Protecting Directors and Officers of Corporations That Are Insolvent or in the Zone or Vicinity of Insolvency: Important Considerations, Practical Solutions

Richard M. Cieri*
Michael J. Riela**

I. INTRODUCTION

The legal landscape for corporate directors and officers has been radically altered in the last two years in the aftermath of spectacular failures such as Enron Corp., Global Crossing Ltd. and WorldCom Inc. In response, Congress enacted the Sarbanes-Oxley Act, which instituted several new requirements for directors and officers of publicly-held companies, and spelled out harsh penalties for those who do not comply. Additionally, courts have held directors and officers of private corporations liable for violating the duties they owe to their corporate constituents. It is safe to say that those who manage corporations are being watched ever more closely, both by enforcement agencies and by the plaintiffs' bar. E. Norman Veasey, chief justice of the Supreme Court of Delaware, recently dispensed sage advice to directors when he suggested that “[d]irectors who are supposed to be

---

* Richard M. Cieri is a partner in the New York office of Gibson, Dunn & Crutcher LLP. Mr. Cieri is the head of the firm’s Business Restructuring and Reorganization Practice Group. As many of you know, prior to joining the law firm of Gibson, Dunn & Crutcher as the practice group leader of its Business Restructuring and Reorganization Practice, I was formerly a partner at the law firm of Jones Day. It was my honor to have chaired Jones Day’s Business Restructuring and Reorganization Practice for almost six years. I thoroughly enjoyed working with my colleagues at Jones Day for 18-1/2 years. This article reflects in part work done by my former colleagues and updates articles I authored with them. Those articles include: An Introduction to Legal and Practical Considerations in the Restructuring of Troubled Leveraged Buyouts, 45 BUS. LAW. 333 (1989); The Fiduciary Duties of Directors of Financially Troubled Companies, 3 J. BANKR. L. & PRACT. 405 (1994); and As Directors Approach the “Zone of Insolvency,” DIRECTORS & BOARDS, Fall 2000.

** Michael J. Riela is an associate in the New York office of Gibson, Dunn & Crutcher LLP. Mr. Riela practices in the firm’s Business Restructuring and Reorganization Practice Group. The authors would also like to thank Michael Collins and Ilissa Watnik of Gibson, Dunn & Crutcher LLP for their assistance with this article.
independent should have the guts to be a pain in the neck and act independently.”1

This is even more true for those who manage public or private companies that are either insolvent or on the brink of insolvency. Although the U.S. economy is showing signs of recovery from its recent downturn, many companies continue to face serious financial challenges. Directors and officers of these companies face mounting pressure to fix their solvency crises quickly by selling assets, restructuring debt, instituting radically new corporate strategies, or by other means. However, one must proceed very carefully when making these corporate decisions, because they can serve as the basis of lawsuits claiming breach of fiduciary duties, or of other claims based upon laws relating to fraudulent conveyances or illegal dividends. Those in charge of a financially troubled company may have their actions questioned by courts, creditors, bankruptcy trustees, and shareholders who have the benefit of twenty-twenty hindsight.

Additionally, directors and officers of insolvent or near-insolvent corporations may be tempted to enhance the corporation’s short term liquidity by failing to make required payments, which may expose directors and officers to personal liability. Such payments arise under tax and environmental statutes, and may impose personal liability on directors and officers of a corporation that fails to obey such statutes.

This Article discusses the fiduciary duties owed by directors and officers of companies that are either insolvent or near-insolvent (i.e., in the “zone of insolvency”), as well as the methods by which courts determine a company’s solvency. The Article then provides suggestions for actions that directors and officers can take to limit their personal exposure to liability in managing their companies.

II. BACKGROUND: THE FIDUCIARY DUTIES OF DIRECTORS AND OFFICERS OF SOLVENT CORPORATIONS AND THE BUSINESS JUDGMENT RULE

The business affairs of a corporation are normally managed by, or under the direction of, a board of directors.2 Officers are typically chosen by, and serve under, the board. The actions and decision-making of the board and officers are governed by the law of the corporation’s state of incorporation. As most large U.S. corporations are

incorporated in the state of Delaware, the Delaware General Corporation Law is widely regarded as the most influential body of corporate statutes in the country. A long line of case law in Delaware and other states have established that directors and officers of a solvent corporation owe their fiduciary duties primarily (if not exclusively) to the corporation and its shareholders.\(^3\) The primary fiduciary duties are the duty of care and the duty of loyalty.\(^4\)

A. The Duty of Care

The duty of care requires directors and officers to act in an informed and considered manner. Directors and officers have a duty to be informed of all material information reasonably available to them before making a decision, and they have the duty to use reasonable care in making the decision itself.\(^5\) Some courts have held that the duty of care requires directors and officers to exercise the degree of care that an ordinarily careful and prudent person would exercise under the same or similar circumstances.\(^6\) Other courts have held that the duty of care is breached if the directors and officers were grossly negligent.\(^7\) The duty of care can be violated by an “unconsidered failure” to act in situations in which due attention would arguably have prevented a loss.\(^8\)

B. The Duty of Loyalty

The duty of loyalty requires that directors and officers act in good faith and in the honest belief that the action taken is in the best interests of the corporation.\(^9\) Directors and officers must be disinterested

5. See id. at 872; see also Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 367-68 (Del. 1993), modified in part on other grounds 636 A.2d 956 (Del. 1994) (directors breached duty of care and were grossly negligent when they made an uninformed decision to sell company for too low a price); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).
7. See Cede, 634 A.2d at 364; Van Gorkom, 488 A.2d at 873.
and independent. The duty of loyalty mandates that the best interests of the corporation and its shareholders take precedence over any interest that is possessed by a director, officer, or controlling shareholder, but not shared by shareholders generally. This means that directors “can neither appear on both sides of a transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally.”

C. Directors and Officers of Solvent Corporations Do Not Owe Fiduciary Duties to Creditors

Most courts have determined that directors and officers of a solvent corporation owe no fiduciary duties to the creditors of the corporation. Additionally, no fiduciary duties are owed to holders of stock options or convertible debentures, at least until purchase or conversion occurs. Creditors of a solvent corporation can only expect the protection for which they had bargained when they entered into their transactions with the corporation. Creditors of a solvent corporation can also rely on lawsuits claiming fraud, the protections afforded by state statutes and the federal securities laws, and the “morals of the marketplace,” and cannot rely on the “special and rare” obligations imposed on a fiduciary. Indeed, directors and officers may face lawsuits brought by shareholders if the corporation grants creditors more rights than those for which they had bargained.

10. See, e.g., Telxon Corp. v. Meyerson, 802 A.2d 257, 264 (Del. 2002); Kahn v. Tremont Corp., 694 A.2d 422, 429 (Del. 1997); Cede, 634 A.2d at 361-63; Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).
13. See, e.g., United States v. Jolly, 102 F.3d 46, 48 (2d Cir. 1996) (noting that “[b]orrower-lender relationships are typically at arm’s-length, and a firm’s obligations to creditors are generally regarded solely as contractual”); Metro. Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504, 1525 (S.D.N.Y. 1989), vacated and remanded on other grounds, 906 F.2d 884 (2d Cir. 1990) (holding that unsecured creditors are not protected by common law fiduciary duties).
16. Id. at 1524-25.
17. See, e.g., Broad v. Rockwell Int’l Corp., 642 F.2d 929, 958 (5th Cir. 1981) (noting that had the corporation conferred upon holders of the debentures rights significantly greater than those
The Business Judgment Rule

A very important protection available to corporate directors and officers is the “business judgment rule,” which is a “presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.”

The business judgment rule is a common-law recognition that the authority to manage a corporation is vested in the board of directors, recognizes that corporate decisions are made under conditions of uncertainty, and prevents courts from imposing liability on the basis of ex post judicial hindsight.

Under the rule, directors and officers are not held liable for losses due to imprudence or honest errors of judgment, so long as the challenged corporate decision can be attributed to any rational business purpose.

A director or officer of a solvent corporation is generally entitled to the protection of the business judgment rule unless it is demonstrated that the director or officer has breached his or her fiduciary duties. In other words, shareholders bear the burden of overcoming the presumption that directors and officers have complied with their fiduciary duties.

In Delaware, the business judgment rule will not apply in situations where directors and officers were “grossly negligent” or were engaged in transactions in which they were not disinterested and independent.

In determining whether a director or officer is entitled to the protections afforded by the business judgment rule, courts generally examine the following factors: (a) whether the director or officer made an informed decision after making a reasonable effort to inform himself or herself of the relevant facts, (b) whether the director or officer made an informed decision after making a reasonable effort to inform himself or herself of the relevant facts, (c) whether the director or officer set out in the indenture, the corporation’s directors and officers might have faced claims by its own shareholders for waste and corporate mismanagement; Revlon Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1985) (holding that directors breached their duty of loyalty by preferring noteholders to stockholders when entering a lock-up agreement).


See, e.g., Van Gorkom, 488 A.2d at 872; Grobow v. Perot, 526 A.2d 914, 925-26 (Del. Ch. 1987); In re Walt Disney Co. Derivative Litig., 825 A.2d 275, 286 (Del. Ch. 2003).
ficer reasonably believed that the action taken was in the best interests of the corporation and its stockholders,\textsuperscript{25} and (c) the disinterestedness of the director or officer (\textit{i.e.}, whether he or she engaged in self-dealing).\textsuperscript{26}

Though the business judgment rule is a powerful shield for officers and directors, it is not perfect. If a business decision leads to failure, courts may scrutinize that decision using perfect hindsight. In other words, courts might question after the fact whether the directors and officers acted with \textit{sufficient} care, or whether they had \textit{any} conflicting loyalties. If the court decides not to apply the business judgment rule to a corporate decision, the directors and officers have the burden of demonstrating the “entire fairness” of the transaction, in which directors and officers will have to prove that the transaction was inherently fair to stockholders (\textit{i.e.}, that the transaction was the product of fair dealing and involved the payment of a fair price).\textsuperscript{27} The entire fairness standard is a much more stringent standard than the business judgment rule because it is an objective one.\textsuperscript{28} The court will make its own determination of whether the transaction was fair, and will disregard the conclusions drawn by the corporation’s directors and officers.

III. \textbf{THE FIDUCIARY DUTIES OF DIRECTORS AND OFFICERS OF CORPORATIONS THAT ARE INSOLVENT OR ARE IN THE “ZONE OF INSOLVENCY”}

A. \textit{Directors and Officers of Insolvent Corporations Owe Their Fiduciary Duties to Creditors}

Once a corporation becomes insolvent, the fiduciary duties of officers and directors shift and run primarily (if not exclusively) to the corporation and its creditors. When a corporation is a debtor in bank-

\textsuperscript{25} See, \textit{e.g.}, Parnes v. Bally Entm’t Corp., 722 A.2d 1243, 1246 (Del. 1999) (a court may review the substance of a business decision made by an apparently well motivated board for the purpose of assessing whether that decision is so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith); Orman v. Cullman, 794 A.2d 5, 20 (Del. Ch. 2002).


\textsuperscript{27} See, \textit{e.g.}, Robert M. Bass Group, Inc. v. Evans, 552 A.2d 1227, 1239 (Del. Ch. 1988); AC Acquisitions Corp. v. Anderson, Clayton & Co., 519 A.2d 103, 111 (Del. Ch. 1986) (finding that a self-dealing transaction will pass muster only if it is objectively and intrinsically fair); Weinberger v. UOP, Inc., 457 A.2d 701, 710-11 (Del. 1983) (“[t]he requirement of fairness is unflinching in its demand that where one stands on both sides of a transaction, he has the burden of establishing its entire fairness, sufficient to pass the test of careful scrutiny by the courts”).

