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SHIFTING BOARD DUTIES FOR CORPORATIONS OPERATING WITHIN THE “ZONE OF INSOLVENCY”

by Hilary Bramwell Mohr¹

Given the current economic climate, members of the Business Law Section are likely seeing an increased number of their clients worrying about thin cash flow and the threat of insolvency. Business clients often have reason to worry beyond their own balance sheets: the financial health of customers, distributors, and others in a company's chain of business is critical as that company awaits payment for valuable goods delivered and services rendered.

Companies are faced with numerous challenges and decisions when potential or inevitable insolvency is on the horizon, whether their own or that of a key business partner. The nature of directors' duties to a corporation operating within the “zone of insolvency” or while insolvent-in-fact is just one such challenging issue. A company's directors should take special care in discharging their fiduciary duties while in the zone of insolvency. As creditors, companies should also be aware that their avenues of recovery against the companies they do business with may be affected by the conduct of that company's board of directors. This article will summarize directors' duties when operating within the zone of insolvency, as articulated primarily under Delaware law, and will discuss the impact that director conduct—both before and during corporate insolvency—has on creditor claims in Washington.

Shifting duties when a company is in the “zone of insolvency”

Directors must manage the affairs of a corporation for the benefit of its shareholders in accordance with their fiduciary duties of care, loyalty, and good faith to the corporation. In very general terms, directors discharge their duty of loyalty by avoiding (or disclosing and properly handling) conflicts between their individual interests and corporate interests. They discharge their duty of care by acting as an ordinarily prudent person would act under similar circumstances and by making informed decisions. Finally, directors must perform their duties in a manner they believe in good faith to be in the corporation's best interest. The business judgment rule protects directors from liability for decisions that are based on a rational business purpose, provided that they did not have a personal interest in the decision, were reasonably well-informed under the circumstances, and rationally believed the decision was in the best interest of the corporation.

When a corporation operates within the zone of insolvency or becomes insolvent, directors' fiduciary duties are

said to shift to include creditors.² Recently, the Delaware Supreme Court clarified that creditors are not owed distinct fiduciary duties and do not have direct claims against directors for breach of their fiduciary duties; rather, creditors of insolvent corporations have standing to sue derivatively on behalf of the corporation for breaches of fiduciary duty.³ If one or more creditors brings suit, any recovery runs to the corporation, not to the individual creditors for satisfaction of their claims. Technicalities aside, if the board's duties did not shift to include creditors, a company's management would arguably have an incentive to take greater risks with creditor dollars in order to return greater value to shareholders, even if the possibility of any increase in return was remote.⁴

The board's position in an insolvent company has often been likened to that of a trustee who holds the corporation's assets in trust for the benefit of the corporation's constituents, and specifically its creditors.⁵ A few courts have described the board's duties as shifting exclusively to creditors because, at least in an insolvent corporation, the shareholders' equity interests are worthless and creditors are therefore the residual owners of corporate assets.⁶ Courts in other cases have explained that directors must manage the corporation in a manner that considers the benefits of all corporate constituencies⁷ rather than just the shareholders, and must maximize the value of the enterprise as a whole rather than maximizing shareholder value.⁸ Directors are prohibited from acting in preference of one constituency or one creditor at the expense of others and are most acutely scrutinized for transactions in which the directors prefer themselves (whether as creditors or shareholders) or other insiders.⁹

What it means to be in the “zone of insolvency”

Just as courts disagree about the precise nature of directors' duties when a company is insolvent or within the zone of insolvency, they also differ in their perception of the precise moment when the directors' duties shift.

Courts primarily use two tests to determine whether a corporation is insolvent: 1) the “balance sheet test,” under which the fair market value of total liabilities exceeds the fair market value of total assets, and 2) the “equitable insolvency” test, under which a company is insolvent if it is unable to pay its debts in the ordinary course of business.¹⁰ Both tests are imperfect. The balance sheet test presents valuation problems. The equitable insolvency test could render a company insolvent simply on account of short-term cash flow problems or, paradoxically, could make an unhealthy company appear solvent if it is timely paying its liabilities but is doing so with cash generated by liquidating its assets. Courts tend to combine the two tests such that if insolvency would result under either standard, directors' duties shift to include creditors.

