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Insolvent Corporations and Director Fiduciary Duties to Creditors: A Review of the Standards in Delaware and Wisconsin

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Individuals serving as directors of corporations face the prospect of making difficult decisions when the enterprise experiences financial distress. In fulfilling their fiduciary duties, do the directors of distressed entities owe their duties of loyalty and care to the entity's shareholders, to its creditors, or to both? Do these duties shift from shareholders to creditors at some point? Terms like "zone of insolvency" and "deepening insolvency" have contributed to the uncertainty directors struggle with when attempting to appropriately discharge their duties. Fortunately, the law governing duties of directors of distressed corporations has recently been clarified and, for the time being at least, both Delaware and Wisconsin courts have articulated clear principles which provide guidance to directors grappling with these issues.

Delaware is the state of incorporation for many entities, including companies which operate in Wisconsin. While the Delaware law of director fiduciary duty may apply to Delaware entities, the Wisconsin Supreme Court has applied Wisconsin choice of law principles, resulting in directors of entities chartered in Delaware becoming subject to Wisconsin law. Therefore, it is important for directors of Wisconsin based companies incorporated in Delaware to understand the scope of their duties under both Delaware and Wisconsin law, and for directors of Wisconsin chartered companies operating in Wisconsin to understand the applicable standards for those duties under Wisconsin law.

Delaware

It is generally recognized that in discharging their duties, directors of corporations owe a duty of care (the duty to make decisions in a prudent manner) and a duty of loyalty (the duty to act without personal economic conflict) to the corporation and its shareholders.[1] What happens, however, when the enterprise experiences financial distress and is at risk of becoming insolvent? Do creditors have a right to demand that directors protect the creditors' interests in addition to (or instead of) the interests of shareholders?

Zone of Insolvency

The concept of "zone" or "vicinity" of insolvency arose in 1991 in *Credit Lyonnaise,* an unpublished Delaware Chancery Court decision.[2] Under the zone of insolvency construct, directors were cautioned to make decisions which did not favor the shareholders at the expense of creditors.[3] *Credit Lyonnaise* and the concept of zone of insolvency, which spawned numerous commentaries and articles,[4] was criticized for inviting claims of breaches of fiduciary duty against directors who were confused about which constituency to serve at any given time.

Fortunately, the specter of competing or perhaps conflicting fiduciary duties when an entity was in the zone of insolvency was put to rest in 2007 in *Gheewalla,* a case decided by the Delaware Supreme Court. The case involved a failed company in the business of creating a national system of wireless connections to the Internet. The defendants were members of the company's board of directors and were also employees of the company's lender, Goldman Sachs. The complaint was filed by a creditor that asserted that the company was in the zone of insolvency and that the directors breached their fiduciary duties giving creditors a direct (rather than a derivative) right of action against them.

After defining "insolvency" as assets being worth less than liabilities or the entity being unable to pay its obligations as they become due,[5] the court held that so long as an entity is solvent under this definition, the directors' fiduciary duties run only to the shareholders. "When 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."[6] Once the corporation becomes insolvent, said the court, the creditors take the place of shareholders as the residual beneficiaries of the value of the corporation. However, the right of creditors to seek redress remains derivative and is not direct.[7]

Deepening Insolvency

Directors were even more confused by the emergence of the potential cause of action of "deepening insolvency"—causing a failing company to worsen its financial condition giving rise to a cause of action in favor of creditors injured by the improvident decisions made. Deepening insolvency[8] was first recognized as a potential cause of action by the Third Circuit Court of Appeals in *Lafferty*,[9] (a

Ponzi scheme case arising under Pennsylvania law). With *Lafferty,* the threat of director liability for deepening insolvency was met by dismay by both insolvency and corporate attorneys alike. The decision caused counselors to be uncertain about what advice to give to their director clients, as any attempt to salvage a sinking ship may prove disastrous for the directors if their efforts, however well intentioned, proved in hindsight to be unsuccessful.

After roiling the waters for several years, during which the deepening insolvency concept was increasingly discredited by academics and practitioners alike, the concept was finally put to rest in Delaware. Closing the door on deepening insolvency in Delaware was *Tenwick*,[10] a Delaware Chancery Court case, which was affirmed by the Delaware Supreme Court. The case involved a suit against the directors of a debtor entity by a litigation trust established pursuant to a bankruptcy reorganization plan. The court dismissed the plaintiff's claims against the directors asserting a cause of action for "deepening insolvency," and in a biting opinion observed that:

> The concept of deepening insolvency has been discussed at length in federal jurisprudence, perhaps because the term has the kind of stentorious academic ring that tends to dull the mind to concept's ultimate emptiness . . .. [T]he fact of insolvency does not render the concept of "deepening insolvency" a more logical one than the concept of "shallowing profitability." That is, the mere fact that a business in the red gets redder when a business decision goes wrong and a business in the black gets paler does not explain why the law should recognize an independent cause of action based upon the decline in enterprise value in the crimson setting and not the darker one.[11]