\textsuperscript{28} See, \textit{e.g.}, Cede & Co. v. Technicolor, 634 A.2d 345, 361 (Del. 1993); Nixon v. Blackwell, 626 A.2d 1366, 1376 (Del. 1993); \textit{Mills}, 559 A.2d at 1279.
The fiduciary duties of its directors and officers of that corporation clearly run to the creditors. The reason for the shift in fiduciary duties is that interests of shareholders are subordinate to the claims of creditors. Under the Bankruptcy Code’s “absolute priority rule,” a corporation’s plan of reorganization may provide recovery for shareholders only if creditors either are paid in full or accept less than full payment. Additionally, creditors of an insolvent corporation have an immediate interest in the value of the corporation’s assets, because it is from these assets that their claims will be paid. Shareholders no longer have a valuable interest in these assets. The shift in fiduciary duties is applied to ensure that the asset value of an insolvent corporation is preserved for creditors, who are the parties for whom the corporation’s assets most matter.

Arguably, with an insolvent corporation, its shareholders would prefer that directors and officers take the corporate assets and “go to Las Vegas”: using the assets in extremely risky ventures that have a high probability of failure, but hold even the smallest possibility of astounding success. If the gamble succeeds, shareholders are back in the money. However, if the ventures fail, the shareholders lose nothing and creditors lose the value of the bet.

B. **Directors and Officers of Corporations that are in the “Zone of Insolvency” Must Enhance the Corporation’s Wealth Generating Capacity**

Directors and officers owe their fiduciary duties to creditors even if the corporation is not yet insolvent, but is rather in the “zone of insolvency” or “vicinity of insolvency.” For purposes of determining the fiduciary duties of officers and directors, a corporation may reach the point of insolvency before it formally commences bankruptcy proceedings. It is unclear whether the fiduciary duties of directors and

29. See, e.g., Unsecured Creditors Comm. of STN Enter., Inc. v. Noyes, 779 F.2d 901, 904 (2d Cir. 1985); In re Baldwin-United Corp., 43 B.R. 443, 459 (S.D. Ohio 1984); Cieri, supra note 2, at 410.


officers of corporations in the zone of insolvency shift completely to creditors, or whether such duties continue to be owed to shareholders as well. Some courts have held that the fiduciary duties of directors and officers of such a corporation are owed solely to creditors, while others have ruled that directors and officers continue to owe their fiduciary duties to shareholders.

In *Brandt v. Hicks, Muse & Co. (In re Healthco Int'l, Inc.),* a Massachusetts bankruptcy court applied Delaware law to determine that directors who voted to approve a leveraged buyout (LBO) that allegedly left the corporation with unreasonably small capital violated their fiduciary duties to the corporation. In this case, the corporation was not insolvent, nor was it in the zone of insolvency prior to the challenged transaction, however the transaction itself left the corporation with unreasonably small capital. The court noted that, “[w]hen a transaction renders a corporation insolvent, or brings it to the brink of insolvency, the rights of creditors become paramount.” The court noted that this differed from the “normal” situation in which “what is good for the corporation’s stockholders is good for the corporation.”

The *Healthco* analysis hinges on whether a transaction leaves the corporation with “unreasonably small capital,” which the court defined as a “condition of financial debility short of insolvency . . . but which makes the insolvency reasonably foreseeable.” Thus, “a transaction leaves the company with unreasonably small capital when it creates an unreasonable risk of insolvency, not necessarily a likelihood of insolvency.” The *Healthco* analysis provides that directors and officers would owe fiduciary duties to creditors if, at the time of the proposed transaction, the corporation’s financial condition was such that the transaction would run the risk of leaving the corporation with unreasonably small capital.

---


37. *See id.* at 302.

38. *See id.* at 300.

39. *Id.*

40. *Id.* at 302.

41. *In re Healthco Int'l, Inc.*, 208 B.R. at 302.

42. *See id.; see also* Barnett, *supra* note 31, at 459.
The simple distinction between creditors and stockholders ignores the differences between trade debt, subordinated debt, secured debt, preferred stock, and common stock. Holders of each of these securities have different economic interests that shift and conflict as a company moves in and out of the zone of insolvency. In analyzing the fiduciary duties of directors and officers of corporations in the zone of insolvency, courts have not addressed distinctions among the different classes of debt and equity.43

Because it is unclear whether directors and officers of corporations in the zone of insolvency owe their fiduciary duties to shareholders (or, even if fiduciary duties are no longer owed to common shareholders, whether fiduciary duties are owed to holders of preferred stock, subordinated debt, etc.), it is wise for directors and officers to take actions that will maximize the corporation’s long-term wealth-creating capacity. This would fulfill the fiduciary obligations to all of the corporation’s stakeholders. At least one court specifically noted that directors of a corporation in the zone of insolvency have an obligation to the “community of interest that sustained the corporation to exercise judgment in an informed, good faith effort to maximize the corporation’s long-term wealth creating capacity.”44

C. Courts May Apply Heightened Scrutiny to Actions of Directors and Officers of Insolvent and Near-Insolvent Corporations

Courts disagree about whether the business judgment rule applies to decisions made by directors and officers of corporations that are insolvent or in the “zone of insolvency.” Some courts have applied the business judgment rule to decisions by directors and officers of these corporations.45 Other courts have ruled that the business judg-
ment rule does not apply, and have characterized directors and officers as being “trustees” for the creditors of the corporation. 46 This concept of a director or officer of an insolvent or near-insolvent corporation as a “trustee” arises from the old trust fund doctrine, and provides that a director or officer may be held liable under a simple negligence standard without the benefit of the business judgment rule.

Courts applying Delaware law have suggested that a level of scrutiny higher than the business judgment rule applies to directors and officers of corporations that are insolvent or will be rendered insolvent by corporate actions. 47 Thus, it is not entirely clear whether the business judgment rule is available to directors and officers of corporations that are either insolvent or in the zone of insolvency. In order to minimize their exposure to liability, directors and officers of an insolvent or near-insolvent corporation should proceed with corporate decisions on the assumption that the business judgment rule will not apply, and that they will have to defend their actions under the much more rigorous “entire fairness” standard.

Two cases illustrate that this course of action is wise because, even if the court were to apply the business judgment rule to a corporate decision, it may use its perfect hindsight in determining whether the directors and officers abided by their fiduciary duties.

46. See, e.g., Geren v. Quantum Chem. Corp., No. 95-7454, 1995 U.S. App. LEXIS 39912, at *3 (2d Cir. Dec. 13, 1995) (noting that “[u]nder New York law, directors of a corporation may become trustees of the creditors when the corporation is insolvent”); Automatic Canteen Co. of Am. v. Wharton, 358 F.2d 587, 590 (2d Cir. 1966); Jewel Recovery, L.P. v. Gordon, 196 B.R. 348, 354 (N.D. Tex. 1996) (“Delaware law recognizes that when a corporation becomes insolvent, the assets of the corporation become a trust for the benefit of the corporation’s creditors. The corporate directors then hold a fiduciary duty as trustees to protect the assets for the creditors.”) (citing Bovay v. H.M. Byllesby & Co., 38 A.2d 808 (Del. 1944)); New York Credit Men’s Adjustment Bureau v. Weiss, 110 N.E.2d 397, 398 (1953) (“[i]f the corporation was insolvent at that time it is clear that defendants, as officers and directors thereof, were to be considered as though trustees of the property for the corporate creditor-beneficiaries”).

47. See Xonics, Inc., 99 B.R. at 872 (court mentioned the trust fund doctrine and stated that the directors “became trustees for the benefit of all creditors at the moment Xonics . . . became insolvent.”) However, the court went on to assess the transaction according to standards usually applied under the business judgment rule); see also Miramar Res., Inc. v. Schultz, (In re Schultz), 208 B.R. 723, 729 (Bankr. M.D. Fla. 1997) (in applying Delaware law, holding that directors of an insolvent corporation owe trustee duties to creditors); Askanas v. Fatjo, Case No. H-91-3140, 1993 WL 208440, at *5 (S.D. Tex. Apr. 22, 1993) (applying Delaware law and stating that “the business judgment rule and other rules applicable to solvent corporations are of no effect in the context of insolvency”); Bovay v. H.M. Byllesby & Co., 38 A.2d 808 (Del. 1944). See generally Weil, Gotshal & Manges LLP, REORGANIZING FAILING BUSINESSES 16-1 – 16-40 (2003).
1. Brandt v. Hicks, Muse & Co. (In re Healthco International, Inc.)

Though the court in Healthco appeared to allow the business judgment rule to apply in transactions that leave a corporation with unreasonably small capital,48 the court refused to apply the business judgment rule to the particular transaction in this case. The court held that the business judgment rule was inapplicable because the directors breached their duty of loyalty by having a pecuniary interest in the LBO transaction.49 The court also found that the directors were “grossly negligent” and thus breached their duty of care by not informing themselves of all material information available to them at the time of the decision regarding the potentially detrimental effects of the proposed LBO on the company. For example, the directors relied solely on a flawed opinion of a solvency research company. The court noted that the directors simply considered the effects that the transaction would have on shareholders, rather than the on the corporation itself.50

2. Pereira v. Cogan

Pereira v. Cogan51 highlights the fact that courts will closely scrutinize the actions (and inactions) of directors and officers of private corporations in the zone of insolvency. In that case, the Chapter 7 trustee of Trace International Holdings, Inc. brought suit against Marshall S. Cogan (the corporation’s major stockholder) as well as the corporation’s directors and officers, alleging that they breached their fiduciary duties to the corporation and its creditors.52 The Chapter 7 trustee challenged several corporate transactions approved by the corporation’s board of directors, including: Mr. Cogan’s excessive compensation; millions of dollars of loans to Mr. Cogan, his family members and other insiders of the corporation; inappropriate and allegedly illegal dividends; a birthday party held at the Metropolitan Museum of Modern Art in Mr. Cogan’s honor that cost over $1 million; and the employment of Mr. Cogan’s daughter as a “consultant” with a salary of

49. See id. at 302-07.
50. See id. at 305-07.
52. Courts appear to be split on the issue of whether a Chapter 7 trustee has standing to sue on behalf of a corporation’s creditors. Compare Pereira, 294 B.R. at 514 (stating that “[t]he Trustee also represents the interests of [the corporation’s] creditors”), with Healthco Int’l, 208 B.R. at 300 (“[i]t is of course true a trustee in bankruptcy is unable to enforce a claim belonging to a creditor”) (citing Caplin v. Marine Midland Grace Trust Co., 406 U.S. 416, 432 (1972) (trustee unable to pursue claims of debenture holders against debenture trustee)).
well over $100,000 per year. Applying Delaware law, the court found that the business judgment rule was not available to directors and officers in this case, because they violated their fiduciary duties to the corporation and its creditors.

In holding that the directors breached their fiduciary duties, the court noted that the board held very few meetings and that, when it acted, it did so by written consent. The board did not seek the advice of outside professionals in determining the proper amount of compensation to award Mr. Cogan. The court found that the directors’ “complete lack of any exercise of diligence in the performance of [their] duties,” as well as their close relationship with Mr. Cogan constituted a breach of their duties of care and loyalty.

The court also held that the corporation’s officers breached their fiduciary duties with respect to transactions that they had the discretionary authority to prevent. Specifically, the court held the corporation’s general counsel and chief financial officer partly responsible for the corporation’s extension of illegal loans and certain other illegal payments.

3. The Moral

It is extremely important that directors and officers of corporations that are in the zone of insolvency do all that they can to comply with their fiduciary duties. Directors must consider any material piece of information relating to their corporate decisions, and must also consider whether their decisions maximize the value of the corporation. Boards of directors must meet often and carefully document what occurred during each meeting in the minutes. Officers must independently consider the impact of any action that they have the authority to either implement or prevent.

IV. Determining the Solvency of the Corporation

As discussed above, the solvency of a corporation determines to whom its directors and officers owe their fiduciary duties. If the corporation is solvent, its directors and officers owe their fiduciary duties

53. See Pereira, 294 B.R. at 486-98.
54. See id. at 528-33. The court stated that the business judgment rule would have been available to the directors and officers, but because they breached their fiduciary duties, the presumptions of the business judgment rule were rebutted. See id. at 526.
55. See id. at 499.
56. See id. at 529.
57. Id.
58. See id. at 522.
59. See Pereira, 294 B.R. at 538-40.
to the corporation and its stockholders. In contrast, if the corporation is insolvent or nearly insolvent, directors and officers may face future lawsuits by the corporation’s creditors alleging a breach of fiduciary duties. This shift of fiduciary duties to creditors from shareholders occurs upon insolvency, even if the corporation has not commenced a bankruptcy case. Accordingly, it is extremely important for directors and officers to closely monitor the corporation’s financial position.

