Why Directors Need To Talk About Insolvency

By **Thomas Berndt** (August 1, 2022)

Thomas Berndt

As a parent of three young children, Disney's excellent film, "Encanto," has been on heavy rotation in my household.

It's the story of an extended family whose members possess unique magical gifts. Through several humorous songs, we learn that the family has ostracized one member, Bruno, whose mystical visions of future calamities disturb the rest of the family.

Rather than confront the unpleasant aspects of the future, the family finds it easier to simply not talk about them, or Bruno.

This is typical human behavior. It's easiest to simply avoid difficult topics. For these reasons, directors of struggling businesses may be reluctant to raise the topic of potential insolvency.

Directors of public companies, in particular, may be wary of broaching the topic for fear that it would be recorded in board minutes or draw increased scrutiny from creditors or the company's auditor.

Social forces may also be at play. Management or fellow directors may become defensive and see it as critical of their performance.

But the truth is that businesses can — and do — fail. And avoiding the topic doesn't make it any less likely to occur.

While fear of failure shouldn't paralyze business leaders, corporate directors should at least educate themselves on the basics of insolvency: What it is, why it matters and its impact on their fiduciary duties.

What Is Insolvency?

Defining exactly when a failing company becomes insolvent can be deceptively tricky.

Courts in most jurisdictions identify insolvency using either the balance sheet test or the cash flow test. The balance sheet test asks if the company's assets exceed its liabilities, while the cash flow test asks if the company is able to pay its debts as they come due.

A third, less common test — the adequate capital test — assesses whether the company possesses adequate capital to continue future operations.

Despite these tests' seeming simplicity, there is enough subjectivity involved in valuing a company's assets, liabilities or future operational costs that even experts can disagree on whether a company is insolvent.

This is particularly true with respect to companies teetering on the brink of insolvency — often referred to as being in the "zone of insolvency."

If directors are in doubt about whether their company is insolvent, they should not be afraid

to ask questions.

A clear and unbiased understanding of the company's finances is essential to understanding the company's options, including potential bankruptcy or restructuring, and protecting directors' decisions from being criticized as uninformed.

Does Insolvency Affect a Director's Fiduciary Duties?

Before 2007, courts and commentators frequently stated that, once a corporation enters the zone of insolvency, directors' fiduciary duties shift from shareholders to creditors.

Some courts found that these fiduciary duties to creditors implied an obligation to manage the corporation conservatively as a trust fund for the creditors' benefit.

But much of this changed in 2007, as a result of the Delaware Supreme Court opinion in North American Catholic Educational Programming Foundation Inc. v. Gheewalla.[1]

There, creditors of a company operating in the zone of insolvency brought direct claims against the company's directors for breach of fiduciary duty. The court dismissed these direct claims, holding that

[t]he creditors of a Delaware corporation that is either insolvent or in the zone of insolvency have no right, as a matter of law, to assert direct claims for breach of fiduciary duty against its directors.[2]

The Gheewalla court went on to clarify at least two other important points. First, while creditors of an insolvent company do not have standing to bring direct claims, they may assert derivative claims on behalf of the company.

The court explained that

when a corporation is solvent, [directors' fiduciary duties] may be enforced by its shareholders, who have standing to bring derivative actions on behalf of the corporation because they are the ultimate beneficiaries of the corporation's growth and increased value.[3]

But when a corporation is insolvent, "its creditors take the place of the shareholders as the residual beneficiaries of any increase in value" and, accordingly, "have standing to maintain derivative claims against directors on behalf of the corporation for breaches of fiduciary duties."[4]

Second, the point at which creditors replace shareholders as residual beneficiaries of the company — and gain standing to assert derivative claims — is actual insolvency, not the so-called zone of insolvency.

The court explained that

[w]hen a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners.[5]

Thus, the oft-used term "zone of insolvency" no longer had significance under Delaware

law; only actual insolvency mattered.

Gheewalla has proven influential. In 2015, the Delaware Chancery Court discussed the sea change Gheewalla represented in Quadrant Structured Products Co. v. Vertin.[6]

The Quadrant court observed that Gheewalla represented a regime change in which the following principles are now true: There is no legally recognized zone of insolvency with implications for fiduciary duty claims. The only transition point that affects fiduciary duty analysis is insolvency itself.

Regardless of whether a corporation is solvent or insolvent, creditors cannot bring direct claims for breach of fiduciary duty. After a corporation becomes insolvent, creditors gain standing to assert claims derivatively for breach of fiduciary duty.

The directors of an insolvent firm do not owe any particular duties to creditors. They continue to owe fiduciary duties to the corporation for the benefit of all of its residual claimants, a category that now includes creditors.

They do not have a duty to shut down the insolvent firm and marshal its assets for distribution to creditors, although they may make a business judgment that this is indeed the best route to maximize the firm's value.[7]

While some jurisdictions haven't embraced Gheewalla, it is still binding precedent under Delaware law. And that's significant given the state of Delaware's claim that more than half of all U.S. publicly traded companies are incorporated under Delaware law.

Thanks to Gheewalla, directors of companies incorporated under Delaware law can rest assured that, upon insolvency, their fiduciary duties continue to run to the company itself — not creditors — and that the business judgment rule continues to protect their decisions.

Indeed, in June, the U.S. District Court for the Northern District of California cited Quadrant for this proposition applying Delaware law in Jiaxing Super Lighting Electric Appliance Co. LTD v. Bruggeman.[8]

Directors of companies incorporated under another state's laws should try to determine if that state adopts Gheewalla and, if not, how insolvency affects directors' fiduciary duties under that state's laws.

The Takeaway

When navigating potential insolvency, it's critical that directors make informed decisions about the company's best options. This requires more — not less — communication with each other and management.

Talk frankly about insolvency, ask questions and — if necessary — seek a second opinion. Take it from Disney, putting off difficult conversations or avoiding them altogether doesn't solve anything.

Thomas F. Berndt is a partner at Robins Kaplan LLP.

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[1] North American Catholic Educational ProgrammingFoundation Inc. v. Gheewalla, 930 A.2d 92 (2007).

[2] Id. at 103.

[3] Id. at 101.

[4] Id.

[5] Id. at 101.

[6] Quadrant Structured Products Co. v. Vertin, 115 A.3d 535 (2015).

[7] Id. at 546-47.

[8] Jiaxing Super Lighting Elec. Appliance Co. v. Bruggeman, No. 21-CV-08489-MMC, 2022 WL 2068220, at *5 (N.D. Cal. June 8, 2022) ("Where, as here, the corporation is insolvent, directors continue to owe fiduciary duties for the benefit of all its residual claimants, a category which now includes creditors.") (internal citations omitted).