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Shifting Board Duties for Corporations Operating within the "Zone of Insolvency" continued

A corporation may be within the "zone" of insolvency, as opposed to being insolvent-in-fact, if it is operating in the "vicinity of insolvency,"¹¹ when the company is "technically solvent but insolvency was approaching and...only a few days away,"¹² or when the board is considering taking some action that is expected to render the corporation insolvent.¹³ Courts again resort to applying the balance sheet and equitable insolvency tests to determine whether a proposed transaction or act would render the company insolvent. If insolvency is expected to result under either test (or both) at the time the transaction or act was contemplated, the company was operating in the "zone of insolvency," and the directors' duties shifted to include creditors.

A court may also apply the "unreasonably small capital" test, which examines whether the company is sufficiently capitalized to support its operations or obtain financing to do so. Under that test, if a transaction "makes insolvency reasonably foreseeable" or creates an "unreasonable risk of insolvency," directors' duties shift to include creditors at the point they knew the transaction, if consummated, would render the company insolvent.¹⁴ Thus, even if a company is perfectly solvent at the moment a board is contemplating a transaction and the board would not otherwise owe fiduciary duties to creditors, if the transaction would render the company insolvent, the directors' approval of the transaction is probably a breach of their duties to creditors. If a board is raising questions about insolvency or impending insolvency, it may be prudent to operate the corporation as if in the zone of insolvency and consider creditors' interests when evaluating a proposed course of action.

For directors, the primary lesson from "zone of insolvency" cases in Delaware and other jurisdictions is to be particularly diligent in considering and discharging their duties to the company. When dissolution or insolvency proceedings result, it is likely that board conduct and decision-making leading up to insolvency will be scrutinized. Directors should therefore fastidiously maintain records related to any proposed corporate actions, consider carefully how any decision will impact the corporation's constituents (including creditors), obtain outside advice, and keep clear and accurate minutes of board decisions. Directors should also avoid transactions in which they have an interest, as self-dealing or insider preferences are at the heart of essentially every "zone of insolvency" breach of duty case.

For creditors, the primary lesson from these same cases is that proper exercise of a debtor company's board's duties includes consideration of creditor interests, and breach of fiduciary duty claims may provide an alternate theory of recovery for creditors in pursuit of payment.

Distinctions in Washington Law

For practical purposes, the lessons from other jurisdictions regarding claims for breach of fiduciary duties will apply to directors and creditors of Washington corporations. Proving or disproving creditors' claims under Washington law often involves rigorous scrutiny of board actions leading up to insolvency. But interestingly, Washington courts do not appear to recognize creditor standing to sue directors derivatively on behalf of the corporation.

Early Washington cases applied the trust fund doctrine. As in other jurisdictions, an insolvent corporation's assets were deemed held in trust for the benefit of creditors, none of which could receive preferential treatment over others, and this trust was seen as giving rise to fiduciary duties to creditors.¹⁵ For example, in *Hein v. Gravelle Farmer's Elevator Co.*,¹⁶ the board of an insolvent corporation approved payments toward notes held by members of the board. A receiver was subsequently appointed, and the trial court held that the receiver should recover the payments made to the board members because such payments were preferential. The Supreme Court affirmed, stating that the payments made by the manager, as authorized by the board:

were not payments made in the ordinary course of business by a solvent corporation. All the stockholders and trustees knew the corporation was insolvent, and their manager must be presumed to have known it. This is...a case of a design on the part of the trustees to protect their own interests at the expense of the other creditors. As trustees, such conduct is a breach of that faith to which the law holds fiduciaries, generally. The legal ownership of the assets of a corporation is not altered by the company's insolvency, and the regular agents of the company would still have the power of representing it, and managing its property, for all authorized purposes. *But the equitable interests of the shareholders and creditors are altered by the insolvency; and the directors or managing agents, who originally stood in a fiduciary relation to the company, become placed in a fiduciary relation to its creditors.* They cannot secure to themselves any advantage or preference over other creditors, by using their powers as directors for that purpose. These powers are held by them in trust for all the creditors, and cannot be used for their own benefit.¹⁷

More recent authority has treated the trust fund doctrine as dramatically circumscribed by preferential transfer law. In *Block v. Olympic Health Spa*, the Court of Appeals observed that by enacting a law for avoidance of preferential transfers, the legislature had statutorily limited application of the trust fund doctrine to two types of transfers: "first, all those made during insolvency to a creditor having reasonable cause to believe he was receiving a preference, and second, all preferential transfers occurring within 4 months of the date of application for appointment of a receiver."¹⁸