There are two distinct tests for insolvency that a court will utilize. The first is called the “balance sheet” test, and the second is called either the “cash flow” test or the “equity” test. It is unclear whether the corporation would have to be found insolvent under both tests in order for fiduciary duties to shift to creditors, or whether the corporation being insolvent under only one test would suffice. There is some support for the proposition that the fiduciary duties of a corporation’s directors and officers shift if the corporation is insolvent under either test.

A. The Balance Sheet Test

The balance sheet test inquires whether the fair value of the corporation’s liabilities exceed the fair market value of its assets. Under the Bankruptcy Code, insolvency is defined as the sum of the debtor’s liabilities exceeding the sum of its assets “at a fair valuation.” Thus, the Bankruptcy Code’s definition of “insolvency” appears to incorporate

60. See Cieri, supra note 43, at 557.
63. See, e.g., Pereira, 294 B.R. at 520 (interpreting Delaware law as stating that a corporation is insolvent if it is insolvent under either the balance sheet test or the cash flow test); LaSalle Nat’l Bank v. Perelman, 82 F. Supp. 2d 279, 291 (D. Del. 2000) (analyzing the solvency of a corporation using both the balance sheet test and the cash flow test); United States v. Gleneagles Inv. Co., 565 F. Supp. 566, 578 (M.D. Pa. 1983) (“[a] reasonable construction of the . . . statutory definition of insolvency indicates that it not only encompasses insolvency in the bankruptcy sense, i.e., a deficit net worth, but also includes a condition wherein a debtor has insufficient presently salable assets to pay existing debts as they mature”) (citation omitted).
rate the balance sheet test of insolvency. Generally accepted accounting principles (GAAP), while relevant, are not controlling for purposes of determining insolvency under the balance sheet test. Under this test, the corporation must assign a fair market value to its assets, and must also estimate the amounts that it will ultimately be required to pay on account of contingent liabilities.

1. Valuation of Assets

The Bankruptcy Code’s “fair valuation standard,” which has been incorporated into the Uniform Fraudulent Transfer Act (UFTA), has been interpreted as follows:

“[F]air value does not mean the amount the property would bring in the worst circumstances or in the best . . . For example a forced sale price is not fair value though it may be used as evidence on the question of fair value . . . The general idea of fair value is the amount of money the debtor could raise from its property in a short period of time, but not so short as to approximate a forced sale, if the debtor operated as a reasonably prudent and diligent businessman with his interests in mind, especially a proper concern for payment of his debts.”

A similar test adopted by the Uniform Fraudulent Conveyance Act (UFCA) is the “Present Fair Salable Value” test. This test also does not require a distress sale or pure liquidation of assets. Courts have

65. See In re Healthco Int’l, 208 B.R. at 301 (stating that the statutory definition of insolvency is “in essence, an excess of liabilities over the value of assets”); see also Cieri, supra note 62, at 359-60 (describing the conflicting statutory definitions of insolvency).

66. See, e.g., Official Asbestos Claimants’ Comm. v. Babcock & Wilcox Co. (In re Babcock & Wilcox Co., Inc.), 274 B.R. 230, 260 (Bankr. E.D. La. 2002) (“[r]equiring application of GAAP would make accountants and the board which promulgate GAAP the arbiters of insolvency questions. Clearly the [Bankruptcy] Code provides that judges should make those decisions . . . . Thus, although GAAP are relevant, they are not controlling in insolvency determinations”); Hirsch v. Gersten (In re Centennial Textiles, Inc.), 220 B.R. 165, 175 (Bankr. S.D.N.Y. 1998) (“[g]enerally accepted accounting principles . . . do not control a court’s decision . . . . However, the court is inclined to assign presumptive validity to the treatment of assets and liabilities according to GAAP”) (citations omitted); R.M.L., Inc. v. Mellon Bank, N.A., 187 B.R. 455, 464 (M.D. Pa. 1995) (noting that “subsequent events, such as actual collection rates for receivables, that may not technically be cognizable under GAAP and Generally Accepted Auditing Standards, may be considered by the bankruptcy judge in insolvency determinations”); Hunter v. Soc’y Bank & Trust (In re Parker Steel Co.), 149 B.R. 834, 845 (Bankr. N.D. Ohio 1992) (“in valuing [debtor’s liability . . . although GAAP are relevant, they are not controlling”); Ohio Corrugating Co. v. DPAC, Inc. (In re Ohio Corrugating Co.), 91 B.R. 430, 438 n.11 (Bankr. N.D. Ohio 1988) (“[i]n spite of their propriety according to GAAP, a court may modify balance sheet entries . . . in order to more accurately reflect the financial condition of the [debtor].”)

defined present fair salable value as “that value which can be obtained if the assets are liquidated with reasonable promptness in an arm’s-length transaction in an existing and not theoretical market.”

Under either valuation test, it is critical for directors and officers to consider the extent to which the corporation’s assets are readily marketable, especially in light of the contingent liabilities that may be associated with those assets and related successor liability issues. Likewise, directors and officers must consider the time frame in which they may be required to sell those assets or businesses, the state of the current and future market for the company’s assets and whether there is in fact any potential buyer of the assets. Even if there is such a buyer, directors and officers need to determine whether those assets should be substantially “written down” from their book values for purposes of determining the corporation’s solvency. The cost of disposal must also be assessed in valuing those assets.

2. Valuing Contingent Liabilities

In determining the solvency of the corporation, courts have required the inclusion of contingent liabilities in the corporation’s solvency analysis. Contingent liabilities may include obligations arising under corporate guarantees of third party debts, potential losses in pending or anticipated litigation, or the risk that the corporation may be held accountable for the liabilities of a related entity under “veil piercing” or “alter ego” theories.

Accurately determining the value of contingent liabilities is a difficult task, especially given the inconsistent treatment of these liabilities by the courts. Some courts have valued contingent liabilities at their full face value. However, most courts rightly discount contingent lia-

---

70. See, e.g., In re Xonics Petrochemical, Inc., 841 F.2d 198, 199-200 (7th Cir. 1998); Barber v. First Midwest Bankr/W. Ill., N.A. (In re Oneida Grain Co.), 202 B.R. 606, 609 (Bankr. C.D. Ill. 1996) (stating that a corporation’s contingent liabilities should be discounted to their present value); CCEC Asset Mgmt. Corp. v. Chemical Bank (In re Consol. Capital Equities Corp.), 175 B.R. 629, 631 (Bankr. N.D. Tex. 1994) (for purposes of solvency analysis under the UFTA, the debtor must have been able to pay its liabilities, including the probable liability on contingent debts).
abilities by their probability of success. Generally, the value of a particular contingent liability is calculated by determining the potential size of the liability, and adjusting the amount of the liability to account for the probability that the contingency will materialize.

Analyzing the value of contingent liabilities in this manner will help directors and officers establish a reasonable estimate of the corporation’s contingent liabilities, and will help them determine the circumstances under which the corporation might be viewed to be insolvent after such liabilities are taken into account.

B. The “Cash Flow” or “Equity” Test

The cash flow test focuses on a company’s ability to produce sufficient cash (which can be derived from continuing operations, disposition of assets or other capital raising activities) for the payments of debts as they mature. Most courts have stated that this test inquires whether, both before and after the consummation of the proposed transaction, the corporation will be capable of paying its debts as and when they become due. However, the court in *Pereira* rejected this formulation of the test, and instead stated that a corporation is insolvent if it is unable to pay its debts as they become due.

liabilities must be valued at full amount, not present value, when determining insolvency); Marine Midland Bank v. Stein, 433 N.Y.S.2d 325, 327 (N.Y. Sup. Ct. 1980) (stating that the full amount of contingency liability exceeded the fair value of assets at the time of the contested transfer).

73. See, e.g., *Xonics Petrochemical*, 841 F.2d at 200 (multiplying the probability of the contingent liability by the amount of the debtor’s assets, not by the face amount of the contingent liability, because “at worst [the debtor] would have to yield up all of its assets”); Lippe v. Bairmaco Corp., 249 F. Supp. 2d 357, 379 (S.D.N.Y. 2003) (taking into account the corporation’s probable liability on its existing debts, and stating that solvency must be gauged at the time of the transaction, and not with the benefit of hindsight); Mellon Bank, N.A. v. Official Comm. of Unsecured Creditors of R.M.L. (*In re R.M.L.*, Inc.), 92 F.3d 139, 156 (3d Cir. 1996) (stating that a court must take into consideration the likelihood of occurrence of an event triggering the contingent liability); *In re Hemingway Transport*, Inc., 993 F.2d 915, 923 (1st Cir. 1993) (applying discount to reflect uncertainty of contingent CERCLA claim); Covey v. Commercial Nat’l Bank of Peoria, 960 F.2d 657, 659 (7th Cir. 1992) (finding that contingent liability cannot be valued at its face value; rather it must be discounted by the probability that it will occur); *In re Chase & Sanborn Corp.*, 904 F.2d 588, 594 (11th Cir. 1990); Ohio Corrugating Co. v. DPAC, Inc. (*In re Ohio Corrugating Co.*), 91 B.R. 430, 439 (Bankr. N.D. Ohio 1988) (for purposes of Section 548(a)(2) of the Bankruptcy Code, “speculation concerning uncertain and indeterminate liability resulting from possible environmental violations must be discounted”).

74. See, e.g., *LaSalle Nat’l Bank v. Perelman*, 82 F. Supp. 2d 279, 290 (D. Del. 2000) (“[u]nder Delaware law, a corporation is insolvent when it is unable to pay its debts as they become due in the ordinary course of business”); MFS/SUN Life Trust-High Yield Series v. Van Dusen Airport Serv. Co., 910 F. Supp. 913, 943 (S.D.N.Y. 1995) (a corporation is insolvent if it is unable to pay its debts as they come due); United States v. Gleneagles Inv. Co., 565 F. Supp. 556, 579 (M.D. Pa. 1983) (a corporation is insolvent under the cash flow test if it cannot produce enough cash to pay its debts as they mature. However the fact that a corporation’s assets are illiquid and could not be sold to produce cash to pay the corporation’s debts as they mature is not dispositive of the
2004] DIRECTORS, OFFICERS, AND THE ZONE OF INSOLVENCY 311

vent under the cash flow test “if it 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.”76 Even if a corporation is solvent under the balance sheet test, it may be insolvent in the cash flow sense if it lacks liquidity and the ability generate sufficient cash.77

In determining the solvency of the corporation under the cash flow test, directors and officers should account for things such as the company’s recent and probable future operating performance, the liquidity of its assets, the value of deferred assets, impending maturities on its debt, the value of contingent liabilities, and its ability to comply with its loan covenants to draw on its credit facilities. In light of the Pereira formulation of the cash flow test, it is advisable to include a reasonable “cushion” in the solvency calculation to account for the variability of the corporation’s business needs over time.78

C. When in Doubt, Assume that the Corporation is Insolvent or in the Zone of Insolvency

Under either insolvency test, courts may judge in hindsight whether the corporation was insolvent at the time that the corporate decision in question was made, “notwithstanding contrary presentations made in the company’s audited financial statements or made to its board of directors.”79 Accordingly, it is prudent for directors and officers to adopt a conservative approach in their evaluation of the corporation’s solvency and to assume that the corporation is insolvent or within the zone of insolvency if there is any reasonable question about the corporation’s solvency.80

V. PROTECTING DIRECTORS AND OFFICERS OF A CORPORATION THAT IS INSOLVENT OR IN THE ZONE OF INSOLVENCY

As discussed above, as a corporation approaches insolvency, its directors and officers face potential personal liability from different sources, and the decisions they make will be subject to a different set

78. See Pereira, 294 B.R. at 520-21.
of rules. By following the strategies outlined below, however, directors and officers can minimize the risks they face.

