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California Court of Appeal Provides Guidance for Directors of Financially Distressed California Corporations

Almost two decades ago, the terms "vicinity of insolvency" and "zone of insolvency" were introduced into the legal and business lexicon by a Delaware Chancery Court decision in *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, 1991 WL 277613 (Del. Ch. 1991). Then, in May 2007, a major decision from the Delaware Supreme Court in *North American Catholic Educational Programming, Inc. v. Gheewalla, et al.*, 930 A.2d 92 (Del. 2007), held that individual creditors of a Delaware corporation that is either in the zone of insolvency or actually insolvent may not assert direct claims for breach of fiduciary duty against the corporation's directors, but they (or a bankruptcy trustee) may assert derivative claims for breach of fiduciary duty against the directors once the Delaware corporation is actually insolvent.

A new decision from the California Court of Appeal

The California courts, however, did not have occasion to consider issues involving the zone of insolvency and fiduciary duties of directors of financially troubled California corporations until quite recently. In a decision in a case called *Berg & Berg Enterprises, LLC v. Boyle,* the California Court of Appeal for the Sixth Appellate District has provided directors of California corporations facing potential insolvency with new guidance on the scope of their fiduciary duties.

The *Berg & Berg Enterprises* case involved Pluris, Inc., a privately held corporation which, upon finding itself unable to raise investment for continued operations, made a general assignment for the benefit of creditors ("ABC") under California law. Its largest creditor, Berg & Berg Enterprises, later sued the directors alleging that they breached their fiduciary duties to creditors by making the ABC instead of investigating an approach advocated by Berg & Berg Enterprises that allegedly would have preserved $50 million in net operating losses as an offset against taxes on future profits.

The decision's major holdings

In affirming the lower court's dismissal of the complaint with prejudice, the Court of Appeal made several important rulings.

- **First**, under California law directors of a corporation do not owe a fiduciary duty to creditors solely by virtue of the corporation operating in the "zone" or "vicinity" of insolvency.
- **Second**, 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.
- **Third**, when a California corporation is actually insolvent, under the long-standing "trust fund doctrine," the scope of a director's duty is limited to avoiding actions that divert, dissipate, or unduly risk corporate assets that might otherwise be used to pay creditors' claims. This would include acts that involve self-dealing or the preferential treatment of creditors.

A step back from broad fiduciary duties to creditors

For directors of financially distressed California corporations, the decision is consistent with rulings by federal courts in California and state courts in Delaware and elsewhere that have recently stepped back from a trend, which had started with the 1991 *Credit Lyonnais* opinion, of imposing on directors broad fiduciary

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duties to creditors. Instead, under *Berg & Berg Enterprises,* directors may continue to consider the interests of shareholders and the corporation the traditional beneficiaries of a director's fiduciary duties until such time as the corporation becomes actually insolvent.

- The *Berg & Berg Enterprises* decision concludes that even at the point of actual insolvency, however, a director's fiduciary duties to creditors are limited to avoiding certain actions, such as self-dealing or giving preferential treatment to certain creditors, that have the effect of diverting, dissipating, or unduly risking corporate assets that otherwise could potentially be available to pay creditors.

- The Court of Appeal also found no fault with the directors' decision to make a general assignment for the benefit of creditors, noting that an ABC is a statutorily recognized alternative to liquidation through bankruptcy. Interestingly, the Court of Appeal did not require the directors to demonstrate that the alternative approach advanced by Berg & Berg Enterprises would not have succeeded.

- In addition, although it did not make a definitive ruling on the issue, the Court of Appeal seemed comfortable with the directors' approval of wage and severance payments to non-insider employees. The Court of Appeal noted that both state ABC law and federal bankruptcy law provide employees with a certain level of priority treatment over general unsecured creditors and, absent a showing of other facts not present that might make the payments improper, the Court of Appeal did not find these payments objectionable.

An important word of caution

While this decision is welcome news for directors of distressed California corporations, it represents the views of only one Court of Appeal and, as yet, there is no guidance from the California Supreme Court on these issues. Moreover, although the decision distances itself from the "zone of insolvency" concept and focuses instead of actual insolvency, for a corporation with declining business and prospects, knowing when the entity has crossed out of the "zone" and into actual insolvency can be difficult to determine. Unfortunately, that determination is often made with the benefit of hindsight in litigation brought by unpaid creditors, bankruptcy trustees, or creditors' committees. As such, it remains important for directors of financially distressed California corporations to continue to make decisions on a fully informed basis, to consider alternative strategies, to avoid self-dealing and other conflicts of interest, and to exercise sound business judgment, in good faith, with the best interests of the corporation in mind.