Pre-Bankruptcy

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Insurers should consider adding specific language to policies to avoid the pitfalls that may arise in jurisdictions recognizing fiduciary duties to creditors.

The purpose of directors and officers (D & O) liability insurance is to protect directors and officers of a corporation against certain losses arising from alleged wrongful acts in their capacity as such. Claims by creditors are generally not covered under D & O insurance policies due to two different exclusions: the exclusion for claims based upon contract and the insolvency exclusion. This is because creditors generally only have standing to bring breach of contract claims or claims as creditors of the debtor-corporation before courts in bankruptcy proceedings.

However, coverage issues may develop related to claims by creditors during an undefined period of time when a company experiences financial issues but has not yet filed for bankruptcy protection, a period referred to as “the zone of insolvency.” D & O insureds attempt to argue that during this period of time they have fiduciary duties to creditors bringing otherwise uncovered claims and lawsuits within the scope of coverage.

The exclusion for claims based upon contract or agreement bars coverage for claims made by creditors while a company is solvent. It is well-settled law that if a corporation is solvent, its directors and officers do not have a fiduciary duty to the corporation’s creditors. Judson Atkinson Candies, Inc. v. Latini-Hohberger Dhimantec, 529 F.3d 371, 384 (7th Cir. 2008); see also N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 99, 101 (Del. 2007); Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504, 1524–25 (S.D.N.Y. 1989) (holding that bondholders are unsecured creditors, not stockholders, and therefore the corporation owed the bondholders contractual rights, not fiduciary duties). Rather, disputes between a corporation and its creditors arise from the contractual obligations that the company has to its creditors. In this regard, based on the common D & O exclusion regarding claims from a contract or an agreement, D & O insurance generally does not cover such claims.

But under certain circumstances such as insolvency, the directors’ and officers’ fiduciary duties do extend to a corporation’s creditors. Technic Eng’g, Ltd. v. Basic Envirotech, Inc., 53 F. Supp. 2d 1007, 1011 (N.D.III.1999). See also Gheewalla, 930 A.2d

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at 101. After insolvency, creditors have standing to bring before a court direct claims against the directors and officers of the insolvent company for breaches of fiduciary duties. Nevertheless, the bankruptcy or insolvency exclusion of a D & O policy usually will not cover creditor fiduciary duty claims.

Policyholders argue that neither of these exclusions precludes coverage for direct claims by creditors against the directors and officers for breaches of fiduciary duties while a company is in “the zone of insolvency.” The policyholders’ argument is based on case law from a few jurisdictions holding that these expanded duties apply before a corporation actually becomes insolvent, during a period known as “the zone of insolvency.”

First, whether a corporation is “insolvent” is not always an easy question to answer. Courts use two different approaches to assessing insolvency, inquiring whether the facts substantiate that one of two circumstances exist, either “equitable” insolvency or “balance sheet” insolvency. Delaware courts have determined that establishing either of these circumstances can demonstrate insolvency. Gheewalla, 930 A.2d at 98. Equitable insolvency is an inability to meet maturing obligations as they fall due in the ordinary course of business. Gheewalla, 930 A.2d at 98. This definition of insolvency focuses only on a corporation’s ability to pay its current debts and ignores the balance sheet. On the other hand, balance sheet insolvency is defined as “a deficiency of assets below liabilities with no reasonable prospect that the business can be successfully continued in the face thereof.” Gheewalla, 930 A.2d at 98. This is the standard of the U.S. Bankruptcy Code. 11 U.S.C. 101(32).

Second, as much as courts differ in how they define “insolvency,” they struggle even more with articulating when a corporation has entered “the zone of insolvency.”

Based on the above articulation, Delaware courts have not precisely defined “the zone of insolvency.” Gheewalla, 930 A.2d at 98. In fact, other courts have echoed the notion that courts have not explicitly defined the phrase “the zone of insolvency” but rather refer to it as “hazy,” “ill defined,” or “confusing.” Berg & Berg Enterprises, LLC v. Boyle, 178 Cal. App. 4th 1020, 1037, 100 Cal. Rptr. 3d 875, 890 (Cal. Ct. App. 2009); Kipperman v. Onex Corp., 411 B.R. 805 (N.D. Ga. 2009); In re Amcast Indus. Corp., 365 B.R. 91 (Bankr. S.D. Ohio 2007).

