WHAT DIRECTORS AND CREDITORS NEED TO KNOW ABOUT STRUGGLING COMPANIES

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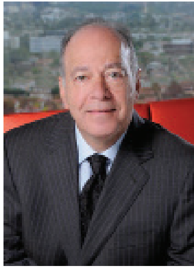

Generally speaking, directors and officers of a corporation and managers of limited liability companies have fiduciary duty to the company and its shareholders and members. Fiduciary duties have been defined in California Corporations Code section 309 which provides: "A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be in the best interests of the corporation and its shareholders and with such care, including reasonable inquiry, as an ordinarily prudent person in a like positions would use under similar circumstances."

Although the California courts have not specifically extended the fiduciary duty to creditors of insolvent companies, they have extended the application of an extra-contractual duty beyond those owed to shareholders and members to include creditors where the company is insolvent. *(Berg and Berg Enterprises v. Boyle 100 CalRptr 3rd 875)*

Trust Fund Doctrine

Under California law, once a corporation or LLC becomes insolvent (its debts exceed its assets, or when it is equitably insolvent), the assets of the company become a subject to the Trust Fund Doctrine for the benefit of their creditors.

Pursuant to the Trust Fund Doctrine, corporate directors, officers and LLC managers owe an extra-contractual duty to the creditors not to divert, dissipate, or unduly risk the assets of the insolvent company.

Examples of Diversion

- Potentially paying a creditor to whom an insider may have extended a personal guaranty.
- The payment of back salaries to insiders.
- Payment of expenses to insiders such as credit card expenses.
- Diversion of sales that would be otherwise available to the company or sales of company asserts to related parties or insiders.

Examples of Dissipation

- The unreasonable delay in liquidating inventory so as to render it less valuable.
- It may also be conduct that causes substantial additional creditor claims to incur, thus resulting in a dilution of creditor dividends

Examples of Undue Risk

- A transaction that has a remote likelihood of success. Often, insolvent companies are desperate to stay afloat and enter into unduly risky deals.
- The pledge of assets for loans that are of high interest and are not justified by the company's cash flow.

California has followed Delaware's lead in determining that the directors may not be sued individually but the claim may only be presented derivatively on behalf of the corporation. This means that the recovery will go back to the corporation and be available to creditors. The directors and officers maintain a defense of the "business judgment rule" in claims made by creditors. The business judgment rule is a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company

Delaware Law

Delaware law extends the Trust Fund Doctrine to an expanded area called the Zone of Insolvency, which has defied a clean definition. Suffice it to say that the company's financial situation does not fit the balance sheet test or the equitable test, but the company has significant financial issues.

The Delaware court has further limited claims against directors and officers by the application of the business judgment rule. The Delaware court has not extended the zone of insolvency rule to LLC's as there is a specific LLC statute in Delaware that the court has interpreted to exclude the fiduciary duty to creditors concept.

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