A. Comply with Fiduciary Duties

Because of the shift in the fiduciary duties they owe when a corporation becomes insolvent or enters the zone of insolvency, directors and officers must monitor their company’s financial position very closely to determine whether it is operating in the zone of insolvency. Directors and officers should assess the fair value of the corporation’s assets and liabilities conservatively and assume that the corporation is insolvent, if there is any reasonable question about whether the corporation is insolvent under either solvency test. Upon proceeding on the assumption that the corporation is in the zone of insolvency, directors and officers should approach every corporate decision with the objective of enhancing the wealth generating ability of the corporation. Moreover, directors and officers should assume that they will not be able to take advantage of the business judgment rule and that they will have to defend the intrinsic or entire fairness of those decisions.

1. Establish a Methodology for Determining Solvency

Because determining the solvency of a corporation at any point in time is an inexact science at best and because courts may use hindsight in judging the solvency of the company at the time of a contested corporate action, it is advisable for directors and officers to use as many data points as possible to help determine solvency. The following is an example of a work plan that directors and officers can use to determine the solvency of their corporation under both the balance sheet test and the cash flow test:

- review the corporation’s historical financial statements (including balance sheets and income statements);
- calculate the applicable financial ratios for the corporation, and compare these ratios to those of competitors;
- review the corporation’s business plan projections and assumptions, and compare them to historical performance, the expected performance of competitors, and industry trends;
- investigate and analyze the corporation’s business by assessing the current conditions and external competitive factors that will impact its operations and financial performance;
- investigate and analyze current market conditions that would impact the corporation’s sources of funding (including equity markets, debt markets, and interest rates);
- test the sensitivity of the corporation’s financial projections with respect to revenue variations, margin variations, and interest rate changes;
2004] DIRECTORS, OFFICERS, AND THE ZONE OF INSOLVENCY 313

- determine the corporation’s liquidity and free cash flow levels under the projection scenarios;
- perform and evaluate a covenant compliance test for the corporation’s funded debt obligations (both drawn and undrawn facilities) under the projection scenarios;
- evaluate the equity cushion available to the company under each of the projection scenarios;
- evaluate the safety margin of the cash flows under each of the projection scenarios;
- investigate and assess the value of the corporation’s assets (including intangible assets); and
- investigate and assess the corporation’s contingent and off balance sheet liabilities.

2. Retain Professionals to Value Assets

Professional advice is often necessary to assist directors and officers in identifying whether the corporation is in the zone of insolvency. Generally, the advice of qualified counsel and financial advisors should be sought whenever directors or officers are considering a transaction or other actions of significance to the corporation, its stockholders, and its creditors. Such transactions include securing previously unsecured antecedent debts, the sale of a major asset, a spinoff of a subsidiary, the incurrence of significant debt, or the issuance of a dividend. In many circumstances, directors and officers will not be able to satisfy the duty of care without the advice of legal and financial professionals.81

3. Preserve the Protections of the Business Judgment Rule

There are certain circumstances under which courts routinely revoke the protections of the business judgment rule. By avoiding the actions described below, directors and officers will increase the likelihood that courts will apply the business judgment rule to their actions.

a. Avoid Conflicts of Interest

The duty of loyalty requires that directors and officers put the interests of the corporation and its shareholders (and creditors, if the corporation is in the zone of insolvency) above the personal interests possessed by a director, officer, or controlling shareholder.82 For ex-

81. See, e.g., Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264, 274-75 (2d Cir. 1986) (“[d]irectors may be held liable to shareholders for failing” to obtain reasonably available “material information or to make a reasonable inquiry into material matters”).
ample, a transaction in which a director appears on both sides or in which a director receives a personal benefit that is not received by shareholders generally is considered to involve a conflict of interest and should be avoided.\textsuperscript{83}

b. Avoid Preferential Treatment of Insiders

Directors and officers must act in the best interests of the corporation and its shareholders (and creditors, if the corporation is in the zone of insolvency). Accordingly, directors and officers should avoid preferential treatment of other insiders, favored shareholders, or any other discrete creditor or constituency. In addition, directors should not accept personal benefits from supporting a particular transaction.\textsuperscript{84}

c. Fully Disclose the Material Aspects of a Transaction

Directors and officers should endeavor to fully disclose all material aspects of a transaction to independent directors. For example, a director should disclose all of his or her relationships with any principals in the transaction, all of the director’s contacts with interested third parties, and all analyses or studies that suggest that the transaction will result in a benefit to a director or officer.\textsuperscript{85}

d. Base All Corporate Decisions upon Sufficient Information and Deliberation

As discussed above, the duty of care requires management to act in an informed and considered manner. Accordingly, prior to making a business decision, the directors should inform themselves of “all material information reasonably available to them.”\textsuperscript{86} This may include reports, studies, or other informational materials prepared by outside professionals or employees of the corporation.

\textsuperscript{83} See, e.g., Brandt v. Hicks, Muse & Co. (In re Healthco Int’l, 208 B.R. 288, 302-05 (finding that at least one director had a conflict of interest because he received a material personal benefit from the challenged transaction); In re Bidermann Indus., U.S.A., Inc., 203 B.R. 547, 551 (Bankr. S.D.N.Y. 1997) (finding that the proposed sale of a debtor’s assets to the turnaround firm that was acting as the debtor’s CEO and majority shareholder, posed a classic conflict of interest and would be subjected to heightened scrutiny because the transaction was “rife with the possibility of abuse”) (internal quotation marks omitted).

\textsuperscript{84} See In re Healthco Int’l, 208 B.R. at 302-05.


\textsuperscript{86} Aronson, 473 A.2d at 812.
4. Maintain Corporate Records Documenting Compliance with Fiduciary Duties and Corporate Formalities

Deliberation, analysis, and information are vital to satisfying directors’ and officers’ fiduciary duties and maintaining the protections of the business judgment rule. The lack of any of these elements may result in the voiding of the transaction, disgorgement of assets, or personal liability. Because courts are willing to view certain transactions with perfect hindsight, directors and officers must always keep the possibility of judicial review in the back of their minds when making decisions. Accordingly, directors should maintain detailed and accurate corporate records documenting compliance with their fiduciary duties and adherence to corporate formalities.

In the past, it was common for minutes of corporate board meetings to be short, and the detail contained in them to be scant. Minutes of a meeting would merely note that a specific action was approved, without describing the directors’ deliberations. However, because of the heightened scrutiny that directors are facing with regard to their corporate stewardship, failing to keep reasonably detailed records of the events that occur in the boardroom is particularly unwise. Minutes of board and committee meetings should contain a description of each significant item discussed by the directors, “including a summary of the topic,” the material issues presented in considering the topic, and “the major factors taken into account - or relied upon –” in reaching a decision. In sum, the minutes should provide sufficient detail to clearly reflect what transpired in the meeting.

It may be advisable for a board or committee to hire an expert, such as independent outside counsel, to draft the minutes for those meetings in which major decisions are made. The reason for this is that the minutes may eventually be closely examined by plaintiffs or judges who are questioning the propriety of actions taken or not taken. The board could also require committee chairpersons to sign the minutes of each committee meeting, because it would help ensure that they have carefully read the minutes. On the other hand, it is probably not preferable or necessary for very detailed minutes to be kept of executive session meetings. This is because directors generally cannot bind the board to any course of action during an executive session and

88. Id.
89. Id.
independent directors may not want management to know the details of what occurred during the executive session.\textsuperscript{90}

The recent \textit{Walt Disney} case highlights the need for directors to keep detailed minutes of board meetings and to document all of the steps they take in making a corporate decision. Failure to do so can result in a court refusing to grant the directors protection under the business judgment rule.

\textbf{a. The Walt Disney case}

In \textit{In re The Walt Disney Company Derivative Litigation},\textsuperscript{91} the Delaware Court of Chancery refused to dismiss a derivative action against the Walt Disney Company’s board of directors, in which shareholders alleged that the directors breached their fiduciary duties in connection with the hiring and subsequent resignation of Michael Ovitz, who was the president of Disney for a short period of time. According to the plaintiffs, after meeting for less than one hour, Disney’s compensation committee recommended Mr. Ovitz’s hiring to the full board, even though the minutes of that meeting reflected that the committee reviewed only an incomplete summary of a draft of Mr. Ovitz’s employment agreement and did not review several internal memoranda that criticized the proposed terms of Mr. Ovitz’s employment as being too generous.\textsuperscript{92}

In an ensuing meeting, the full board approved Mr. Ovitz’s employment. “The minutes of that meeting were fifteen pages long, but only a page and a half” were devoted to the board’s consideration of Mr. Ovitz’s employment.\textsuperscript{93} The minutes did not indicate that the directors asked any questions about the details of Mr. Ovitz’s salary, stock options, or the termination provisions in his employment agreement. The minutes also did not indicate that the compensation committee made any report to the board concerning its decision to hire Mr. Ovitz.\textsuperscript{94}

\textsuperscript{90.} \textit{Id.}
\textsuperscript{91.} \textit{In re Walt Disney Co. Derivative Litig.,} 825 A.2d 275 (Del. Ch. 2003).
\textsuperscript{92.} \textit{Id.} at 280. The final version of the employment agreement executed on December 12, 1995 (but backdated to October 1, 1995, the date Mr. Ovitz began serving as president) differed greatly from the summary draft employment agreement provided to the compensation committee. \textit{Id.} at 282. The final version granted Mr. Ovitz a large signing bonus, a number of stock options that “was far beyond the normal standards of both Disney and corporate America,” \textit{id.} at 280, as well as a “non-fault termination” clause that would pay Mr. Ovitz more than $38 million and grant him three million stock options when he would leave Disney’s employ, as long as he did not act with gross negligence or malfeasance. \textit{Id.} at 282-289.
\textsuperscript{93.} \textit{Id.} at 281.
\textsuperscript{94.} \textit{Id.} at 281.
The court stated that there was no evidence that the directors seriously undertook their duty to consider the terms of Mr. Ovitz’s hiring and subsequent termination, it appeared that the directors “consciously and intentionally disregarded their responsibilities, adopting a ‘we don’t care about the risks’ attitude concerning a material corporate decision.”\(^95\) The court also stated that there was “reason to doubt whether the board’s actions were taken honestly and in good faith.”\(^96\) Accordingly, the court refused to apply the business judgment rule in this situation and allowed the shareholders’ derivative lawsuit to proceed. Furthermore, the court stated that the plaintiffs’ allegations supported a finding that the directors’ actions either were “not in good faith” or “involve[d] intentional misconduct.”\(^97\) Such a finding would be significant because if a director consciously ignores his or her duties to the corporation, thereby causing economic injury to its stockholders, the director’s actions may fall outside the liability waiver of a Delaware corporation’s certificate of incorporation.\(^98\) Therefore, Disney’s directors could be held personally liable.

The *Walt Disney* case illustrates the importance of keeping adequately detailed minutes of committee and board meetings, particularly if a major corporate decision is made at such meetings. It is possible that Disney’s directors did indeed consider and discuss all of the material information related to Mr. Ovitz’s employment. However, because the minutes of the committee and board meetings were so sparse the court drew an inference that the directors did not exercise their duty of care. Furthermore, because shareholders and government regulators have recently become much more focused on the high level of executive compensation,\(^99\) directors must take pains to

\(^{95}\) Id. at 289 (emphasis in original).

\(^{96}\) Id. at 286.

\(^{97}\) Id. at 290 (internal quotation marks omitted).

\(^{98}\) The Delaware General Corporation Law provides that a corporation’s certificate of incorporation may contain “[a] provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director.” DEl. CODE. ANN. tit. 8, § 102(b)(7) (2003). However, the provision may, not eliminate or limit the liability of a director:

(i) [for any breach of the director’s duty of loyalty to the corporation or its stockholders;
(ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law;
(iii) under § 174 of [the Delaware General Corporation Law]; or
(iv) for any transaction from which the director derived an improper personal benefit. DEL. CODE. ANN. tit. 8, § 102(b)(7) (2003).