While courts may not have defined the term “the zone of insolvency” precisely, in many states the courts have attempted to clarify when fiduciary duties are owed to creditors by directors of corporations operating in the zone of insolvency.

In 2007, the Delaware Supreme Court held that directors’ fiduciary duties do not extend to creditors while companies are in the zone of insolvency, and directors’ duties to creditors are generally limited to contractual duties. Gheewalla, 930 A.2d at 99, 101. The court stated 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.” Id. at 101. Therefore, directors and officers of corporations operating in the zone of insolvency under Delaware law do not have increased fiduciary duty obligations to the corporations’ creditors.

However, not all jurisdictions have followed Delaware’s lead on this issue. In a recent Court of Appeals of Arizona decision the court held that the duties of a director or officer of a corporation are implied by the law, Dooley v. O’Brien, 244 P.3d 586, 591 (Ariz. Ct. App. 2010). The court stated that “these fiduciary obligations can apply even to creditors when a corporation enters the zone of insolvency, without regard to the terms in the underlying contracts.” Id. (citing Dawson v. Withycombe, 163 P. 3d 1034, 1057 (Ariz. Ct. App. 2007)).

In Gladstone v. Stuart Cinemas Inc., 178 Vt. 104, 117 (Vt. 2005), the Supreme Court of Vermont held similarly, stating that “corporate directors do owe a fiduciary duty to creditors, particularly when the corporation becomes insolvent.” Further, the court held that this duty could even be applied to corporations that are not technically insolvent; when a “corporation operates in the vicinity or the zone of insolvency” a duty to creditors applies. Id.
Further, some jurisdictions appear undecided on the issue or have failed to address the issue at all. For example, in *RMB Fasteners, Ltd. v. Heads & Threads International, LLC*, 2012 WL 410490, 11 CV 02071 (N.D. Ill. Feb. 7, 2012), an individual creditor of an insolvent corporation brought direct claims for among other things breach of fiduciary duty against the directors and officers of the corporation. While the court acknowledged that the creditor contended that as a corporation operating in the zone of insolvency it owed the creditor a fiduciary duty, the court did not resolve that issue because it found that individual creditors did not have standing to bring claims against the corporation before a court; only the creditors as a group could do so. *Id.* at *15. (applying Illinois law). In contrast, in both *Innskeep v. Griffin*, 440 B.R. 148 (N.D. Ill. 2010), and *In re Griffin Trading Company, Inc.*, 418 B.R. 714 (N.D. Ill. 2009), the parties agreed, and the courts, applying Illinois law, accepted that for creditors to prevail on claims for breach of fiduciary duty against officers and directors of a corporate debtor, the bankruptcy trustee must prove as an element of the cause of action that the debtor was insolvent *or within zone of insolvency* to extend the defendants’ respective fiduciary duties to the debtor’s creditors. However, neither the *Innskeep* or *Griffin* courts issued a holding to that effect; the parties in litigation agreed to this standard, and the courts accepted it.

Therefore, it appears that in some untested jurisdictions courts, may find that D & O coverage exists for claims by creditors made against a corporation’s directors and officers when those courts hold that the directors and officers have a fiduciary duty to the creditors while operating in “the zone of insolvency.” If a jurisdiction allows these “zone of insolvency” claims to proceed, then a policyholder’s attorney probably will claim that the exclusion for “claims based on contract or agreement” would no longer apply to creditor claims for breaches of fiduciary duty. Moreover, because a company is not technically insolvent, a policyholder’s attorney will argue that the insolvency exclusion does not apply to claims arising from obligations that a company has during “the zone of insolvency” period.

In conclusion, if insurance companies do not intend to underwrite D & O policies covering claims brought by creditors at any time, those insurers should consider adding specific language to policies on that issue to avoid the pitfalls that may arise in jurisdictions recognizing fiduciary duties to creditors while corporations are in “the zone of insolvency.”