



## Bankruptcy

Florida courts have yet to decide what duties companies near insolvency have to creditors

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In the midst of the worst economic environment since the Depression, many companies are likely to find themselves operating while insolvent or in the so-called “zone of insolvency.”

That environment raises a number of issues for company directors about their fiduciary duties — whether and at what point they owe fiduciary duties to the company’s creditors, and what is the nature of any such duties. Unfortunately, the answers to these questions are not entirely clear.

When a company is solvent, directors owe the company and its shareholders the fiduciary duties of care, loyalty and good faith. Nevertheless, a 2000 bankruptcy case in the Middle District of Florida found those duties are expanded to include the interests of creditors when a company becomes insolvent. A Minnesota judge in the case of Security Asset Capital last year went so far as to imply creditors may be owed fiduciary duties when a company is in the “zone of insolvency” or the “vicinity of insolvency.”

The Delaware Supreme Court decided the extent to which creditors could pursue company directors for breach of fiduciary duty in the case of the North American Catholic Educational Programming Foundation in 2007. Under Delaware law, the court concluded no fiduciary duties were owed to creditors when a company was in the “zone of insolvency.” The court reasoned creditors already had existing protections under their contractual agreements, fraudulent transfer laws and the implied covenant of good faith and fair dealing.

Once a company becomes insolvent, however, the court recognized that creditors were the residual beneficiaries and “the principal constituency injured by any fiduciary breaches that diminish the firm’s value.” A breach of any fiduciary duty by the directors that harmed the company would ultimately harm creditors. Nevertheless, the court held creditors could not assert a direct cause of action against directors of an insolvent company for breach of fiduciary duty, only a derivative claim on behalf of the company.

Under Florida law, the Florida Supreme Court long ago recognized directors “of an insolvent corporation occupy, toward the creditors of the corporation, a fiduciary relation in that the properties of the corporation constitute a fund for the payment of the corporation’s debts, which fund the directors are charged with managing to the best interests of the creditors.”

Federal courts in Florida differ about whether fiduciary duties are owed to creditors when the company is in the “zone of insolvency,” though that may depend on what state’s law applies.

As of yet, no Florida state court has addressed the issue or discussed the implications of the Delaware standard, something that is likely to occur when interpreting Florida corporate law. It remains to be seen what courts applying Florida law will do when addressing the “zone of insolvency” issue and fiduciary duties.

Assuming directors owe a fiduciary duty to an insolvent company’s creditors, the question for directors is this: What is the nature of their duties?

Unfortunately, the nature of those duties was not addressed by the Florida Supreme Court, and other courts in Florida have provided little, if any, guidance. It seems unlikely those duties require the directors to simply liquidate a company’s assets for the benefit of the creditors.

Instead, directors must continue to exercise their business judgment and pursue a variety of strategies as part of their good faith attempts to restructure an insolvent company and maximize its value. In doing so, however, they must consider the interests of the company’s creditors in the decision-making process.

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