\(^{99}\) William McDonough, chairman of the Public Company Accounting Oversight Board, recently observed that Americans are angry about corporate conduct, particularly about the high level of executive compensation. Marcy Gordon, *Americans Angry About Executive Pay*, Offi-
ensure that the minutes of meetings in which executive compensation is approved demonstrate that the directors acted in an informed and considered manner.


In some instances, state law provides directors and officers with a safe harbor that insulates them from liability with regard to a particular type of decision or action. For example, in Delaware, directors are protected from liability for certain actions if they rely in good faith on (a) the records of the corporation; (b) information, opinions, reports, or statements presented to the company by its officers and employees or by committees of the board of directors; and (c) information, opinions, reports or statements presented to the company by any other person as to matters the directors reasonably believe “are within such other person’s professional or expert competence” and whom the directors have selected using reasonable care.100

To the extent possible, directors and officers should ensure that all steps are taken to comply with and maximize the benefits of these safe harbor rules. Directors and officers should also ensure that any decisions are made only after appropriate deliberation and consideration of all material information reasonably available to them. By taking these steps, directors and officers can help ensure compliance with their duty of care and thus preserve the protections of the business judgment rule.

B. Take Steps to Avoid or Minimize Liability Arising from Corporate Transactions

In order to avoid or minimize liability for transactions taken by the corporation when it is insolvent or in the zone of insolvency, directors and officers should comply with their duty of care and thoroughly examine the benefits and risks of each transaction. If a transaction results in the insolvency of the corporation or leaves it with unreasonably small capital, courts may assume that the transaction was improper and deny directors and officers the benefit of the business judgment rule.101 As discussed above, directors and officers official Says, THE COMMERCIAL APPEAL, Oct. 21, 2003, at 1, available at 2003 WL 66402999. The Public Company Accounting Oversight Board is a private-sector, non-profit corporation created by the Sarbanes-Oxley Act to oversee the auditors of public companies.

100. See DEL. CODE. ANN. tit. 8, § 172 (2003) (protection against liability for declaring an illegal dividend).

entimes should engage professionals to identify the various risks posed by a transaction and analyze the nature and extent of each risk.

1. Comply with Laws Regarding the Payment of Dividends and Stock Redemptions

Directors and officers should ensure that the Board complies with all applicable state laws regarding the payment of dividends. For example, Section 174(a) of the Delaware General Corporation Law provides that directors are jointly and severally liable to the corporation, or “to its creditors in the event of dissolution or insolvency,” for any willful or negligent violation of the state’s statutes regarding the payment of dividends or regarding the purchases or redemptions of stock.102 The statute also provides a safe harbor in which a director can avoid this liability “by causing his or her dissent to be entered on the books containing the minutes of the proceedings of the directors at the time the same was done, or immediately after such director has notice of the same.”103 Therefore, in Delaware it is important that any dissent be timely, explicit, and entered in the minutes of the applicable board meeting.104

2. Be Very Cautious When Engaging in Insider Transactions

Directors and officers must carefully monitor transactions involving the corporation in which they or another insider has either a direct or indirect interest. Because of the danger that an insider can benefit at the corporation’s expense, these transactions are subject to heightened scrutiny. While some states have enacted statutes to allow corporations to engage in these transactions,105 directors and officers...
must make certain that insider transactions are fair to the corporation and to any other constituencies to which they owe fiduciary duties.

3. Beware of Fraudulent Transfer and Preference Liability

Most states have adopted either the Uniform Fraudulent Conveyance Act\textsuperscript{106} or the Uniform Fraudulent Transfer Act.\textsuperscript{107} Under these statutes, creditors can assert fraudulent transfer claims against the corporation and its directors and officers. Additionally, if a corporation is a debtor under the Bankruptcy Code, two other fraudulent transfer statutes apply. First, under Section 548 of the Bankruptcy Code, the trustee or debtor in possession may institute a proceeding on behalf of creditors to avoid fraudulent transfers that were made within one year prior to the date that the bankruptcy petition was filed.\textsuperscript{108} Second, under Section 544(b) of the Bankruptcy Code, the trustee or debtor in possession may institute a proceeding to avoid any transfer that is voidable under non-bankruptcy (e.g., state) law.\textsuperscript{109}

a. Intentional Fraudulent Transfers

The UFCA, UFTA, and Section 548 of the Bankruptcy Code all function in much the same way. These statutes prohibit transfers, or obligations incurred, with an intent to “hinder, delay, or defraud creditors.”\textsuperscript{110} There are suggestions in several cases that proof of a conscious, improper purpose to hinder, delay, or defraud creditors is not required – and that, because “a party is deemed to have intended the natural consequences of his acts,”\textsuperscript{111} a transferor’s knowledge, rather


\textsuperscript{107} See \textit{Unif. Fraudulent Transfer Act}, 7A Part II U.L.A. 266 (2003). The UFTA was promulgated by the National Conference of Commissioners on Uniform State Laws in 1984, and is in force in thirty-nine states.


\textsuperscript{110} Section 548(a)(1)(A) of the Bankruptcy Code prohibits transfers made “with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted . . .” 11 U.S.C. § 548(a)(1)(A). Section 4(a)(1) of the UFTA prohibits transfers made “with actual intent to hinder, delay, or defraud any creditor of the debtor.” Section 7 of the UFCA prohibits transfers made “with actual intent . . . to hinder, delay, or defraud either present or future creditors.”

\textsuperscript{111} See Cieri, \textit{supra} note 43, at 584-85 (citing United States v. Tabor Court Realty Corp., 803 F.2d 1288, 1304 (3d Cir. 1986)).
than fraudulent motive, is the touchstone of the “intent” standard.\textsuperscript{112} Accordingly, the transfer itself may be all that is necessary to demonstrate the requisite wrongful intent,\textsuperscript{113} and creditors would not need to prove that the actual intent of the transfer was to hinder, delay, or defraud creditors. Rather, creditors may infer such intent by the circumstances surrounding the transfer.\textsuperscript{114} Courts rely upon objective evidence to infer actual intent of a transferor. Section 4(b) of the UFTA provides so-called “badges of fraud,” which include consideration of whether:

- the transfer was to an insider of the transferor,
- the transferor retained possession or control of the property,
- the transferor was sued or threatened with a lawsuit before the transfer was made,
- the transfer was of substantially all of the transferor’s assets,
- the value of the consideration received by the transferor was not reasonably equivalent to the value of the assets transferred,
- the transferor was insolvent or became insolvent shortly after the transfer was made,
- the transfer occurred shortly before or after a substantial debt was incurred, and
- the transferor transferred essential assets of the business to a liar, who in turn transferred the assets to an insider of the transferor.\textsuperscript{115}

Though used not nearly as often as the “defraud” prong, the “hinder” and “delay” prongs of fraudulent transfer statutes are also significant. Fraudulent transfers include those that are made in order to frustrate creditors by putting property beyond their reach. A transfer may be fraudulent even if its purpose is merely to “buy some time” for the transferor.\textsuperscript{116}

\textsuperscript{112} See, e.g., Ferrari v. Barclays Bus. Credit, Inc. (In re Morse Tool, Inc.), 148 B.R. 97, 138 (Bankr. D. Mass 1992) (“courts applying UFCA § 7 agree that, for purposes of determining fraudulent intent, a party is deemed to have intended the natural consequences of his acts”); Moody v. Sec. Pac. Bus. Credit, Inc., 127 B.R. 958, 990 (W.D. Pa. 1991) (noting that intent is “often hard to prove” and held that a plaintiff may meet his or her burden of proof under the UFCA by introducing evidence that supports an “inference of intent”).

\textsuperscript{113} See Cieri, supra note 43, at 584-85.

\textsuperscript{114} See, e.g., Tabor Court Realty, 803 F.2d 1305 (“[u]nder Pennsylvania law, an intent to hinder, delay, or defraud creditors may be inferred from transfers in which consideration is lacking and where the transferer (sic) and transferee have knowledge of the claims of creditors and know that the creditors cannot be paid”); Moody, 127 B.R. at 990.

\textsuperscript{115} See Cieri, supra note 43, at 586.

\textsuperscript{116} See, e.g., Kelley v. Thomas Solvent Co., 725 F. Supp. 1446, 1455 (W.D. Mich. 1988) (“[e]ven if the company only intended to hinder or delay creditors, these purposes satisfy the intent element where a debtor’s purpose is merely ‘to stave off creditors by putting property beyond their reach even when the purpose is not to cheat them of ultimate payment but only to wrest from them time to restore the debtor’s affairs’”); Bumgardner v. Ross (In re Ste. Jan-Marie, Inc.), 151 B.R. 984, 987 (Bankr. S.D. Fla. 1993) (“actual intent to defraud will be found to
b. Constructive Fraudulent Transfers

Even if there is no intent by management to hinder, delay, or defraud creditors, a transaction can still be characterized as a fraudulent transfer. A constructive fraudulent transfer is one in which the transferor does not receive reasonably equivalent value in exchange for the transfer, and in which the transferor (a) is insolvent at the time of the transfer or is rendered insolvent because of the transfer, (b) retains unreasonably small capital with which to operate its business, or (c) intends to incur debts beyond its ability to pay as those debts mature.\textsuperscript{117} There is no requirement to show ill intent. In determining whether the value received by the transferor was “reasonably equivalent,” the focus is on the quantifiable economic consideration received by the transferor in exchange for the transfer, rather than on the value given up by the transferee.\textsuperscript{118}

If a corporation is or may be insolvent or in the zone of insolvency, oftentimes it would be wise for the corporation’s directors and officers to retain the services of qualified outside professionals to determine whether proposed transactions would yield the corporation reasonably equivalent value. If professional services are retained, directors and officers will meet their duty of care by relying on the analyses of those professionals.\textsuperscript{119} On the other hand, reliance on such analyses could be held to breach the duty of care, if they are flawed in some fashion and the directors or officers have additional material information at their disposal that would call into question the favorable opinion of a transaction.\textsuperscript{120}


\textsuperscript{118} See Cieri, supra note 43, at 589 (citing Consove v. Cohen (\textit{In re Roco Corp.}), 701 F.2d 978, 982 (1st Cir. 1983) (“the value to be considered is that received by the [transferor] and not that forfeited by the transferee”); SPC Plastics Corp. v. Griffith (\textit{In re Structurlite Plastics Corp.}), 193 B.R. 451, 456 (Bankr. S.D. Ohio 1995) (“whether consideration in a transfer alleged to be fraudulent is ‘fair’ must be viewed from the standpoint of the [transferor]”).

\textsuperscript{119} See Munford, Inc. v. Valuation Res. Corp., 98 F.3d 604, 611 (11th Cir. 1996) (per curiam) (directors that considered expert analysis when approving a leveraged buyout transaction did not breach their fiduciary duties).

\textsuperscript{120} See Brandt v. Hicks & Muse, Co. (\textit{In re Healthco Int’l}), 208 B.R. 296, 305-07 (Bankr. D. Mass. 1997) (finding that directors breached their duty of care in deciding to approve a leveraged buyout transaction, when they did not review all material information available to them at the time of the decision regarding the potentially harmful effects of the transaction on the company itself but relied solely on a flawed opinion of a solvency research company).
c. Preferences

Section 547 of the Bankruptcy Code provides that a bankruptcy trustee or debtor in possession may avoid transfers that the debtor made to creditors within the ninety day period prior to the debtor’s bankruptcy filing.\textsuperscript{121} However, if a transfer is made to an “insider” of the debtor, it may be avoided if it was made within one year prior to the debtor’s bankruptcy filing.\textsuperscript{122} Though the Bankruptcy Code does not clearly define the term “insider,” the term does include directors, officers, and “person[s] in control” of that corporation.\textsuperscript{123} Avoidable transfers from the corporation include those that are not in the corporation’s ordinary course of business, such as deferred compensation, severance payments, and bonuses.