Since the *Bloch* opinion, Washington's legislature repealed its preferential transfer law,¹⁹ and, like most states, adopted the Uniform Fraudulent Transfers Act (UFTA).²⁰ No subsequent case has addressed whether UFTA, like the predecessor preferential transfer law, circumscribes Washington's trust fund doctrine. Nor has a subsequent case (including *Bloch*) negated the *Hein* Court's observation that directors of an insolvent company stand in a fiduciary relation to the company's creditors. It may be happenstance that the proper case for a Washington court to directly address these issues has not arisen. Meanwhile, although receivers and bankruptcy trustees may assert breach of fiduciary duty claims derivatively on behalf of debtor corporations for the benefit of creditors, no Washington jurisprudence has developed wherein creditors were allowed standing to assert such claims themselves.²¹

Nevertheless, even though creditors in Washington may not have standing to pursue breach of fiduciary duty claims unless aided by a receiver or bankruptcy trustee, directors should carefully discharge their fiduciary duties if insolvency is on the horizon—and creditors should take notice if there is evidence of breach of duty—for two basic reasons.

First, if a receivership or bankruptcy results, the receiver or trustee may scrutinize director conduct and assert breach of fiduciary duty claims against the directors. A receiver has the power to assert claims of the corporation,²² and may, on behalf of the corporation and for the benefit of creditors, sue directors for breaches of fiduciary duty.²³ Washington's approach in the receivership setting is consistent with Delaware law specifying that creditors have derivative, not direct, claims for breach of fiduciary duty.²⁴ If a company instead goes into bankruptcy, the bankruptcy trustee may avoid preferential and fraudulent transfers²⁵ and may derivatively assert the debtor corporation's claims for breach of fiduciary duty against its directors.²⁶ Any recovery from the trustee's efforts will ultimately be paid to creditors according to their priority and anything that remains after creditors are paid in full will be paid to shareholders.

Second, director conduct during or preceding insolvency is likely to be scrutinized because other creditor claims focus on many of the same factual issues as breach of fiduciary duty claims. For example, in the rare, appropriate case, Washington courts, like courts of other jurisdictions, will impose personal liability on corporate shareholders or managing agents under the doctrine of corporate disregard (piercing the corporate veil). Corporate disregard may be applied where: (i) a corporation is intentionally used to violate or evade a duty owed to another; (ii) there is a causal connection between the intentional misconduct and the harm that corporate disregard is necessary to relieve; and (iii) the person a party seeks to hold liable had actual control over, or dominated, the corporation to be disregarded.²⁷ Much like breach of fiduciary duty cases,

corporate disregard cases will focus on director conduct such as milking corporate assets, fraud, failure to follow corporate formalities, and commingling of corporate and personal assets.

A creditor's action to avoid fraudulent transfers under the Uniform Fraudulent Transfers Act²⁸ will also focus on the same type of director conduct that would be relevant in a breach of fiduciary duty case on the same facts. For example, such actions will examine transactions in which corporate assets are transferred to insiders and affiliates, for less than reasonably equivalent value, with fraudulent intent, or made at a time when the corporation was insolvent or would become insolvent as a result of the transfer.

Conclusion

A variety of potential creditor claims are focused on board conduct during and preceding insolvency. Board conduct may be scrutinized in the context of breach of fiduciary duty claims asserted derivatively by creditors in many jurisdictions, and by receivers or bankruptcy trustees in Washington. Board conduct may also be scrutinized in the course of proving creditors' corporate disregard or UFTA claims. In Washington, as well as other jurisdictions, directors wishing to minimize the potential for liabilities while operating within the zone of insolvency should faithfully discharge their fiduciary duties to the corporation—including by considering creditors' interests when contemplating a proposed transaction—and creditors would be wise to pay attention when directors fail to do so.

