

VIEWPOINT

Upon Entering Zone Of Insolvency, Private Companies Must Stay Alert

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At a time when much attention is paid to zones of insolvency, deepening insolvency and fiduciary duties to creditors, private companies facing possible restructuring have more to ponder than ever before. Add to this the imposition of Sarbanes-Oxley public-company standards on private companies, and what may be the perfect storm in corporate governance could severely affect the next wave of private-company bankruptcies.

Issues tied to zones of insolvency and the rest came into sharp focus with *Pereira v. Cogan*, out of the Southern District of New York. This case extended traditional standards for public companies in corporate governance to private businesses. Issues related to its holding make *Pereira v. Cogan* a particularly important case three years after it was decided.

The most significant impact was how sweepingly the court was willing to impose liabilities on private-company directors for breach of fiduciary duties, including ratification of CEO compensation without sufficient information, failure to act on a CEO's stock redemption when the company was in financial decline, and failure to determine the feasibility of board-approved dividends in light of the company's financial decline.

Basically, *Cogan* set the stage for bringing together Sarbanes-Oxley mandates with deepening insolvency issues, making pre-bankruptcy planning for private companies something to be viewed in a whole new light.

The issues highlighted by *Cogan* and subsequent cases, while indicating what may be an emerging trend, are not conceptually new. The 4th U.S. Circuit Court of Appeals first melded insolvency and fiduciary-duty issues in 1982, in *FDIC v. Sea Pines*. In the context of that case the court found that when a company becomes insolvent, the duty owed by directors to shareholders shifts to creditors.

The court went further, not only establishing this duty shift, but laying the groundwork for prohibitions of property or cash transfers that might adversely affect creditor interests. That finding has been carried forward to the post-*Cogan* era, when bankruptcy courts around the U.S. are finding with increasing regularity that fiduciary duties to creditors arise upon a debtor's insolvency - without necessarily clarifying when that defining moment has occurred.

As a result of this noticeable shift in the law, a private company can no longer enjoy a carte blanche ride through bankruptcy using the business-judgment rule as its shield when the current environment places a premium on director inattentiveness, dereliction of duty and failure to monitor a CEO.

Once it is established that a company is in the "zone of insolvency," there is an extension of fiduciary duties owed to creditors.

As courts become more willing to apply public-company fiduciary standards to private businesses, the position that public accountability isn't applicable to the latter has decreasing defensive value in private-company bankruptcies. At the same time,

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this creates a cost to director defendants, who are now being pressured to pay a proportional share of creditor losses.

Some might argue that the business-judgment rule is dead as a result of the heightened level of scrutiny being applied to the actions of private-company officers and directors. And while this legal principle has narrowed, it clearly continues to shield corporate directors, particularly where there is no finding of self-dealing or bad faith.

That was the finding of the court in the Southern District of New York case of RSL Com Primecall Inc. v. Beckoff, which both reaffirmed deference to the business-judgment rule and left the door open to overcoming the rule in instances of self-dealing or bad faith.

As the public- and private-company worlds come closer together on director accountability, private companies must now be aware of what's becoming an expanded view of the independence of private-company directors, senior management accountability, and how officers' compensation is treated and approved - concepts traditionally applied to the public sector prior to Cogan and to subsequent cases involving deepening insolvency. The upshot is that distressed private companies and their directors have been left in a position of vulnerability never before seen in corporate America.

Not only do we live in an era when deepening insolvency has morphed into a theory of recovery, but bankruptcy courts have raised the bar on fiduciary duties owed to creditors when a debtor enters the "zone of insolvency." In a Pennsylvania case involving Total Containment Inc., the court categorically found that "where a company becomes insolvent, the fiduciary duty owed by corporate officers and directors shifts to the company's creditors." The court in the Central District of Illinois case of Fleming Packaging Corp., relying on a Delaware Chancery Court case, agreed with the position that upon insolvency, additional duties are owed to a corporation's creditors. Such cases only heighten the effects of Cogan and the standards emerging from Sarbanes-Oxley's applicability to private companies.

With these issues still developing - but very much a part of the law - private companies must plan for the inevitable clash between the business-judgment rule and liability being imposed as an independent cause of action against its directors and officers once the company has fallen into the "zone of insolvency."

Although Sarbanes-Oxley requirements aren't applicable to all private companies, with deepening insolvency alive and well, such companies need to look long and hard at issues like corporate-governance reform, director independence and enhanced disclosure. Attention to these should help protect a company, particularly one in financial decline, when claims of bad faith or self-dealing are made. At the same time, directors should come to expect that their actions before a bankruptcy filing will be scrutinized at a heightened level, as creditors and trustees use this increasingly popular method of recovery.

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