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# “ZONE OF INSOLVENCY” CLAIMS AGAINST OFFICERS AND DIRECTORS STILL ALIVE (AND WELL?) OUTSIDE OF DELAWARE

By J. Eric Lockridge, JD

In the current economy, corporate officers and directors face an increased risk of derivative suits and other litigation against them from frustrated shareholders and other stakeholders in a corporation. Should officers and directors also be concerned about claims brought against them by their company's creditors? The answer may depend on what state's law applies to the creditors' claims.

It is well settled that directors and officers of a corporation owe to shareholders three primary fiduciary duties: the duty of care, the duty of loyalty, and the duty of good faith. Language from a 1991 Delaware case, however, caused concern that directors of an insolvent firm, or a firm in the “Zone of Insolvency,” owe fiduciary duties to the corporation's creditors, also. The controversy concerning the perceived expansion of director duties arose out of a footnote in *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, No. 12150, (Del. Ch. Dec. 30, 1991). Footnote 55 to that opinion stated that directors of a corporation “in the vicinity of insolvency” had certain duties in order to “maximize the corporation's long term wealth creating capacity.” A body of case law was created after that decision that attempted to define the “vicinity of insolvency” and to enumerate the duties owed by directors and officers to parties outside the corporation and its shareholders. For example, in *Carriero v. Jobs.com, Inc.*, the Fifth Circuit stated that officers and directors of a Texas corporation operating in the zone of insolvency owe fiduciary duties to creditors. 393 F.3d 508, 534, and n. 24 (2004).

Delaware dramatically curtailed zone-of-insolvency liability litigation in 2007. In *North American Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007), the Delaware Supreme Court announced that the officers and directors of Delaware corporations do not owe fiduciary duties to the corporation's creditors, regardless of how close the firm is to insolvency. Directors and officers owe fiduciary duties to the corporation and its shareholders only. The Court held that the only actions individual creditors may assert against officers or directors are derivative

claims on behalf of the corporation and, “any other direct nonfiduciary claim.” *Id.* at 103.

The “zone of insolvency” theory of fiduciary duties to creditors may still be viable in Louisiana and other states, however, despite being rejected by Delaware. In 2008, after the *Gheewalla* decision, the Eastern District of Louisiana decided that the manager of a Louisiana limited liability company owed fiduciary duties to one of the company's creditors because the company was within the zone of insolvency. *3 Point Holdings, L.L.C. v. Gulf South Solutions, L.L.C.*, Civ. No. 06-10902 (E.D. La. Mar. 13, 2008). The court cited *Carriero v. Jobs.com, Inc.* for a legal proposition that was important to its holding: “Officers and directors who are aware that the entity is within the ‘zone of insolvency’ have expanded fiduciary duties which include the creditors, not just equity holders.” The *3 Point Holdings* court made no reference to *Gheewalla*.

Another 2008 case from the Eastern District of Louisiana reached a different result on a similar question when it applied Delaware law. In *Torch Liquidating Trust v. Stockstill*, the court relied on the *Gheewalla* decision to hold that creditors of an insolvent corporation have no right to assert direct claims for breach of fiduciary duty against corporate directors. Civ. No. 07-133 (E.D. La. Mar. 13, 2008). The *Torch Liquidating Trust* decision noted that the parties agreed that Delaware substantive

law applied to the creditors' claims because the corporation was organized in Delaware. The *3 Point Holdings* decision, in contrast, presumably applied Louisiana substantive law because the limited liability company at issue was organized in Louisiana.

While the law appears settled in Delaware, it appears uncertain in Louisiana and possibly elsewhere within the Fifth Circuit. Officers and directors of corporations operating in or near “the zone of insolvency” would be wise to contact their outside counsel or their D&O insurer to discuss steps they can take to avoid being the test case for whether this theory is still a viable cause of action outside of Delaware.



**Editor's Note:** Eric Lockridge is a partner in the Baton Rouge office of Kean Miller. He joined the firm in September 2005 and practices in the Commercial Litigation, Business Reorganization and Bankruptcy and Intellectual

Property groups.

Eric devotes a majority of his practice to commercial bankruptcy and litigation. He has tried commercial and tort cases to verdict, and successfully defended judgments on appeal. He currently focuses on bankruptcy-related litigation and complex commercial cases for Kean Miller's construction, energy and financial sector clients.



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