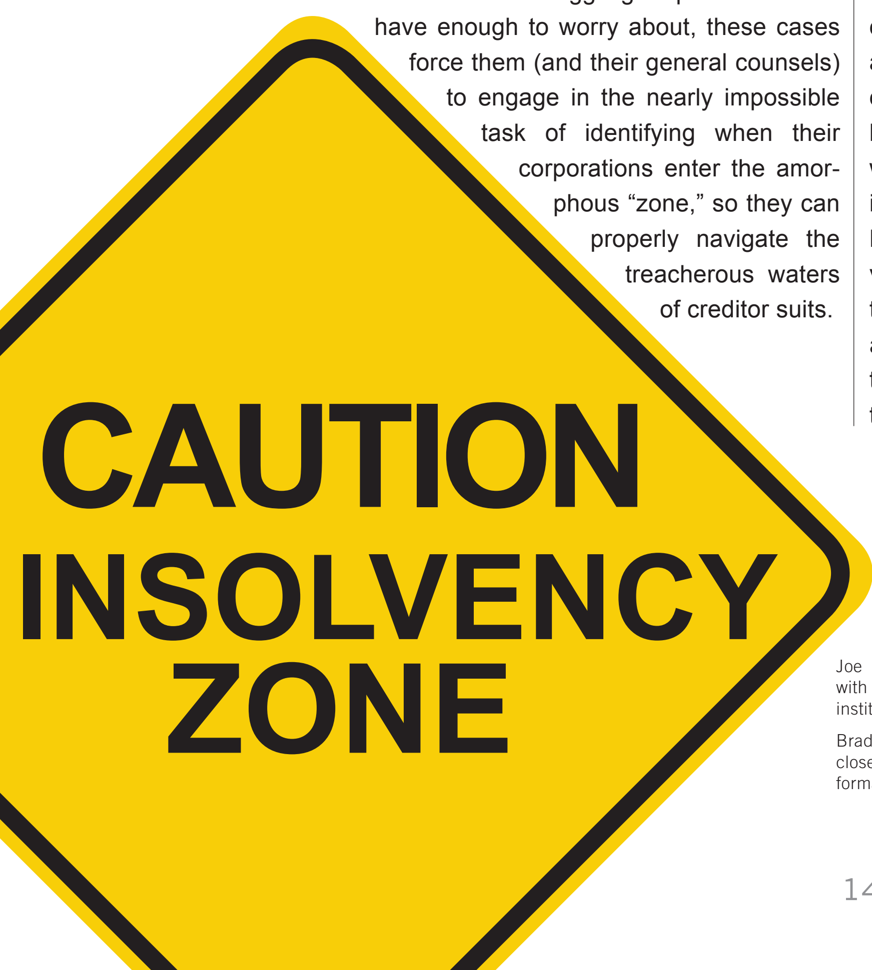
ON BOARD: IN (or OUT of) THE ZONE

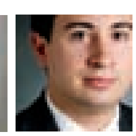
The economic crisis has caused huge financial losses for companies, shareholders and individual investors. Directors, officers, executives and fiduciaries are increasingly caught in the crosshairs of legal liability as their companies enter the "zone of insolvency." Once in the "zone," a director may suddenly find that his or her fiduciary duty is shifting away from the familiar realm of the shareholder, to the fractured and contentious world of the corporate creditor.

Directors generally owe a fiduciary duty to act in good faith and in the best interests of their shareholders. So long as directors do so, their actions are usually governed by the "business judgment rule," which defers corporate decision making to them and restricts a court's ability to second-guess their decisions. However, numerous courts throughout the country have held that once a corporation enters the "zone of insolvency," directors owe their main fiduciary duty to creditors, not shareholders. As if the directors of a struggling corporation do not have enough to worry about, these cases force them (and their general counsels) to engage in the nearly impossible task of identifying when their corporations enter the amorphous "zone," so they can properly navigate the treacherous waters of creditor suits.



Courts, directors and lawyers have focused on numerous formulae and tests based on revenues, assets, liabilities, ability to raise funds, balance sheets and burn rates to determine when a corporation entered the "zone," with frequently inconsistent outcomes. In 2007, the Delaware Supreme Court, a leading corporate law authority, took a step towards ending the confusion in the *Gheewalla* case. It eliminated the "zone of insolvency" concept altogether and held that directors owe fiduciary duties to their shareholders, not creditors, until the actual point of insolvency. The *Gheewalla* court further held that a director's duty was, as always, to act in the best interest of the corporation and its shareholders. The court further noted that in cases of insolvency, creditors could pursue derivative claims against directors for breach of fiduciary duty to the corporation because they were the true economic stakeholders in the company.

The *Gheewalla* court emphasized that the business judgment rule still applies to the directors' decisions, whether the shareholders or creditors are the beneficiaries of the decisions. Consequently, directors of financially distressed corporations must be particularly careful to document that their actions were the result of informed business judgment made in the interests of the corporation as a whole. In Minnesota currently, directors of companies on the verge of insolvency owe a limited fiduciary duty to creditors. The Delaware decision is likely to be adopted in other states, including Minnesota. Until that day, however, directors near the "zone" must tread lightly.



By Joe Alexander & Brad Pederson

Joe Alexander is a prominent corporate and financial services attorney with more than 25 years of experience advising businesses and financial institutions in all phases of activity. joseph.alexander@maslon.com

Brad Pederson is a commercial attorney focusing his practice primarily on closely held businesses, mergers & acquisitions, securities offerings, entity formations and business counseling. bradley.pederson@maslon.com