Unlike fraudulent conveyances, in order for a transfer to be avoided as a preference, the bankruptcy trustee or debtor in possession does not need to show an intent to hinder, delay, or defraud or that the corporation received an exchange of less than reasonably equivalent value. Instead, the bankruptcy trustee or debtor in possession needs to show that the corporation was insolvent at the time of the transfer, that the transfer was for or on account of an antecedent debt, and that the transferee received more than it would have received in a Chapter 7 liquidation of the debtor.\textsuperscript{124} As a result, payments to directors or officers within one year prior to the corporation’s bankruptcy may be avoided as preferential transfers, regardless of the intent of management in making the payments.

C. Continue to Comply with Applicable Statutes and Regulations

As a corporation encounters financial problems, directors and officers may consider improving its short-term liquidity position by temporarily ceasing to comply with certain laws or government regulations. For instance, a corporation may delay in paying trust fund taxes or in taking steps necessary to comply with labor, environmental, or other regulations. However, directors and officers may face personal liability for a corporation’s failure to comply with these laws and regulations. The prudent course for the long-term interests

\textsuperscript{121} See 11 U.S.C. § 547(b) (2003).
\textsuperscript{124} See 11 U.S.C. § 547(b) (2003). There is a presumption that a debtor is insolvent during the 90 days prior to its bankruptcy. See 11 U.S.C. § 547(f) (2003). However, there is no presumption that the debtor was insolvent between 90 days and one year prior to its bankruptcy. See Dent v. Martin, 86 B.R. 290, 291 n.1 (S.D. Fla. 1988); In re Old World Cone Co., 119 B.R. 473, 476 (Bankr. E.D. Pa. 1980).
of both the corporation and its managers is to continue to comply with these laws and regulations.

1. Tax Laws

Many tax statutes provide for personal liability of directors and officers of the corporation. 125 Such personal liability is most prevalent in cases involving “trust fund taxes” or taxes that are collected by a corporation on behalf of a taxing authority and thus are never considered to be the corporation’s property. Non-trust fund taxes may also give rise to personal liability in many cases. Taxing authorities are typically eager to collect these funds from alternative sources if they cannot collect from the corporation, and courts have interpreted statutes in ways that give these authorities wide latitude to collect these taxes from directors and officers personally.

a. Trust Fund Taxes

Generally, even though a trust fund tax is collected by a corporation, it is deemed to be held in trust for the government entity for which it was collected. This trust is a creature of statutory law in which funds remain in the general corporate accounts of the corporation rather than being placed aside in a separate trust fund. 126 Because federal or state law provides that these funds are not the property of the corporation, they are not considered property of the bankruptcy estate when a corporation enters bankruptcy. 127 As such, these funds are not available to satisfy a corporation’s creditors or for other uses. In addition, this means that federal or state authorities may continue to pursue these funds, despite the corporation’s bankruptcy.

Many of the laws relating to trust fund taxes provide for personal liability of officers responsible for the corporation paying the taxes, if the corporation fails to pay such taxes. For example, Section 6672(a)

125. See, e.g., 26 U.S.C. § 6672(a) (2003) (making “responsible persons” liable for any payments which were willfully not made on federal trust fund taxes); CAL. REV. & TAX CODE § 6829 (Deering 2003) (providing for personal liability for unremitting sales tax collections for officers of corporations that have ceased to conduct business); N.Y. TAX LAW §§ 1131(1), 1133 (McKinney 2003) (providing for personal liability for any director or officer who is under a duty to act for a corporation in complying with sales tax or fuel tax laws).

126. See, e.g., Begier v. I.R.S., 496 U.S. 53, 60-61 (1990) (finding that FICA taxes had a trust fund status when the relevant employee was paid, even if the funds were not segregated or properly withheld).

127. See 11 U.S.C. § 541 (2003); Begier, 496 U.S. 53 at 66-67 (holding that federal income taxes and ticket excise taxes withheld by a corporate debtor are not property of the bankruptcy estate); City of Farell v. Sharon Steel Corp., 41 F.3d 92, 98-103 (3d Cir. 1994) (finding city income tax withholdings to be a trust fund tax).
of the Internal Revenue Code provides that “[a]ny person required to collect, truthfully account for, and pay over any tax imposed by this title who willfully fails to collect such tax . . . shall, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded or not collected.”¹²⁸ This penalty applies to any federal withholding tax, including income and social security taxes collected by employers on behalf of employees.¹²⁹ Under IRS regulations, these funds are typically held by a corporation before it is remitted to the government.¹³⁰

In determining who may be liable under Section 6672 of the Internal Revenue Code, courts generally examine the degree of control one has over corporate funds.¹³¹ Persons who have the ability to sign checks on behalf of the corporation are often found to be responsible.¹³² The IRS assumes that a corporation’s president, secretary, and treasurer all have the authority to pay payroll taxes.¹³³ Courts have even held liable persons who were ordered by a corporate superior not to pay taxes.¹³⁴ Corporate directors and officers have been held responsible when they delegated responsibility to an employee to pay the taxes, and were told by that employee that the taxes were being paid, when they were in fact not paid.¹³⁵

Given the significant issues arising from the failure to pay trust fund taxes, directors and officers of potentially insolvent corporations should ascertain that the corporation continues to pay trust fund taxes on a current basis. Directors and officers should take particular care if the corporation plans a bankruptcy filing, and the corporate debtor should seek authority at the outset of a bankruptcy case to pay any trust fund taxes in its possession.

b. Non-Trust Fund Taxes

A corporation’s failure to pay non-trust fund taxes can also subject directors and officers to personal liability. An example of a non-trust

---

¹³⁰ See id.
¹³¹ See, e.g., Purcell v. United States, 1 F.3d 932, 937 (9th Cir. 1993); Gephardt v. United States, 818 F.2d 469, 475 (6th Cir. 1987).
¹³² See Howard v. United States, 711 F.2d 729, 734 (5th Cir. 1983).
¹³⁴ See Howard, 711 F.2d at 734.
¹³⁵ See United States v. Rem, 38 F.3d 634, 643 (2d Cir. 1994).
fund tax is a franchise tax. However, some courts have held that directors and officers are not personally liable for unpaid corporate taxes if they follow the advice of an attorney with regard to payment of those taxes.

2. Environmental Statutes and Regulations

Various environmental statutes provide for the personal liability of directors and officers of corporations that are engaged in activities that pose potential environmental hazards. The most significant environmental statute is the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA).

CERCLA grants the President of the United States broad power to command government agencies and private parties to clean up hazardous waste sites. CERCLA’s two fundamental goals are to deter the release of hazardous substances into the environment through a liability scheme; and to provide for cleanup if a hazardous substance is released or threatened to be released into the environment. The statute achieves these goals through two main provisions. First, the statute provides for a federal fund that allows the government to finance the cleanup of a waste site. Second, the statute provides a means for the government or any other party funding a cleanup to recoup cleanup costs from all potentially responsible parties.

“Potentially responsible parties” include (a) current owners and operators of facilities where hazardous substances are released; (b) current owners and operators of facilities where hazardous substances are threatened to be released; (c) owners or operators of facilities at the time that hazardous substances are disposed; (d) persons who arranged for the transportation, disposal, or treatment of hazardous sub-

137. See In re Stoecker, 179 F.3d 546, 550 (7th Cir. 1999) (holding that an officer lacked the willfulness required to impose personal liability for unpaid use taxes on an airplane brought into the state, because a reputable attorney had advised the corporation that it was not obligated to pay the tax).
stances; and (e) persons who accepted such substances for transport to disposal, or treatment.\footnote{141}

“Notably, a potentially responsible party does not have to cause the environmental harm, nor does the plaintiff have to prove causation.”\footnote{142} Because of this, the primary defense to CERCLA liability is to avoid being determined a potentially responsible party. However, both “owners” and “operators” of contaminated facilities can be deemed potentially responsible parties under CERCLA.\footnote{143} Because neither term is defined in the statute, courts define the scope of those terms.

Operator liability under CERCLA creates liability for parties who “exercise direction over the facility’s activities.”\footnote{144} This can result in liability for parties that would ordinarily be shielded from liability, without the need to meet the criteria for piercing the corporate veil.\footnote{145} In some cases, courts have found operator liability for officers who had control of corporate operations that led to the emissions of hazardous waste. For example, one court found an individual who was the president, CEO, and sole shareholder of a corporation liable for cleanup of a site where the corporation sent waste for disposal.\footnote{146} Another court held personally liable a corporate officer who was in charge of managing a facility for a corporation that purchased property that was known to be contaminated.\footnote{147} Other courts have found that the appropriate test for imposing operator liability on corporate directors and officers is whether such individuals had sufficient authority to control a facility at the time hazardous material was discharged.\footnote{148}

State environmental laws provide differing approaches for imposing director and officer liability. The variance in approaches under state law means that directors and officers should carefully consider whether they are in compliance with applicable state laws, and that directors and officers should seek the advice of knowledgeable counsel in analyzing environmental cleanup responsibilities.

Directors and officers of an insolvent or near-insolvent corporation should be even more vigilant in ensuring that the corporation follows

\footnotesize{141. Id.}
\footnotesize{142. Id.}
\footnotesize{143. 42 U.S.C. § 9607(a)(1) (2003).}
\footnotesize{145. See id. at 65.}
\footnotesize{146. Carter-Jones Lumber Co. v. Dixie Distrib. Co., 166 F.3d 840, 846 (6th Cir. 1999).}
\footnotesize{147. New York v. Shore Realty Corp., 759 F.2d 1032, 1037 (2d Cir. 1985).}
all applicable environmental laws and regulations. Otherwise, they run the risk of being held personally liable for damages if the corporation is unable to pay its obligations. Retaining counsel and implementing an environmental response program are steps that can spare a corporation and its management from substantial liability.

3. Labor and Employment Laws

The Fair Labor Standards Act (FLSA)\textsuperscript{149} imposes various duties and liabilities upon employers. The FLSA defines an “employer” as “includ[ing] any person acting directly or indirectly in the interest of an employer in relation to an employee and includes a public agency, but does not include any labor organization (other than when acting as an employer) or anyone acting in the capacity of officer or agent of such labor organization.”\textsuperscript{150} Under the FLSA, directors and officers are exposed to personal liability if they exercise operational control or are directly responsible for employee supervision.\textsuperscript{151} In these situations, the directors and officers may be held jointly and severally liable with the corporation for unpaid wages.\textsuperscript{152}

Directors and officers also need to be mindful of their potential liability under the Employee Retirement Income Security Act of 1974 (ERISA)\textsuperscript{153} if the employer’s “401(k)” or other employee benefit plan invests in employer stock. ERISA imposes significant duties on “fiduciaries”\textsuperscript{154} of employee benefit plans. Often, a plan committee that consists of officers and other high-level employees is designated as the applicable fiduciary with respect to benefit plan investments. 


\textsuperscript{150} Id. § 203.

\textsuperscript{151} See Patel v. Wargo, 803 F.2d 632, 637-38 (11th Cir. 1986) (“[t]he overwhelming weight of authority is that a corporate officer with operational control of a corporation’s covered enterprise is an employer along with the corporation, jointly and severally liable under the FLSA for unpaid wages”) (citing Donovan v. Agnew, 712 F.2d 1509, 1511 (1st Cir. 1983)).

\textsuperscript{152} See, e.g., Baystate Alternative Staffing, Inc. v. Herman, 163 F.3d 668, 677-78 (1st Cir. 1998) (holding that officers who have operational control of significant aspects of the corporation’s daily activities and who are employers under the FLSA may be personally liable for failure to pay minimum and overtime wages); Fegley v. Higgins, 19 F.3d 1126, 1131 (6th Cir. 1994) (holding that a CEO and major owner of company who controlled significant functions of the business, determined salaries and made hiring decisions was jointly liable with the corporation).


