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DEAD ZONE? DIRECT CLAIMS BY CREDITORS OF A CALIFORNIA CORPORATION MAY NOT LIE AGAINST MANAGEMENT BASED ON MANAGEMENT'S ALLEGEDLY SHIFTING DUTIES WHEN CORPORATION IS IN THE ZONE OF INSOLVENCY OR EVEN INSOLVENT

The California Court of Appeal recently rejected the argument that directors and officers owe fiduciary duties to the company's creditors when the company is in the so-called "zone of insolvency," or is even clearly insolvent. In *Berg & Berg Enterprises, LLC v. John Boyle, et al.*, 100 Cal. Rptr. 3d 875 (Cal. Ct. App. 6th Dist. Oct. 29, 2009), the California court expounded that "there is no broad, paramount fiduciary duty of due care or loyalty that directors of an insolvent corporation owe the corporation's creditors solely because of a state of insolvency." *Id.* at 893-94. The court was even much less inclined to find that directors owed such duties when the corporation is not clearly insolvent but on the brink of insolvency, and held that "there is no fiduciary duty prescribed under California law that is owed to creditors by directors of a corporation solely by virtue of its operating in the 'zone' or 'vicinity' of insolvency." *Id.* at 893.

It is well settled that directors and officers of a solvent company owe fiduciary duties to act with honesty, loyalty and good faith to the company's shareholders, since the shareholders are the owners of the company and its residual risk bearers. So long as the company remains solvent, the company's obligations to its creditors are governed simply by their contractual arrangement.

When the company becomes insolvent, some courts outside of California have held that management's duties shift to the company's creditors. *See, e.g., Geyer v. Ingersoll Publ'ns Comp.*, 621 A.2d 784, 787 (Del. Ch. 1992) ("When the insolvency exception does arise, it creates fiduciary duties for directors for the benefit of creditors."). The rationale for this shift in the fiduciary duties is that when a company is insolvent, creditors' contract claims are affected by management's decisions in a way they are not outside of insolvency. At the same time, shareholders' interests become essentially worthless. While there are no California cases specifically recognizing this shift, some courts have found it to be an application of the "trust fund doctrine" recognized by the California courts. Under that doctrine, which is typically limited to situations where officers or directors divert, dissipate, or unduly risk corporate assets, an insolvent company's assets are said to be managed as though held in trust for the benefit of its creditors.

Beginning in the 1990's, courts outside of California began to suggest that management's fiduciary duties are owed to creditors not only when insolvency ensues, but also when the company is still technically solvent but within what has been termed as the "zone" or "vicinity" of insolvency. The catalyst for this trend was

Chancellor Allen's statement in an unpublished decision in Delaware in 1991. *See Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, No. 12150, 1991 Del. Ch. LEXIS 215, *108 (Del. Ch. Dec. 30, 1991) ("At least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise."). Chancellor Allen expanded on this statement in his now-famous footnote 55, outlining a hypothetical situation in which a board of directors' best course of action would be one that neither stockholders, creditors nor any particular group would prefer, but rather one that would best serve the "community of interests" represented by the corporation. *Id.* at *108 n.55. Chancellor Allen noted that "the possibility of insolvency can do curious things to incentives, exposing creditors to risks of opportunistic behavior and creating complexities for directors." *Id.* The proponents of expanding the zone-of-insolvency theory have relied on this footnote to argue that, once the company teeters on the brink of insolvency, the pool of those to whom directors owe their fiduciary duties expands to include the company's creditors.

This concept of a "zone of insolvency" has caused no small amount of consternation among practitioners, judges and commentators alike. For example, how does a company know when it is in the dreaded "zone"? *See Prod. Res. Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772, 790 (Del. Ch. 2004) ("[I]t is not always easy to determine whether a company even meets the test for solvency.").

In 2007, the Delaware Supreme Court brought much-needed clarity to this issue, and significantly limited creditors' ability to bring zone-of-insolvency-type claims against the management of Delaware companies, when it announced that "no direct claim for breach of fiduciary duties may be asserted by the creditors of a solvent corporation that is operating in the zone of insolvency." *North American Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007).

In California, until the decision in *Berg*, no published opinion had addressed the issue of whether California law recognizes claims for breach of management's fiduciary duties to creditors either when the company is insolvent or in the zone of insolvency. In *Berg*, the California Court of Appeal made it clear that such claims cannot lie against the management of a California company.

