As the economy worsens, officers, directors and principals of struggling companies must recognize a shift in duty which arises when a company descends into what has become known as the “zone of insolvency.” Directors and officers owe fiduciary duties to the shareholders of a corporation. There are three basic duties: the duty of care; the duty of loyalty; and the duty of good faith.

The duty of care requires the director or officer to act as a reasonably prudent person in a similar position would under the circumstances. The duty of loyalty requires directors and officers to put the interest of the corporation ahead of their own. The duty of good faith requires decisions to be made with information available which are thought to be in the best interests of the corporation. Decisions made based upon insufficient or nonexistent information or which demonstrate an indifference to the potential harm to the company may breach the duty of good faith.

Duties of directors and officers of an insolvent company shift from acting solely in the interests of ownership (the shareholders) to also protecting the interests of creditors. Under New Jersey law, once a corporation becomes insolvent, the directors assume a fiduciary or quasi-trust duty to the corporation’s creditors. Board of Trustees of Teamsters, Local 863 Pension Fund v. Foodtown, Inc., 296 F. 3d 164, 173 (3d Cir. 2002). “In this quasi-trust relationship, ‘officers and directors cannot prefer one creditor over another, and they have a special duty not to prefer themselves.’” In re Stevens, 476 F. Supp. 147, 153, n. 5 (D.N.J. 1979).

The preliminary question is when does a company enter the zone of insolvency? The company’s board may already notice typical operating signs of insolvency, such as the company stretching out payment of its payables, taking on more debt or falling out of formula on its loan covenants. There are three general tests of insolvency. The first is the traditional balance sheet test. Does the value of the company’s assets exceed its liabilities? The second test is the cash flow test. Can the company meet its fixed financial obligations as they become due? The third, lesser-known test looks at the company’s capital in terms of its ability to support financing of future operations.

If the signs of insolvency are apparent, the company’s directors, officers and other fiduciaries must take action with caution to avoid personal exposure to the company’s creditors. They must act to protect the overall value of the enterprise. The duty to protect the value of the company may also extend to professionals advising the directors and officers of a company. See, NCP Litigation Trust v. KPMG, 399 N.J. Super 606 (Law Div. 2007).

There are specific claims which may arise where directors of insolvent corporations act contrary to the interests of creditors. Perhaps one of the most common defalcations of fiduciary duty occurs when a director claims to be unfamiliar with the predicament of the company or turns a “blind eye” to the problem. Directors of insolvent corporations (or those deemed to owe duties to creditors) must review financial statements and information which raise concern over the conduct of the company by other directors and officers. Francis v. United Jersey Bank, 87 N.J. 15 (1981). A director with specific knowledge of insider fraud or self-dealing must take actions to report the “bad acts” or there may be exposure for the director to shareholders and creditors.

The quasi-trust duty of directors of an insolvent company prohibits them from transferring assets of the company which could constitute fraud upon creditors. This is true even where the transfer is to a creditor in preference over another. AYR Composition, Inc. v. Rosenberg, 261 N.J. Super. 495 (App. Div. 1993). Thus, insiders of a company have liability to creditors where they transfer assets such as a customer list to a competitor, thereby
securing personal benefit and gain to the detriment of the company and its creditors.

Similarly, an insolvent corporation in most jurisdictions makes a preferential payment subject to avoidance where debt to an insider is repaid when the company is insolvent. Portage Insulated Pipe Co. v. Costanzo, 114 N.J. Super 164 (App. Div. 1971). However, a single creditor typically does not have standing to set aside this type of conveyance. The action must be brought on behalf of all creditors by a trustee, committee or similar representative.

A more recent variant of the breach of fiduciary duty claim is the theory of deepening insolvency. This “theory” has spawned significant litigation over the last few years. The premise of deepening insolvency is that a director or officer of a company cannot approve an action whereby the company incurs additional debt, thereby negligently or fraudulently prolonging its corporate life. Deepening insolvency claims have been recognized by certain courts as an independent cause of action. However, some courts treat the claim as merely factual elements of a more traditional breach of duty type of action.

In NCP Litigation Trust, the Superior Court of New Jersey, on remand, held that deepening insolvency is a legally cognizable claim in New Jersey. The court noted various court decisions which have recognized this theory as legally cognizable on its own. Id. at 619; See, eg., In re CitX Corp., 448 F.3d 672 (3d Cir. 2006). The CitX court held that deepening insolvency is an independent cause of action under Pennsylvania law and defined it as the fraudulent expansion of corporate debt and prolongation of corporate life; Corcoran v. Frank B. Hall & Co., 149 A.D.2d 165, 545 N.Y.S.2d 278,283 (1989) (failure to disclose the insolvency of an insurance corporation is an injury to that corporation for which the Superintendent may institute an action).


There are, of course, routine actions fiduciaries of a company may take to protect themselves from breach of duty and deepening insolvency claims. When making decisions in the zone of insolvency, officers and directors must expand their view beyond that of ownership. Although directors may be protected by the business judgment rule, decisions in the zone of insolvency are often made during times when business is not conducted “as usual.” Accordingly, decisions to take on additional debt, sell assets, transfer assets, issue stock, merge, acquire assets and the like must be carefully examined in terms of preserving the enterprise value of the company for creditors. Equally as important, the company cannot sit back and do nothing, relying on business as usual, while the financial condition of the company continues to deteriorate.

It may be necessary for officers and directors to resign. An interim board may be put in place during the company’s time in the zone of insolvency. The company may also place interim management in control, particularly in situations where current management may be perceived by creditors as part of the problem or where the board has uncovered evidence of mismanagement, insider dealing or fraud.

Often the company must retain outside auditors to conduct a thorough financial review of the company’s books and records. Further, although a company’s internal legal and financial professionals should certainly be heavily involved in the process, ultimately the directors and officer should obtain insolvency advice from experienced insolvency professionals. In many instances, the directors of a company “in the zone” must additionally retain independent legal counsel to represent their interests if there is the potential that these interests may conflict with those of the corporation.

Officers and directors of a company in the zone of insolvency have a difficult and complex role to fulfill for an expanded trust constituency. They must act in the best interests of both shareholders and creditors and are limited by the company’s insolvency in the actions they may take. In the end, their decisions will be closely scrutinized by creditors who may not have the best prospects for recovery. These are often the parties in later proceedings who will be collectively searching for alternative avenues to be made whole on their claims.