delineates how, and to what extent, courts within the Ninth Circuit have discussed and/or recognized the issue.

First, in *In re AgriBioTech, Inc.*, 319 B.R. 216 (D. Nev. 2004), the court considered (and denied) a motion for summary judgment filed by the corporation’s former outside accountant against claims brought by the bankruptcy trustee acting on behalf of non-debtor third parties. *Id.* at 218, 224-25. The accountant maintained that the trustee did not have standing, as a matter of law, to pursue claims not belonging to the debtor’s estate. *Id.* The court acknowledged that the Ninth Circuit has previously recognized that state law permits a trustee to pursue general creditor claims which “serv[e] the orderly and equitable distribution of the bankrupt’s assets,” but not personal claims on behalf of individual creditors “where the estate has no interest in the claims.” *Id.* at 221. Significant to the instant matter, the court permitted, *inter alia*, the trustee to pursue a claim that the corporation’s “officers and directors breached the fiduciary duties they owed to [the corporation], and while in the vicinity of insolvency, to [the corporation’s] creditors.” *Id.* at 222 (citing to *Pepper*, 308 U.S. at 306-07, in support hereof) (emphasis added).

Therefore, it is implicit from the court’s decision in *AgribioTech* to grant the trustee standing to pursue a claim relative to a director’s breach of fiduciary obligation owed to the corporation’s creditors in the “vicinity of insolvency,” that the Ninth Circuit (and, in all probability, Nevada state courts) would recognize this concept and claim for relief.

In *In re Mortgage & Realty Trust*, 195 B.R. 740 (Bankr. C.D. Cal. 1996) the court analyzed, in the context of an attorney who formerly served as director of a corporation prior to its reorganization, whether the attorney’s law firm could represent an adversary challenging a proceeding to set aside a post-petition sale by the debtor-corporation to the adversary. *Id.* at 744-46. With respect to the fiduciary duties of a director of a corporation, the court noted, “[T]he fiduciary duties of a corporate director are expanded to include creditors when a corporation becomes insolvent.” *Id.* at 750 (citing to, among other cases, *Credit Lyonnais Bank Nederland* for the proposition that directors owe fiduciary duties to creditors when the corporation is in the “vicinity of insolvency”). The court explained that, “[i]t is the time of insolvency, not the time of the filing of a bankruptcy case, that determines the ripening of these additional fiduciary duties.” *Id.* Wherefore the court found, *inter alia*, that the attorney had owed fiduciary duties to the debtor-corporation and its creditors during insolvency as former director of the debtor-corporation. *Id.* at 751.

In *Mann v. GTCR Golder Rauner, L.L.C.*, 483 F. Supp. 2d 884 (D. Ariz. 2007), the court considered a motion for summary judgment brought by the defendants (majority shareholders, directors and officers) against claims initially pursued by the bankruptcy trustee and minority shareholders for violation of fiduciary duties under Delaware law. *Id.* at 889, 892. The defendants challenged the individual employees for lack of standing, maintaining that their claims were derivative and therefore, could only be brought by the

trustee. *E.g., id.* at 893. The court ultimately found, after a lengthy discussion, that the individual minority shareholders failed to prove a direct injury independent of any injury to the corporation. *Id.* at 899. However, the court did discuss and apply Delaware law, and made reference to plaintiff's claim based thereupon that directors owe fiduciary duties to creditors in the "vicinity of insolvency." *See id.* at 895.

In *In re Bonilla*, Nos. 07-30309 TEC, 07-3079 TC, 2007 WL 4556913 (Bankr. N.D. Cal. Dec. 17, 2007), the court offered the following observation with respect to relevant Delaware law on the concept of a director's fiduciary duties owed to a corporation's creditors during insolvency:

It is well settled that directors owe fiduciary duties to the corporation. When a corporation is solvent, those duties may be enforced by its shareholders, who have standing to bring derivative actions on behalf of the corporation because they are the ultimate beneficiaries of the corporation's growth and increased value. When a corporation is insolvent, however, its creditors take the place of the shareholders as the residual beneficiaries of any increase in value.