The Berg Decision

Berg, the largest creditor of a California corporation based in Cupertino, Pluris, Inc. ("Pluris"), sued the directors of Pluris after Pluris had experienced financial difficulties and entered into an assignment for the benefit of its creditors ("ABC") under sections 493.010 and 1802 of the California Code of Civil Procedure.

Berg alleged that prior to the ABC, Pluris and a Berg-related entity were involved in a litigation regarding a lease repudiated by Pluris. The litigation was later settled when Pluris, which was experiencing financial distress, informed Berg that it was in the process of securing outside financing to continue operations and that such financing was conditioned on the settlement of its dispute with Berg. Pluris and the Berg-related entity agreed to a settlement of the litigation that assigned the claim of the Berg-related entity to Berg, making him Pluris' largest creditor. Berg allegedly informed Pluris at the time that, in case Pluris was unable to obtain the financing, Berg had a plan to derive value from Pluris' net operating losses by reorganizing under the Bankruptcy Code or exploring other alternatives.

Eventually, Pluris could not secure sufficient outside financing, and its directors entered into the ABC instead of pursuing Berg's plan.

The Trial Court

After several amendments to his complaint, the essence of Berg's claim was that the Pluris directors owed their fiduciary duty to Berg and the other creditors because the company was either insolvent or operating in the "zone of insolvency" at the time the ABC was accomplished. Berg alleged that Pluris' directors breached this duty when they approved the ABC transaction and did not pursue Berg's plan or alternative options that may have preserved the value of Pluris' $50 million net operating loss.

The directors demurred, and the trial court ultimately sustained the demurrer without leave to amend. In its dismissal of Berg's complaint, the trial court relied on a decision by the United States District Court for the Northern District of California interpreting California law. *CarrAmerica Realty Corp. v. nVIDIA Corp.*, Case No. 05-00428, 2006 U.S. Dist. LEXIS 75399 (N.D. Cal. September 29, 2006). The *CarrAmerica* court had concluded that the trust fund doctrine governs the duties of management of an insolvent corporation in California. The court stated that the scope of this doctrine is limited to cases where directors or officers have "diverted, dissipated, or unduly risked the insolvent corporation's assets" necessary to satisfy' creditors' claims. Such conduct involves self-dealing or prohibited preferential treatment of certain creditors. As such, since Berg failed to point to such misconduct by Pluris' directors, Berg's allegations failed to state a cognizable claim under California law.

On Appeal

The Court of Appeal affirmed the trial court's decision and approved the lower court's reliance on *CarrAmerica*. In effect, according to the *Berg* court, under California law, the company's insolvency does not create new duties on part of the directors who continue to be bound by their obligation to refrain from engaging in misconduct, self-dealing or preferential transfers to creditors.

According to the court, there was no misconduct on the part of Pluris' directors when they approved the ABC, which the court described as "a recognized statutory alternative to liquidation through bankruptcy," instead of "investigating, exploring or pursuing a bankruptcy reorganization." Such other alternatives described by Berg were "inherently speculative," the costs and risks of which "would not have been eliminated by discussions with Carl Berg or anyone else."

Further, the court held that even assuming that Berg's complaint pled a cognizable claim, the Pluris' directors would not be liable on alternative grounds. The Court found that the directors would be insulated from liability pursuant to the business judgment rule that immunizes directors when they acted in good faith in what they believed to be the company's best interest and without the presence of conflict of interest. According to the court, Berg made merely conclusory allegations that, without more, failed to rebut the presumption afforded by the business judgment rule.

Closing Thoughts

While the *Berg* decision is very favorable to directors of California corporations, the Supreme Court of California is yet to opine on the issue, and other appellate courts may hold differently in the future. In addition, a different set of circumstances facing directors charting the troubled waters of insolvency may yield a different result. Lastly, while there have been no California cases holding that directors owed their fiduciary duties to the company's creditors, directors of California companies have been found liable for breaches of fiduciary duties owed to the corporation and its shareholders when their decision to file bankruptcy harmed the value of the company's shares and when they did not consider other alternatives to bankruptcy. *See*, *e.g.*, *Davis v. Yageo Corporation*, 481 F.3d 661 (9th Cir. 2007) (directors liable as the bankruptcy filing was a breach of fiduciary duty designed to enable the majority shareholder to acquire the corporation's assets at less than fair value). Therefore, it remains important for California directors to continue to exercise diligence in weighing the options available to them when their company is insolvent and in considering the impact of these alternatives on all the company's constituencies, including its shareholders and creditors.

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