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Corporate Duties Rise When Companies Enter the Zone of Insolvency

by BARRETT HOWELL and PHILLIP LAMBERSON

Hypothetical Company Inc. (HCI) is in desperate need of cash, and its board of directors decides to raise capital by selling some of the company's underutilized assets. HCI conducts an expedited search for a buyer, but because of the distressed economic environment, cannot find one offering a reasonable price. Nonetheless, the board ultimately decides to accept the only offer received. All of HCI's equity holders support the proposed transaction, since their equity, in all likelihood, would be wiped out if HCI files bankruptcy, and the cash generated by the asset sale allows HCI to survive a little longer. HCI's largest creditor, however, vehemently opposes the transaction, claiming the price is insufficient and the assets should be sold in a lengthier process, even if that means filing bankruptcy. Despite the creditor's opposition, HCI's counsel concludes that the board faces very little exposure, since all of HCI's equity holders support the transaction. Is HCI's counsel correct or misguided?

HCI's counsel very likely provided incorrect advice or at least did not consider the board's potential liability broadly enough. As all lawyers know, corporate officers and directors owe fiduciary duties to their corporations. Hence, the right to bring a cause of action against officers and directors for breaches of fiduciary duties belongs to the corporation. In general, only equity holders may derivatively pursue breach of fiduciary duty claims. Creditors, on the other hand, typically lack standing to assert derivative claims, a fact that makes sense given the contractual relationship between the company and its creditors. Unlike equity holders, creditors have the ability to protect themselves through the negotiation process and ultimately by requiring protective provisions in their agreement with the company.

General rules aside, officers and directors of an insolvent company have expanded fiduciary duties that run to the company's creditors, in addition to shareholders. As the 5th Circuit explained in *Carrieri v. Jobs.com* in 2004, officers and directors who "are aware that the corporation is insolvent, or within the 'zone of insolvency' . . . have expanded fiduciary duties to include the creditors of the corporation." In other words, when a company enters the zone of insolvency, members of the board of directors owe fiduciary duties to creditors, who have standing to assert derivative claims based on alleged breaches of those duties. Significantly, a company does not have to actually be insolvent before the expanded fiduciary duties are triggered; rather, it merely has to be in the "zone of insolvency."

A company's solvency is most commonly determined by comparing the value of the company's assets to the sum of its liabilities, or what is commonly referred to as balance sheet insolvency. In the litigation context, this

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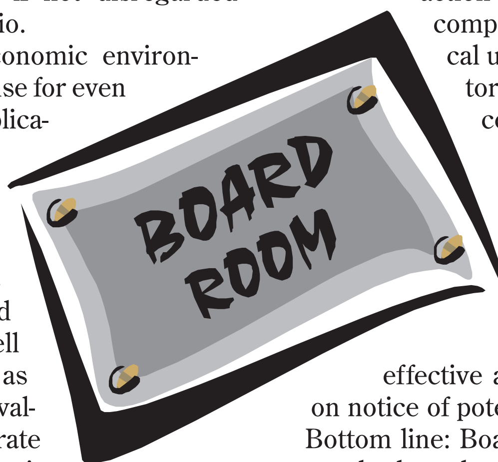
analysis is almost always conducted with the benefit of hindsight. Lawyers for boards of directors should, therefore, advise their client to be wary of unquestioningly relying on the balance sheet or book value of assets and liabilities, which are determined in accordance with generally accepted accounting principles. Directors should also consider whether the value of certain balance sheet items, such as intangible assets, would be substantially lowered, if not disregarded altogether, in a liquidation scenario.

Furthermore, the current economic environment gives corporate directors cause for even greater awareness about the implications the zone of insolvency has on their fiduciary duties. Nearly all asset classes have lost value over the last several months, and many financial assets, such as mortgage-backed securities and commercial debt obligations, as well as commodity-based assets, such as oil and gas assets, have seen their values decimated. Analyzing a corporate decision in this distressed economic environment places even more pressure on directors to ensure they have updated, timely, and — above all — realistic information regarding their company's solvency.



Creditors' Interests

Performing a realistic evaluation of the company's solvency is only the first part of the board's analysis. If the board believes the company is near the zone of insolvency, then the directors must consider creditors' interests in connection with management of the company, and whether creditor involvement in significant corporate decisions is appropriate. Directors may feel that creditor involvement presents somewhat of a Pandora's Box if the creditors disagree with the board's decision. Engaging creditors early in the process, however, might help avoid creditor-driven derivative claims based on alleged breaches of fiduciary duties while the company was in the zone of insolvency. Even if directors later find themselves listed as named defendants in a derivative proceeding, the directors' involvement of creditors in the decision-making process should help strengthen the protective presumption of the business judgment rule by demonstrating that the creditor's perspective was solicited and considered.

From a different angle, creditors should consider invoking zone of insolvency duties if it becomes necessary to dissuade a borrower from taking a course of action the creditor deems harmful to the company. For example, in the hypothetical used above, HCI's dissenting creditor would be advised to formalize its concerns by sending a letter to the board stating that, based on the precarious state of HCI's financial condition, the expedited sale of significant company assets may constitute a breach of the directors' expanded fiduciary duties. Such a letter can be surprisingly effective and, at a minimum, put the board on notice of potential claims.

Bottom line: Boards should not continue business as usual when the company is in the neighborhood of insolvency. Rather, boards should consider taking sometimes unorthodox measures, such as soliciting creditor input on significant business decisions. By being aware of the potential pitfalls inherent in the shifting landscape of fiduciary duties when a company is in the zone of insolvency, lawyers representing boards of directors are well poised to help their client avoid subsequent creditor-initiated derivative claims. TL

Barrett Howell is an associate with Winstead's corporate, securities, and mergers and acquisitions practice group. Phillip Lamberson is a shareholder in and chairman of Winstead's business restructuring and bankruptcy practice group. Both are in Dallas.

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