Consequently, the creditors of an insolvent corporation have standing to maintain derivative claims against directors on behalf of the corporation for breaches of fiduciary duties. The corporation's insolvency "makes the creditors the principal constituency injured by any fiduciary breaches that diminish the firm's value."

Id. at *1 (quoting *N.A. Catholic Educational Programming Foundation, Inc., v. Gheewalla*, 930 A.2d 92,101-02 (Del. 2007) (emphasis and quotations in original) (footnotes omitted)).

The following case is not available for citation purposes; notwithstanding, the case offers further guidance and observation on whether courts in the Ninth Circuit recognize the concept of the "zone," or "vicinity," of insolvency relative to duties owed by a director to a corporation's creditors. In *Official Committee of Bond Holders of Metricom, Inc. v. Derrickson*, No. C 02-04756 JF, 2004 WL 2151336 (N.D. Cal. Feb. 25, 2004), plaintiffs (creditors of the bankrupt corporation) brought an action alleging, *inter alia*, that the directors breached their fiduciary duties while the corporation was in the "zone of insolvency" through misappropriation and depletion of corporate resources because the directors were influenced by a majority shareholder with interests adverse to those of the creditors. *Id.* at *1. Applying Delaware law, the court set forth the following jurisprudence relative hereto:

Typically, directors do not owe fiduciary duties to creditors because the relationship between debtor and creditor is contractual in nature. "At the moment a corporation becomes insolvent, however, the insolvency triggers fiduciary duties for directors for the benefit of creditors." Such duties exist when a company becomes "insolvent in fact"; that is, when it

is within the “zone” or “vicinity” or insolvency, a poorly defined state that may exist when “the corporation cannot generate and/or obtain enough cash to pay for its projected obligations and fund its business requirements for working capital and capital expenditures with a reasonable cushion to cover the variability of its business needs over time.” “[C]reditors have a right to expect that directors will not divert, dissipate or unduly risk assets necessary to satisfy their claims.” Notably, “in insolvency the duty runs not directly to the creditors but to the ‘community of interest.’” Thus, “while this duty does not necessarily place creditor interests ahead of the interests of stockholders, it requires the board to maximize the corporation's long-term wealth creating capacity.”

Id. at *3 (internal citations and references omitted) (emphasis added). The court ultimately dismissed the breach of fiduciary duties’ claim because the plaintiffs failed to articulate a cognizable claim for relief and/or plead particularized facts beyond generalized, merely conclusive assertions. *Id.* at *3-*4.

Of interest in *Official Committee of Bond Holders of Metricom* is that the court found that the plaintiffs had failed to plead facts indicating that the corporation had entered the “zone of insolvency.” *Id.* at *5-*7. The court noted that it was insufficient to simply assert that the corporation has entered the “zone of insolvency,” based on the deteriorating financial markets, the corporation’s inability to secure funding to support operation, and failure to generate significant revenues. *Id.* at *5. The court determined that, though the corporation admitted experiencing financial difficulties, nothing indicated, at the time, that the corporation was unable to acquire working capital to cover its business needs. *Id.* at *6. Plaintiffs also failed to suggest that the corporation was not operating according to its general business plan. *Id.* The court did note that asserting that the company “bl[ed] . . . its cash reserves at the rate of \$50-70 million per month for expenses that were of no use to the company” supported that money was inappropriately spent after the corporation entered the zone of insolvency, but failed to indicate when this transition occurred. *Id.*

Based on the foregoing, I would submit that, in the event a claim is pursued either in District Court in Nevada, or, in the U.S. District Court for the District of Nevada, the court, in all likelihood, would recognize that a director owes the same fiduciary duties to a corporation’s creditors in the “zone,” or “vicinity,” of insolvency as he or she owes the corporation, and its shareholders, when solvent. The underlying inquiry thus becomes when the transition occurs from solvency to “zone,” or “vicinity,” of insolvency, because case law suggests that, upon said transition, courts permit the creditors to pursue derivative claims against the directors for a breach of their fiduciary duties. However, case law from the Ninth Circuit, with the exception to the unreported case discussed above, did not delve into the circumstances that constitute or encompass the “zone,” or “vicinity,” of insolvency. Therefore, attention is warranted to ascertain when Delaware law considers a corporation to be in the “zone,” or “vicinity,” of insolvency.