The deepening insolvency concept has been rejected in almost every jurisdiction. Even the Third Circuit, which in 2001 started the deepening insolvency confusion with *Lafferty,* recently acknowledged that the concept has been rejected in most jurisdictions, and indicated that, if presented with the issue *en banc*, it would revisit the decision.[12]

Directors' Duties Are Clarified

In 2015, after more than a decade of confusion and uncertainty, fiduciary duty law in Delaware was further clarified in the *Quadrant*[13] case. *Quadrant* involved a suit by a noteholder against the directors of Athilon, a company which sold credit default swaps prior to the 2008 financial crises. The complaint alleged that the directors breached their fiduciary duties and Delaware's Uniform Fraudulent Transfer Act by transferring corporate value to affiliates of the debtor.

The *Quadrant* decision establishes clear guidelines for directors of troubled companies. Reiterating the standards for insolvency as being the balance sheet and the cash flow tests,[14] the court confirmed that Delaware does not recognize the concept of deepening insolvency[15] and that ". . . there is no legally recognized 'zone of insolvency' with implications for fiduciary duty claims."[16] Additionally, the fiduciary duty of directors and the standing to sue directors for breaching that duty does not shift from stockholders to creditors at the point of solvency.[17] Rather, the duty to creditors, which is derivative and not direct,[18] is not a discreet duty owed to creditors *per se*, but is a duty owed to the insolvent corporation for the benefit of all residual claimants, which, upon insolvency, includes creditors.[19]

The directors are shielded from liability by the business judgment rule in making decisions for the ailing enterprise and are not required to shut down an insolvent entity for the benefit of its creditors (although in exercising their business judgment, they may choose this alternative).[20] However, if the entity is insolvent, creditors have standing to seek redress if they believe they have been wronged.[21] There are two important prerequisites to maintaining an action. First, the entity must be insolvent when the suit is filed. However, there is no requirement that the insolvent condition be continuous.[22] (In *Quadrant,* the defendants caused the enterprise to achieve balance sheet solvency by, among other things, converting debt to equity and excluding a contingent tax liability, and then argued that the debtor's insolvency had to be continuous.) Second, a creditor must continuously be owed a debt to have standing to sue. If there is a divestiture of the obligation owed, whether the divestiture was voluntary or involuntary, the creditor loses its standing to sue.[23]

The *Quadrant* decision clears away the noise of the past decade and a half. The decision cogently lays out the principles about which directors in Delaware should be aware when making important decisions during what may be the end of the life cycle of the corporate enterprise. Fortunately, the decision confirms the demise of the concepts of "zone of insolvency" and "deepening insolvency." Moreover, it makes clear that upon insolvency, there is not a shifting of the directors' fiduciary duties from the shareholders to the creditors. Rather, upon an entity's insolvency, the pool of constituents which can assert derivative claims rather than direct claims is expanded to include creditors. The right of creditors to assert derivative claims is conditioned upon their continuing to be a creditor of the enterprise for the duration of the action and the entity being insolvent at the time the complaint is filed. However, continuous insolvency is not required. Finally, the business judgment rule protects directors in making decisions for a failing company, which decisions may include attempting to restructure rather than close the distressed enterprise.

Wisconsin

A more beneficial standard relating to fiduciary duties to creditors has been established for directors governed by Wisconsin law. In 2004 (post-*Lafferty* and *Credit Lyonnaise* and pre-*Gheewalla* and *Trenwick*) the Wisconsin Supreme Court decided *Beloit Liquidating Trust v. Grade.*[24] Beloit Corporation ("Beloit") (a company which designed and manufactured pulp and papermaking machines) and its parent, Harnischfeger Industries, Inc., both Delaware corporations, filed Chapter 11 proceedings in Delaware in 1999.

During the Chapter 11 proceedings, the Unsecured Creditors Committee (the "Committee") obtained an order from the court authorizing the Committee to bring actions on behalf of Beloit, including claims against the directors for breach of fiduciary duties. The Committee commenced the action in June 2001 in Milwaukee County Circuit Court. Beloit Liquidating Trust (the "Trust") was substituted as a party in July 2001 after confirmation of the reorganization plan and the trust's creation. The complaint alleged that the directors breached their duty of care by entering into a contract to build a de-inking and pulping mill in Fitchburg, Massachusetts, which Beloit breached, and entering into a series of disastrous contracts to build and install paper making machines for Asia Pulp and Paper Company, the largest pulp and paper producer in Indonesia. The plaintiff asserted that the directors breached their fiduciary duties by mismanaging the company when it was insolent or in the vicinity of insolvency, and drove it further into insolvency by entering into agreements which the company could not perform.