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- 2 *Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp.*, No. 12150, 1991 WL 277613, at *34 (Del. Ch. Dec. 30, 1991); *Roselink Investors, LLC v. Shenkman*, 386 F.Supp. 2d 209, 215 (S.D.N.Y. 2004) (applying Delaware law); *Weaver v. Kellog*, 216 B.R. 563, 582 (S.D. Tex. 1997) (applying both Texas and Delaware law); *In re Kingston Square Assocs.*, 214 B.R. 713, 721 (Bankr. S.D.N.Y. 1997); *In re Mortgage & Realty Trust*, 195 B.R. 740, 750 (Bankr. C.D. Cal. 1996).
- 3 *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007); see also *Brandt v. Hicks, Muse & Co. (In re Healthco Int'l, Inc.)*, 208 B.R. 288, 299 (Bankr. D. Mass. 1997) (bankruptcy trustee cannot enforce claims of creditors, but breach of fiduciary duty claims belong to the corporation, not to creditors, and may therefore be asserted by bankruptcy trustee); *accord Pereira v. Cogan*, 413 F.3d 330, 343 (2d Cir. 2005).
- 4 See *Credit Lyonnais*, 1991 WL 277613, at *34 n.55.
- 5 *Bovay v. H. M. Byllesby & Co.*, 38 A.2d 808, 813 (Del. 1944) ("An insolvent corporation is civilly dead in the sense that its property may be administered in equity as a trust fund for the benefit of creditors."); *Askamase v. Fatjo*, 1993 WL 208440, at *5 (S.D. Tex. 1993) (discussing differences between trust fund doctrine under Delaware and Texas law); *In re Xonics, Inc.*, 99 B.R. 870, 872 (Bankr. N.D. Ill. 1989) (applying Delaware's trust fund doctrine); *Mirammar Resources, Inc. v. Shultz (In re Shultz)*, 208 B.R. 723, 729 (Bankr. M.D. Fla. 1997) (under Delaware trust fund doctrine, trust arises upon insolvency

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Shifting Board Duties for Corporations Operating within the “Zone of Insolvency” *continued*