\textsuperscript{154} ERISA’s definition of “fiduciary” is expansive. It generally includes any person with respect to a plan to the extent “(i) [s]he exercises any discretionary authority or discretionary control respecting management or disposition of its assets, (ii) [s]he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) [s]he has any discretionary authority or discretionary responsibility in the administration of such plan.” ERISA § 3(21)(A), 29 U.S.C. § 1002(21)(A). Fiduciary status is determined under a functional analysis, rather than based on official titles. Id.
ous lawsuits in recent years have alleged that plan committees and other fiduciaries have violated their duties in this regard. Among the defendants in these lawsuits have been fiduciaries of the Tyco, Worldcom, Duke Energy, Textron, Lucent, Global Crossing, Healthsouth, and Xerox “401(k)” plans. The lawsuits generally have made some or all of the following claims: (i) the relevant fiduciary knew of material information that could affect the value of the stock and had a fiduciary duty to disclose the information to plan participants, (ii) the concentration of employer stock under the plan violated ERISA’s prudence requirements, or (iii) the circumstances required the complete elimination of employer stock as an investment option and the divestment of all of the plan’s holdings. Although the law is still developing in this area, it seems clear that the applicable plan fiduciaries may, at least in some circumstances, be required to take action to protect plan participants from likely declines in the value of employer stock invested in the plan, especially if they are aware of nonpublic information — such as an impending bankruptcy filing — that could be expected to lead to a substantial decline in the stock price. \[155\] This can place fiduciaries in the awkward position of having to choose between their duty as officers and under the securities laws (to keep such information confidential) and their duty as fiduciaries (possibly to disclose such information for the benefit of plan participants or to freeze or eliminate the employer stock investment alternative).

In addition, plaintiffs frequently allege that directors and officers serve in “fiduciary” capacities with respect to employee benefit plans and, thus, may be liable if they fail to act in the face of declining stock values. Thus, financially troubled employers need to closely review the fiduciary structure of their plans in order to minimize potential exposure for directors and officers.

D. **D&O Insurance: Problems Caused by Bankruptcy**

Corporations typically elect to protect their directors and officers by purchasing directors’ and officers’ insurance (D&O insurance). D&O insurance covers directors and officers if they are sued because of their management of the corporation. D&O insurance takes on an increased importance in bankruptcy because a corporate debtor may be unable or unwilling to pay judgments, settlements, and costs of de-

155. See *In re Enron Corp. Sec., Derivative & ERISA Litig.* (Tittle v. Enron Corp.), 284 F. Supp. 2d 511 (S.D. Tex. 2003); see also *Moench v. Robertson*, 62 F.3d 553, 568-72 (3d Cir. 1995); *Kuper v. Iovenko*, 66 F.3d 1447, 1457-60 (6th Cir. 1995) (there can be a duty to diversify the assets of an employee stock ownership plan out of employer stock in certain circumstances).
fense incurred by directors and officers. As such, a corporation’s bankruptcy may change the degree to which, or even whether, certain D&O insurance policies will cover directors and officers of a financially distressed company.

When a corporation and its directors and officers are co-insureds under a D&O insurance policy with a single limit of liability, the bankruptcy of the corporation may have a profound effect on the right of directors and officers to the coverage under the policy. In bankruptcy, the policy proceeds of certain types of D&O insurance coverage may belong in whole or in part to the corporation’s bankruptcy estate. If this is the case, the automatic stay imposed under the Bankruptcy Code could prohibit directors and officers from having recourse to the proceeds and deem the proceeds an estate asset, which would be shared by all creditors. Some bankruptcy courts have demonstrated a willingness to seize control of the proceeds of the D&O insurance policies when corporations file for bankruptcy protection.

The difficulties directors and officers face with respect to D&O insurance in bankruptcy relate directly to the type of insurance involved. Accordingly, directors and officers should carefully review their D&O insurance policies periodically, especially if the corporation is insolvent or in the zone of insolvency.

Courts tend to distinguish between an insurance policy and its proceeds when deciding what is the property of the corporation’s bankruptcy estate. With certain insurance policies, such as general liability or fire protection policies, both the policy and its proceeds are typically considered property of the corporation’s bankruptcy estate. However, courts have recognized that this general rule does not apply to D&O insurance policies, because they fundamentally differ from

156. See Jonathan C. Dickey, et al., Indemnification and Insurance for Directors and Officers of Public Companies: What Directors and Officers Need to Know in the Post-Sarbanes-Oxley World 16 (Oct. 8, 2003) (on file with Gibson, Dunn & Crutcher LLP). This is an excellent piece on the current major issues relating to D&O insurance.


158. See id. at 585.

159. The Bankruptcy Code defines “property of the estate” to include “all legal and equitable interests of the debtor in property as of the commencement of the case.” See 11 U.S.C. § 541(a)(1).


161. See Eitel, supra note 157, at 585-86.

162. D&O Insurance Draws a Crowd, THE DAILY DEAL (Mar. 11, 2002) (noting that D&O insurance policies have “become fair game in bankruptcies”).

other types of liability insurance. The corporation is often not the direct beneficiary of the policy.\textsuperscript{164} In most cases, the corporation purchases the policy for the benefit of its directors and officers, and not for the benefit or protection of the corporation itself.\textsuperscript{165} Also, the proceeds typically do not inure to the benefit of the company, but rather to its officers and directors.\textsuperscript{166} Due to the structural differences between D&O insurance and general liability policies, courts have created a distinction between ownership of the policy and ownership of its proceeds.

1. Types of D&O Insurance

There are three basic types of coverage found in typical D&O insurance policies: (a) direct coverage of officers and directors (also known as “Side A” coverage), (b) coverage of indemnification payments that the corporation is permitted or required to make to directors and officers (also known as “Side B” coverage), and (c) entity coverage, which covers the corporation’s own losses arising from a claim.\textsuperscript{167} Each type of coverage, and the possible effect of a corporation’s bankruptcy on directors and officers with regard to the type of coverage, is described below.

a. Direct Coverage of Directors and Officers

Direct coverage covers the losses of directors and officers when the corporation has not indemnified them.\textsuperscript{168} The proceeds are paid directly to the directors and officers of the corporation, and the corporation does not have an ownership interest in the funds paid under a direct coverage policy.\textsuperscript{169}

Courts have reasoned that although the insurance policy itself may be the property of the corporation’s estate in bankruptcy, only the directors and officers covered by the direct coverage policy have the

\textsuperscript{164} See id. at 1399-1400; Gillman v. Continental Airlines, 203 F.3d 203, 216 (3d Cir. 2000).

\textsuperscript{165} See, e.g., Youngstown Osteopathic Hosp. Ass’n v. Ventresco (\textit{In re Youngstown Osteopathic Hosp. Ass’n}), 271 B.R. 544, 550 (Bankr. N.D. Ohio 2002) (“[w]hile [the debtor] is the named insured on the policy, the policy is for the benefit of the directors and officers’); see also Dickey, \textit{supra} note 156, at 17-18.

\textsuperscript{166} See Dickey, \textit{supra} note 156, at 18.

\textsuperscript{167} See Eitel, \textit{supra} note 157, at 588.

\textsuperscript{168} See id.

\textsuperscript{169} See, e.g., Louisiana World Exposition, Inc. v. Fed. Ins. Co. (\textit{In re Louisiana World Exposition, Inc.}), 832 F.2d 1391, 1399 (5th Cir. 1987).
right to the proceeds from the policy. As a result, the proceeds from a direct coverage policy are not property of the estate.

Such a determination is good for directors and officers, because the insurance proceeds would not be subject to the automatic stay, and because directors and officers would not have to share the proceeds with the corporation’s creditors. However, if a policy combines direct coverage with indemnity coverage or entity coverage, it becomes less clear whether proceeds from the policy are property of the corporation’s bankruptcy estate.

b. Indemnification Coverage

With indemnification coverage, the corporation itself has the right to receive the proceeds of the policy. Many corporate charters and bylaws require corporations to indemnify directors and officers in certain circumstances. Accordingly, many corporations include indemnification provisions in their D&O insurance policies. These provisions state that the corporation shall receive proceeds to the degree necessary to reimburse the corporation for its indemnification payments to officers and directors.

Since indemnification coverage allows the corporation to receive the funds paid by the insurance policy, some courts have determined that policies containing indemnification provisions are property of the bankruptcy estate. This can cause a significant problem when the indemnification coverage and the director coverage have a single liability cap, because the corporation and its officers and directors then

170. See id. at 1401; see also Gillman v. Continental Airlines (In re Continental Airlines), 203 F.3d 203, 216 (3d Cir. 2000) (proceeds from an insurance policy should be evaluated separately from the debtor’s interest in the policy itself); Houston v. Edgeworth, 993 F.2d 51, 56 (5th Cir. 1993) (“When the debtor has no legally cognizable claim to the insurance proceeds, those proceeds are not property of the estate.”); First Cent. Fin. Corp. v. Lipson (In re First Cent. Fin. Corp.), 238 B.R. 9, 16 (Bankr. E.D.N.Y. 1999) (“While a majority of courts consider a D&O policy estate property, there is an increasing view that a distinction should be drawn when considering treatment of proceeds under such policies.”); In re Daisy Sys. Sec. Litig., 132 B.R. 752, 755 (Bankr. N.D. Cal. 1991) (proceeds from D&O policy found not to be estate property because the directors and officers were the primary beneficiaries under the plan).

171. See, e.g., Louisiana World Exposition, Inc., 832 F.2d at 1401.

172. See Eitel, supra note 157, at 600-05.

173. See id.

174. See, e.g., In re Sacred Heart Hosp., 182 B.R. 413, 419-21 (E.D. Pa. 1995); In re Jasmine, Ltd., 258 B.R. 119, 128 (D.N.J. 1999); Minoco Group of Cos., Ltd. v. First State Underwriters Agency, 799 F.2d 517, 519 (9th Cir. 1986) (policies are “property of the estate because the policies insure the corporation against indemnity claims”); In re Circle K Corp., 121 B.R. 257, 259 (Bankr. D. Ariz. 1990) ("Louisiana World appears distinguishable as it primarily focused on director-officer liability coverage, not indemnification coverage. Thus, that court had no need to address the issue confronted . . . : Whether the policy protects against a diminution of estate assets").
have competing claims to a single sum of money. The result is that directors and officers can be cut off from the D&O insurance proceeds.

On the other hand, many courts have stated that the proceeds from indemnification coverage are not the property of the corporation. The reasoning behind this is that indemnification insurance only insures the corporation for its liability to the directors and officers, and that the corporation has no right to keep those proceeds when the insurer paid on a claim. In essence and at its core, a D&O policy remains a safeguard of officer and director interests and not a vehicle for corporate protection.175

c. Entity Coverage

Entity coverage is a part of D&O insurance policies that covers the corporation itself for losses relating to claims brought against it.176 Until the recent advent of entity coverage, D&O insurance policies did not insure the company for securities or other claims brought against the company. In typical securities class action lawsuits, where both the corporation and its directors and officers were sued, “allocation” disputes between the insureds and the insurance companies occurred.177 Insurance companies had the incentive to argue that large portions of joint liability with insured directors and officers were attributable to the corporation (which was uninsured), rather than to individual directors and officers (who were insured).178

Entity coverage solved the allocation dispute problems by making entity liability a covered claim. However, many insurance companies now believe that entity coverage creates a situation where corporations no longer have an incentive to keep litigation and settlement costs low, as long as a settlement can be achieved within the limits of the policy.179 Furthermore, when insured companies file for bankruptcy protection, the presence of entity coverage has made it more likely for bankruptcy courts to find that the proceeds of the D&O

175. See e.g., In re CHS Elecs., Inc., 261 B.R. 538, 542 (Bankr. S.D. Fla. 2001) (“The fact that [the corporation] obtained and owned the policies is not here determinative. Instead, the court must focus on who has the rights against the proceeds”); In re Daisy Sys. Sec. Litig., 132. B.R. 752, 755 (proceeds are not estate property because the directors and officers are the primary beneficiaries of the D&O insurance policy).
176. See Eitel, supra note 157, at 588-89.
177. See Dickey, supra note 156, at 10.
178. See id.
179. See id.
policy should be swept into the corporation’s bankruptcy estate, because those proceeds make the estate more valuable.\textsuperscript{180}

Because of the possibility that proceeds of a D&O insurance policy that includes entity coverage would be found to be part of the corporation’s bankruptcy estate, the inclusion of entity coverage may leave directors and officers virtually uninsured if the corporation enters bankruptcy and a claim is brought against both the corporation and its officers and directors.\textsuperscript{181} Because an insurance policy with entity coverage provides coverage directly to the corporation for its own losses, there is a possibility for the courts to hold that \textit{all of} the proceeds from the insurance policy are property of the corporation’s bankruptcy estate.\textsuperscript{182}