The Wisconsin Circuit Court granted the defendant directors' motion for summary judgment with prejudice. The Court of Appeals reversed. In reversing the decision of the Court of Appeals and upholding the trial court, the Supreme Court listed the issues to be addressed, including whether Wisconsin or Delaware law should apply; what standard should be used in considering the duties of the directors of an insolvent company to creditors; what statute of limitations should be applied; and whether that statute was extended by application of 11 U.S.C. § 108 of the United States Bankruptcy Code.

Choice of Law

Regarding the choice of law to be applied, the court found controlling Wisconsin Statutes section 180.1704, which applies the Wisconsin Corporate Code to all foreign corporations operating in the state. In doing so, it rejected the Trust's argument that it was appropriate to apply Delaware law pursuant to the internal affairs doctrine (*e.g.*, the law of the state of incorporation should be applied to disputes between the corporation and its directors), finding that Wisconsin had not adopted the internal affairs doctrine by either statute or in case law.[25] The court also applied the multi-part choice of law test set out in *Heath v. Zellmer*:***[26]*** predictability or results; maintenance of interstate and international order; simplification of the judicial task; advancement of the forum's governmental interests; and advancement of the better rule of law. The court found that each factor dictated the application of Wisconsin law, noting especially Beloit's 140 year history of operating in the State of Wisconsin.[27]

Directors' Duties to Creditors

Turning to the question of what fiduciary duties directors owe to an insolvent entity's creditors, the court relied upon several turn of the last century cases[28] to find that, under Wisconsin law, directors have no duty to creditors unless the corporation is both insolvent and not a going concern. The court found the appropriate test for insolvency to be an entity's assets being insufficient at fair valuation to pay its debts. It rejected tests of the inability to meet obligations as they become due or of operating the business at a loss, as these tests would not provide the latitude to the directors to take calculated business risks.[29] Without addressing insolvency, the court found that Beloit was a going concern as it was fully operating during the pre-bankruptcy period[30] and, consequently, the directors had no duty to creditors.[31] It also found that the Trust did not have a cognizable claim on behalf of the corporation.

Statute of Limitations

The court also concluded that the applicable statute of limitations was two years, as an action for breach of fiduciary duty is an intentional tort under Wisconsin Statutes section 893.57.[32] However, because no cause of action was available to the Trust because of Beloit's status as a going concern, the court did not decide whether the statute of limitations was extended by 11 U.S.C. § 108 of the United States Bankruptcy Code.[33]

Wisconsin Law After Beloit

The *Beloit* decision has been consistently applied by courts in Wisconsin.[34] However, one Wisconsin Court of Appeals decision sharply criticizes the requirement that for a director's duty to creditors to arise, the corporation must be both insolvent and not a going concern. In *Polsky v. Virnich*,[35] a receiver appointed under Chapter 128 of the Wisconsin Statutes (Wisconsin's assignment for the benefit of creditors' statute) commenced an action on behalf of the debtor corporation seeking to hold liable directors who extracted in excess of $10 million by excessive salaries, management fees, loans, dividends and excessive lease rates. The Court of Appeals initially certified the case to the Wisconsin Supreme Court because of the conflict of Wisconsin's standard with that of a majority of jurisdictions. The Supreme Court accepted the case but split three to three, with one judge not participating. Consequently, the case was remanded to the Court of Appeals, which remained bound by *Beloit* and reluctantly reversed the Circuit Court.

In its opinion, the Court of Appeals indicated that *Beloit* did not set forth a "sensible rule."[36] The court noted that the general rule outside Wisconsin is that a director's fiduciary duty to creditors arises when the company becomes insolvent, citing *Gheewalla*.[37] However, the Wisconsin Supreme Court's requirement for insolvency, coupled with the requirement that the company not be a going concern, leaves the door wide open for substantial abuse:

> The problem, as we see it, is this: A business can be run as a "going concern," well after it is insolvent, thus making it a relatively simple matter for the officers and owners of a closely held corporation to strip many of the remaining assets of the "sinking ship" without fear of running afoul of a duty to creditors. . . . Therefore, it appears to us that corporations as whole would benefit if our supreme court modified *Beloit Liquidating* holding to bring it into line with the majority of other jurisdictions. Lacking the authority to do that, we apply *Beloit Liquidating* and affirm.[38]

Consequently, the legal standard in Wisconsin remains that a director has no duty to creditors unless the corporation is both insolvent and not a going concern. However, the three to three split decision on the appropriate legal standard (with one justice not participating) at the Wisconsin Supreme Court suggests that a change in the law may possibly be in the offing.