- or when corporation is operating in vicinity of insolvency, creating fiduciary duties owed from officers and directors to creditors); *Collie v. Becknell*, 762 P.2d 727, 731 (Colo. App. 1988); *N.Y. Credit Men’s Adjustment Bureau, Inc. v. Weiss*, 110 N.E.2d 397, 398 (N.Y. 1953).
- 6 *See FDIC v. Sea Pines Co.*, 692 F.2d 973, 976–77 (4th Cir. 1982), *cert. denied*, 461 U.S. 928 (1983); *Official Comm. of Unsecured Creditors of Toy King Distribs., Inc. v. Liberty Savings Bank, FSB (In re Toy King Distribs., Inc.)*, 256 B.R. 1, 166–67 (Bankr. M.D. Fla. 2000); *First Options of Chi., Inc. v. Polonitza*, 1990 WL 114740, at *4 (N.D. Ill. July 31, 1990).
 - 7 It is unclear what “constituents” a corporation could have other than its shareholders and creditors. Employees are one possibility, but if a corporation is insolvent or is considering a transaction that will render it insolvent, employees’ interests would be considered as a class of creditors having compensation-related claims, or, if applicable, as shareholders. Surely an employee would have no standing to sue directors for breach of fiduciary duty unless the directors’ decisions while the company was insolvent or within the zone of insolvency damaged the employee as either a creditor or a shareholder.
 - 8 *Credit Lyonnais*, 1991 WL 277613 at *34; *Odyssey Partners, L.P. v. Fleming Cos., Inc.*, 735 A.2d 386 (Del. Ch. 1999); *Geyer v. Ingersoll Publ’ns Co.*, 621 A.2d 784, 789 (Del. Ch. 1992); *see also Askamase*, 1993 WL 208440, at *5 (under Delaware law, directors of insolvent company are in position of trust to corporate enterprise).
 - 9 *See Steinberg v. Kendig (In re Ben Franklin Retail Stores, Inc.)*, 225 B.R. 646, 655 (Bankr. N.D. Ill. 1998), *aff’d in part and rev’d in part*, 2000 WL 28266 (citing *Credit Lyonnais*, 1991 WL 277613 and *Geyer*, 621 A.2d 784); *see also Healthco*, 208 B.R. at 302, 307; *Collie*, 762 P.2d at 731.
 - 10 *U.S. Bank Nat’l. Ass’n v. U.S. Timberlands Klamath Falls, LLC*, 864 A.2d 930, 947–48 (Del. Ch. 2004), *vacated on other grounds*, 2005 WL 1353766 (Del. 2005); *Pereira*, 413 F.3d at 343.
 - 11 *Credit Lyonnais*, at *34 (offering no guidance on what it means to be in the “vicinity” of insolvency, other than to note that the company had been in bankruptcy and, thereafter, its directors “labored in the shadow of that prospect”). In the course of discussing the *Credit Lyonnais* opinion at length, one court has opined that “‘the vicinity of insolvency’ seems to refer to the extent of the risk that creditors will not be paid, rather than balance sheet insolvency.” *Ben Franklin Retail Stores, Inc.*, 225 B.R. at 655 n.14 (citing *Credit Lyonnais*, at *34 n.55).
 - 12 *N.Y. Credit Men’s Adjustment Bureau*, 110 N.E.2d at 398.
 - 13 *Healthco*, 208 B.R. at 300–01; *Shultz*, 208 B.R. at 728; *Weaver*, 216 B.R. at 583–84.
 - 14 *Healthco*, 208 B.R. at 302; *Shultz*, 208 B.R. at 729.
 - 15 *E.g., May v. Rudell*, 149 Wash. 393, 397, 270 P. 1041 (1928) (“Under the law of this state, the property of an insolvent corporation is a trust fund for the payment of its obligations, and such corporation has no right to prefer one or more of its creditors to the exclusion of others.” (internal citation omitted)).
 - 16 164 Wash. 309, 2 P.2d 741 (1931).
 - 17 *Id.* at 316–17 (internal citations and quotations omitted, emphasis added).
 - 18 *Block v. Olympic Health Spa, Inc.*, 24 Wn. App. 938, 947–48, 604 P.2d 1317 (1979) (citing Laws of 1931, ch. 47 and Laws of 1941, ch. 103).
 - 19 Laws of 1941, ch. 103 (repealing Laws of 1931, ch. 47, § 3); Laws of 2004, ch. 165, § 47 (repealing Laws of 1941, ch. 103).
 - 20 Chapter 19.40 RCW.
 - 21 *See Block*, 24 Wn. App. at 947–48; *Carey v. Gujral*, 149 Wn. App. 1034, 2009 WL 807517, at *1 n.1 (March 30, 2009) (in suit initiated by creditors and shareholders, receiver, once appointed, was made sole plaintiff for breach of fiduciary duty claim). Even in the *Hein* case, a receiver, not a creditor, sought to avoid preferential transfers. 164 Wash. 309. Notably, if creditors do not have standing to assert breach of fiduciary duty claims in Washington, a creditor may be left without a remedy in the rare case in which: no receivership or bankruptcy ensues, and because of the particular facts at issue, the creditor cannot recover using corporate disregard or UFTA theories (discussed further on), yet *could* recover if it were allowed to assert a breach of fiduciary duty claim. It probably happens more often that a creditor can recover under one or more theories than a creditor is denied recovery because the only claim it could establish is one for breach of fiduciary duty which it has no standing to pursue. Jurisdictions allowing creditors standing to assert breach of fiduciary duty claims have arguably afforded creditors duplicative avenues of recovery in most cases, the necessity of which is questionable.
 - 22 RCW 7.60.060(1)(c).
 - 23 *See Senn v. Nw. Underwriters Inc.*, 74 Wn. App. 408, 875 P.2d 637 (1994); *Carey*, 2009 WL 807517, at *1 n.1.
 - 24 *Gheewalla*, 930 A.2d 92.
 - 25 11 U.S.C. §§ 544, 546–548.
 - 26 The bankruptcy trustee has capacity to sue and be sued, and is obligated to collect and reduce to money the property of the bankruptcy estate. A debtor corporation’s legal and equitable interests, including causes of action, are property of the estate. *Smith v. Arthur Andersen LLP*, 421 F.3d 989 (9th Cir. 2005) (quoting 11 U.S.C. §§ 323, 541(a)(1), and 704(a)(1)).
 - 27 *Morgan v. Burks*, 93 Wn.2d 580, 585–87, 611 P.2d 751 (1980); *Dickens v. Alliance Analytical Labs., LLC*, 127 Wn. App. 433, 441, 111 P.3d 889 (2005); *Soderberg Adver., Inc. v. Kent-More Corp.*, 11 Wn. App. 721, 733, 524 1355 (1974).
 - 28 RCW 19.40.071.