When directors and officers are sued, creditors of the insolvent corporation often attempt to prevent payment of the insurance proceeds to the directors and officers, because payments to directors and officers would reduce the amount of proceeds available to be shared among creditors. When both the corporate debtor and the directors and officers are defendants in ongoing litigation, the corporation’s creditors would prefer to reserve any proceeds from insurance policies to pay for the legal fees and liability of the corporation, because doing so would preserve more of the corporation’s assets for creditors.\textsuperscript{183} This approach would leave directors and officers without meaningful coverage, and would force them to pay legal fees and liabilities out of their own pockets. Few courts have ruled expressly on whether the existence of entity coverage would result in ownership by the corporation of the D&O insurance proceeds. One court refused to establish a \textit{per se} rule, but rather stated that the question had to be answered on a case-by-case basis.\textsuperscript{184}

2. Treatment of D&O Indemnity Claims in Bankruptcy as Unsecured Claims

Finally, directors and officers should make sure they have adequate insurance even though the corporation has promised to indemnify them for the costs incurred in fulfilling their duties as directors. Directors and officers should not rely on indemnification claims against the corporation after it enters bankruptcy proceedings. Such claims

\textsuperscript{180} See id.
\textsuperscript{181} See Eitel, \textit{supra} note 157, at 590.
\textsuperscript{182} See id.
\textsuperscript{184} See Ochs v. Lipson (\textit{In re} First Cent. Fin. Corp.), 238 B.R. 9, 16 (Bankr. E.D.N.Y. 1999).
may be disallowed by the bankruptcy court, which means that directors and officers would receive nothing on account of their claims. Even if indemnification claims are allowed by the bankruptcy court, directors and officers receive little or no recovery on account of their indemnification claims. This is because indemnification claims against a bankrupt corporation are unsecured and paid along with other unsecured creditors. Furthermore, if there is evidence of wrongdoing by directors and officers in the management of the corporation, courts may place the claims of directors for indemnification behind claims for general creditors to the estate, under the doctrine of equitable subordination. Accordingly, D&O insurance that will cover directors and officers in the event of bankruptcy is absolutely necessary.

3. Alternative Mechanisms

In response to concerns about the availability of indemnification and D&O insurance coverage, and in an effort to provide their directors and officers with the maximum possible protection from personal liability, many companies are exploring alternative ways to fund indemnification, as well as alternatives to traditional D&O insurance. Alternative mechanisms generally fall into two categories: (a) mechanisms that serve as a means of funding indemnification by segregating funds and authorizing their release when certain procedures are followed, such as indemnification trusts and letters of credit, and (b) mechanisms that may serve as a substitute for traditional D&O insurance and that can provide coverage for claims that may not be indemnifiable under state and federal law, such as captive insurance companies.

Whether these mechanisms can work as a substitute for traditional insurance depends on whether they constitute “insurance” under state and federal law. This is significant because if an arrangement is not insurance, the amounts used to fund the arrangement may not be tax-deductible. In addition, funding these mechanisms may not be authorized with corporate funds under a state statute that permits the

185. See Eitel, supra note 157, at 606-08.
186. See 11 U.S.C. § 510(c) (2003); see also In re Mid-Am. Waste Sys., Inc., 228 B.R. 816, 826 (Bankr. D. Del. 1999) (noting that “claims emanating from tainted securities law transactions should not have the same priority as the claims of general creditors of the estate”).
187. See Eitel, supra note 157, at 606.
188. See Dickey, supra note 156, at 26.
189. See id. at 26.
190. See id.
purchase of insurance, but does not explicitly authorize expenditures for special arrangements.\textsuperscript{191}

\textbf{a. Drop-Down Insurance}

Another step that directors and officers can take to protect themselves against the possibility of bankruptcy is to secure drop-down insurance.\textsuperscript{192} Drop-down insurance provides coverage if the directors and officers are denied coverage for any reason under the primary insurance plan.\textsuperscript{193} Drop-down coverage may be purchased as an additional provision to most insurance agreements or may be purchased as a separate policy.\textsuperscript{194} The latter approach has the advantage of having a policy clearly intended solely for the benefit of the directors and officers. If such a policy consists only of director and officer coverage in the event of a failure of the underlying insurance policy, the estate will not be able to claim a right in the proceeds of the drop-down policy.

\textbf{b. Indemnification Trusts}

A possible mechanism for funding a corporation’s indemnification obligation is an indemnification trust. Indemnification trusts, if appropriately structured, can provide directors and officers with greater comfort that funding will be available in the event of a corporation’s insolvency.\textsuperscript{195} Under an indemnification trust, a third party trustee holds in trust funds that a corporation deposits for the benefit of the corporate officials who are entitled to indemnification. Claims for indemnification are paid as they arise in accordance with procedures set forth in the trust documents.\textsuperscript{196}

Although indemnification trusts have received only limited judicial scrutiny, some case law suggests that they are enforceable generally.\textsuperscript{197} An appropriately structured indemnification trust could possibly be irrevocable and unamendable. This assures, to the extent possible, that the corpus of the trust will be beyond the reach of creditors in the event of insolvency.\textsuperscript{198} Although the trust documents could

\begin{itemize}
  \item \textsuperscript{191} See id. Delaware law does not explicitly authorize expenditures of corporate funds for special insurance arrangements. \textit{See Del. Code Ann. tit. 8, § 145(g) (2003)}.
  \item \textsuperscript{192} See Eitel, \textit{supra} note 157, at 604-05.
  \item \textsuperscript{193} See id.
  \item \textsuperscript{194} See id.
  \item \textsuperscript{195} See id. Delaware law does not explicitly authorize expenditures of corporate funds for special insurance arrangements. \textit{See Del. Code Ann. tit. 8, § 145(g) (2003)}.
  \item \textsuperscript{196} See id. Delaware law does not explicitly authorize expenditures of corporate funds for special insurance arrangements. \textit{See Del. Code Ann. tit. 8, § 145(g) (2003)}.
  \item \textsuperscript{197} See id. (citing \textit{Sec. Am. Corp. v. Walsh}, No. 82 C 2953, 1985 U.S. Dist. LEXIS 23482 (N.D. Ill. Jan. 11, 1985) (applying Delaware law)).
  \item \textsuperscript{198} See Dickey, \textit{supra} note 156, at 28.
\end{itemize}
provide that a trust becomes irrevocable and unamendable automatically upon insolvency, this may make the trust more vulnerable to challenge by a bankruptcy trustee or the corporation’s creditors. Additionally, there may be a risk that payments to directors and officers from indemnification trusts would be avoidable as a preferential transfer or a fraudulent conveyance.

c. Captive Insurance Company

Corporations may consider using a captive insurance company to fill in gaps in its D&O insurance. Captive insurance companies require the formation and capitalization of a wholly owned insurance company by a parent entity. The captive insurance policy is managed by insurance brokers or other professional insurance managers, and provides insurance policies that are generally modeled on commercially available policies, except that it may omit exclusions and restrictions that are objectionable to the parent company. A captive insurance company can provide cost-reduction benefits because its premium schedules focus on the parent company’s loss history and actuarial analysis.

Whether a captive insurance company policy can effectively fill gaps in indemnification coverage depends on whether it constitutes “insurance” under state and federal law. Because insurance generally involves a spreading or shifting of loss, an insurance policy that assigns the risk to a wholly owned company – whose profits and losses are borne entirely by the parent company – is unlikely to qualify as insurance and the amounts used to fund the policy may not be tax deductible. This problem may be averted by establishing a group captive insurance company, in which risk is spread among a number of unrelated corporations. However, with a group captive insurance company, each participating corporation must agree on the terms of implementation and each participant must be comfortable with the others’ risks.

199. See id.
200. See Dickey, supra note 156, at 28-29.
201. See id. at 29.
202. See id. (citing Helvering v. LeGierse, 312 U.S. 531, 539 (1941) (stating that, in the tax context, “historically and commonly insurance involves risk-shifting and risk-distributing”).
203. See id.
204. See id.
VI. Conclusion

Directors and officers of a corporation that is either insolvent or in the zone of insolvency face risks in the management of their company. If a corporation cannot cover the claims of disappointed creditors, shareholders and others, they might attempt to seek recovery from its directors and officers personally. With this in mind, those who manage these companies must be aware of the shifting fiduciary obligations and their continuing obligations to comply with applicable laws. Careful planning is necessary to navigate these increasingly dangerous waters. The following checklist delineates action items for directors and officers in minimizing potential liability.
DIRECTORS, OFFICERS, AND THE ZONE OF INSOLVENCY

Minimizing Potential Liability: Action Items for Directors and Officers

I. DETERMINE THE POTENTIAL INSOLVENCY OF THE CORPORATION

- Review the corporation’s historical financial statements.
- Calculate applicable financial ratios for the corporation, and compare these ratios to those of competitors.
- Review the corporation’s business plan projections and assumptions, and compare them to historical performance, the expected performance of competitors, and industry trends.
- Investigate and analyze the corporation’s business by assessing the current conditions and external competitive factors that will impact its operations and financial performance.
- Investigate and analyze current market conditions that would impact the corporation’s sources of funding (including equity markets, debt markets, and interest rates).
- Test the sensitivity of the corporation’s financial projections with respect to revenue variations, margin variations, and interest rate changes.
- Determine the corporation’s liquidity and free cash flow levels under the projection scenarios.
- Perform and evaluate a covenant compliance test for the corporation’s funded debt obligations under the projection scenarios.
- Evaluate the equity cushion available to the company under each of the projection scenarios.
- Evaluate the safety margin of the cash flows under each projection scenario.
- Investigate and assess the value of the corporation’s assets (including deferred assets).
- Investigate and assess the corporation’s contingent and off balance sheet liabilities.
- Retain professionals to value assets.

II. COMPLY WITH FIDUCIARY DUTIES

- If the corporation is in the vicinity or zone of insolvency, carefully consider whether corporate decisions benefit the corporation, its shareholders, and its creditors. In other words, ensure that the proposed course of action would maximize the value of the corporation.
- Make sure that directors and officers possess all material information relating to each business decision.
- Carefully consider how each business decision would impact the corporation’s stakeholders.
- If prudent, seek the advice of qualified experts inside and outside of the corporation.
The board of directors should keep very detailed minutes of each meeting, which describes everything that the board considered before making its decisions.

Maintain written reports and memoranda that reflect in detail the materials reviewed and discussed in connection with a business decision.

Take advantage of any applicable legal “safe harbor” provisions.

Avoid transactions with insiders and other conflicts of interest.

Avoid preferential treatment of insiders, and do not accept personal benefits for supporting or opposing a particular transaction.

III. Minimize Liability Arising From Corporate Transactions

- Comply with laws regarding the payment of dividends and regarding stock redemptions.
- If insider transactions are consummated, make certain that these transactions are fair to the corporation.
- Refrain from making transfers by the corporation that may be seen as an attempt to hinder, delay, or defraud creditors.
- Refrain from making transfers by the corporation, in which the corporation does not receive reasonably equivalent value in exchange.
- If such transactions are commenced, create a record of the fairness of the transaction. Remember that all decisions will be reviewed in hindsight.

IV. Avoid Personal Liability Resulting From the Corporation’s Violations of Law

- Ensure that the corporation continues to pay all taxes as they come due.
- Ensure that the corporation continues to comply with environmental laws and regulations.
- Ensure that the corporation continues to comply with labor and employment statutes and regulations, including ERISA and the Fair Labor Standards Act.

V. Protect D&O Insurance Coverage in the Event of the Corporation’s Bankruptcy

- Carefully review the corporation’s D&O insurance policies to ensure that directors and officers are covered if the corporation files for bankruptcy. Consult experts if necessary.
- If necessary, consider drop-down insurance or alternatives to D&O insurance, to ensure coverage in case directors and officers are denied coverage for any reason under the primary D&O insurance plan.