Conclusion

In Delaware, directors have the benefit of the business judgment rule in making decisions regarding an entity which is in financial distress. When an entity becomes insolvent, the universe of constituents which can, on a derivative basis, seek redress from directors for breach of fiduciary duty expands to include creditors. There is, however, no requirement that the insolvency be continuous. The entity must be insolvent when the complaint is filed and the plaintiff must retain its status as a creditor throughout the proceeding. The specters of "deepening insolvency" and shifting duties in the "zone of insolvency" have, for the most part, been put to rest. In Wisconsin, for the present at least, directors subject to Wisconsin law owe fiduciary duties to creditors only when the business is both insolvent and not a going concern. It remains to be seen how long this standard, which is substantially more beneficial to directors, will survive.

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[1] *Pinnacle Consultants, Ltd. ex rel. S'holders of Leucadia Nat'l Corp. v. Leucadia Nat'l Corp*., 923 F. Supp. 439, 447 (S.D.N.Y. 1995), *aff'd*, 101 F.3d 900 (2d Cir. 1996) ("The common law characterizes this obligation as having two prongs, the duty of care and the duty of loyalty.")

[2] *Credit Lyonnaise Bank Nederland, N.V. v. Pathe Commc'ns. Corp.,* No. Civ. A. 12150*,* 1991 WL 277613 (Del. Ch. Dec. 30, 1991).

[3] *Id.* at *34 n.55.

[4] *See for example,* Patrick M. Jones and Katherine Heid Harris, *Chicken Little Was Wrong (Again): Perceived Trends in the Delaware Corporate Law of Fiduciary Duties and Standing in the Zone of Insolvency,* 16 J. Bankr. L. & Prac. 2 (2007). *See also N. Am. Catholic Education Programming Found., Inc. v. Gheewalla,* 930 A.2d 92, 99 n.28 (Del. 2007) and the articles cited therein.

[5] *Gheewalla,* 930 A.2d at 98.

[6] *Id.* at 101.

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[7] *Id.* at 102.

[8] The term was coined by the Seventh Circuit Court of Appeals in 1983. *See Schacht v. Brown,* 711 F.2d 1343 (7th Cir. 1983).

[9]*Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc.,* 267 F.3d 340 (3d Cir. 2001).

[10] *Trenwick Am. Litig. Tr. v. Ernst & Young, L.L.P.,* 906 A. 2d 168 (Del.Ch. 2006); *aff'd*. no. 495,2006, 2007 WL 2317768 (Del. Aug. 14, 2007).

[11] *Id.* at 204-205.

[12] *Official Committee of Unsecured Creditors v. Baldwin (In re Lemington Home for the Aged),* 659 F.3d 282, 294 n.6 (3d Cir. 2011).

[13] *Quadrant Structured Prods. Co. v.Vertin,* 115 A.3d 535 (Del. Ch. 2015).

[14] *Id.* at 556.

[15] *Id.* at 547 (citing *Trenwick).*

[16] *Id.* at 546 (citing *Gheewalla).*

[17] *Id.* at 556.

[18] *Id.* at 546.

[19] *Id.* at 546-547.

[20] *Id.* at 547-548.

[21] *Id.* at 556.

[22] *Id.*

[23] *Id.* at 552.

[24] *Beloit Liquidating Tr. v. Grade,* 2004 WI 39, 270 Wis. 2d 356, 677 N.W.2d 298 (2004).

[25] *Id.* at ¶¶ 23-24.

[26] *Heath v. Zellmer,* 35 Wis. 2d 578, 151 N.W.2d 664 (1967).

[27] *Beloit Liquidating Tr. v. Grade,* 2004 WI 39, ¶¶ 22-34.

[28] *Stack v. NW. Nat'l Bank of Superior,* 103 Wis. 57, 79 N.W. 51 (1899*); Hamilton v. Menominee Falls Quarry Co*., 106 Wis. 352, 81 N.W. 876 (1900); *Boyd v. Mut. Fire Ass'n. of Eau Claire,* 116 Wis. 155, 94 N.W. 171 (1902); *McGivern v. AMASA Lumber Co.,* 77 Wis. 2d 241, 252 N.W.2d 371 (1977).

[29] *See Beloit Liquidating Tr. v. Grade,* 2004 WI 39, ¶ 39 n.16.

[30] *Id.* ¶¶ 39-40.

[31] *Id.*

[32] *Id.* ¶ 40.

[33] *Id.*

[34] *See Compuware Corp. v. Innovatec Commc's*., *LLC*, 2005 WL 2076717 (E.D. Wis. Aug. 24, 2005); *Exec. Ctr. III, LLC v. Meieran*, 823 F. Supp. 2d 883 (E. D. WI. 2011); *Auto-Owners Ins. v. Cover-All of Wis., LLC*, No. 13-CV-748-BBC, 2014 WL 2865160 (E.D. Wis. June 24, 2014).

[35] *Polsky v. Virnich,* 2010 WI App 20,323 Wis. 2d 811, 779 N.W.2d 712.

[36] *Id.* at ¶ 15.

[37] *Id*.

[38] *Id*.