

## Directors' Duties for Corporations Near Insolvency

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Ordinarily, directors of a corporation owe a fiduciary duty of care and loyalty to the corporation and its shareholders. The director's decisions are subject to a broad "business judgment rule," which acts to protect directors from second-guessing by shareholders or others. However, directors need to be aware that they may owe certain fiduciary duties to the corporation's creditors, rather than its shareholders, if, depending on the corporation's state of incorporation, (a) the corporation enters into a "zone of insolvency," (b) if the corporation actually becomes "insolvent," and (c) the corporation files a petition in bankruptcy court. Moreover, depending on what the corporation's articles and bylaws provide regarding director indemnification and exculpation, failure to follow the correct principles may subject the directors to either direct or derivative claims of breach of duty and liability from creditors or other third parties.

### **Director Duties in the "Zone of Insolvency"**

As a legal matter, in most jurisdictions a corporation is insolvent when either (1) its current liabilities exceed its current assets with no reasonable prospect that the business can be successfully continued, or (2) it is unable to meet its maturing obligations as they come due in the ordinary course of business. But there has also been considerable litigation concerning corporations operating in the "zone of insolvency," i.e., technically solvent but facing a reasonable foreseeability of soon becoming insolvent.

Fortunately, both Michigan and Delaware courts have pronounced that so long as the corporation is not actually insolvent, even if it is operating in the amorphous zone of insolvency, the directors owe their fiduciary duties to the corporation and its shareholders. The directors do not owe their duties to the corporation's creditors, which may already be protected through contractual agreements, fraud and fraudulent conveyance law, implied covenants of good faith and fair dealing, bankruptcy law, commercial law, and other sources. But the 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."

While Delaware affords creditors additional protection when the corporation is insolvent, Michigan law does not, placing the initial burden on creditors to contract for rights and protection during negotiations.

### **Director Duties when a Corporation is "Insolvent"**

What happens when the corporation actually becomes insolvent, pursuant to the legal definition above (but before a filing in bankruptcy court)?

For Michigan corporations, the rule is the same: directors do not owe a fiduciary duty to creditors of the corporation and do not hold corporate assets for the benefit of creditors as trustees; they owe their fiduciary duties to the corporation and its shareholders. However, of course, Michigan law still imposes limitations on when corporations can make distributions to its shareholders.

For Delaware corporations, the rule is similar, but with a twist. Under a recent Delaware Supreme Court decision, the court made it clear that, of course, directors still owe their fiduciary duties to the corporation, and also made it clear

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that creditors do not have the right to file direct actions against directors who are not acting in the best interests of particular creditors.

However, the Delaware court still allowed creditors to bring derivative claims for breach of fiduciary duty to redress harm done to the corporation, under the theory that once a corporation becomes insolvent, its creditors become the principal beneficiaries of the directors' decisions. But in a derivative action, any recovery belongs to the corporation (while in a direct action, damages are paid to the plaintiff). Moreover, because Delaware law allows corporations to indemnify and exculpate directors contractually and through articles/bylaws provisions, and because Delaware court rules make it more difficult to initiate and prove a derivative action, directors are less exposed to liability from creditor-initiated derivative actions.

Other states, such as New York, still adhere to a "trust fund" doctrine of director fiduciary duties. According to this doctrine, the corporate assets of an insolvent corporation are a "trust fund" for the benefit of the corporation's creditors, which the directors have a duty to protect as if trustees for the creditors.

Notwithstanding the above, directors should also be aware of an emerging legal theory which may give creditors another basis of argument for recovery against directors of insolvent corporations, known as "deepening insolvency." Under this theory, the corporation's directors, officers, and controlling shareholders are liable to the corporation's creditors if, after becoming insolvent, or even while in the zone of insolvency, the corporation prolongs its business operations while its value continues to drop to the detriment of the creditors.

A recent case in Delaware has rejected the deepening insolvency theory as an independent cause of action.<sup>1</sup> In that case, the court noted that Delaware law does not require an insolvent corporation's board to cease operations and liquidate, but rather allows a board to pursue, in good faith, strategies to maximize the value of the firm. So long as the board meets its obligations under the business judgment rule, it will be protected and does not become the "guarantor of [its] strategy's success." Ultimately, the board's action will be judged against its fiduciary duties as they currently stand under Delaware law, but directors can rest assured that there will not be another layer of second-guessing by way of a deepening insolvency action.

In Michigan, however, a 2004 decision of the Michigan Court of Appeals seems to have left open the possibility of a deepening insolvency claim as a basis of recovery.<sup>2</sup>

In any case, given the crisis in the financial markets today, and depending on the particular facts in a case, directors need to be aware of the possibility that this legal theory, among others, may find a sympathetic ear in Michigan courtrooms.

### **Director Duties when a Corporation is in Bankruptcy**

Upon the filing and during the pendency of the bankruptcy process, virtually all major decisions made by the corporation's board are scrutinized and approved by the court. Indeed, the Bankruptcy Code requires the board to seek approval prior to taking any action outside the ordinary course of business. By statute, the directors of a Chapter 11

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corporation become trustees of the estate created by the bankruptcy and are required to act as such. Thus, the nature of a director's fiduciary duty changes "from helmsman to guardian," and as a practical matter, rather than argue over whether the duty is owed primarily to creditors or shareholders or other interested parties, such conflict is avoided by seeking court approval of all significant decisions.

### **A Few Recommendations**

In these financially turbulent times, it may be worthwhile for directors to consider and pay special attention to the following:

- Understand what a director's fiduciary duties are in your particular jurisdiction, and to whom such duties are owed.
- Be aware of the financial situation of your corporation; whether it is near insolvency or actually insolvent, even if a bankruptcy filing is not imminent.
- Review director protections afforded by law, as well as by the corporation's articles, bylaws, contracts and insurance policies, and make sure they are updated and accurate.
- Ensure that director board and committee actions are properly recorded in the minutes.
- Consult with legal counsel if you have any questions.

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<sup>1</sup> *Trenwick America Litigation Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168 (Del. Ch. 2006), *aff'd*, 931 A.2d 438 (Del. 2007).

<sup>2</sup> *MCA Financial Corp. v. Grant Thornton, L.L.P.*, 263 Mich.App. 152 (2004).