"Zone of Insolvency" Meets the "Zone of Coverage"
During Periods of Insolvency

(Liability & Management Lessons for the Corporate CEO, CFO & Director; from the Official Take-Under of Bear Stearns & the Mortgage Meltdown)

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Issues Overview - All Sides

It was beyond another historic day on Wall Street. The Federal Reserve (Fed) hadn't made a similar move for over 50 years. Rumor had it that Bear Stearns was to file bankruptcy that Monday, March 17, 2008, but the Fed invoked an arcane regulation which effectively "forced" the take over of Bear Stearns by suitor JP Morgan Chase. This move was guaranteed by the unknowing taxpayer to the tune of $29 billion when the Fed granted access to the Discount Window and accepted collateral in amounts and quality which remains secret, uncertain and unknown. Maybe we should call it what it is: a take-under and lateral pass. Over that infamous weekend the Fed, JP Morgan Chase and Bear Stearns agreed to a $2 per share buyout; against a recent $84 per share book value. As late as January 2007, Bear Stearns had a $171 share price. JP Morgan Chase will pay $236 million (with the downside "put option" guarantee or backing of the Fed), including an option on the building. The building is said to be worth more than the deal price alone.

What are the legal ramifications? What laws come into play from such conduct?

Lawsuits > Corporate Duties > Business Judgment Rule > Insurance Litigation

The Fed apparently fashioned a credit guarantee take-under (with lateral pass) template for the investment banks, which wipes out common equity while passing the revised and taxpayer guaranteed going-concern to the suitor. It circumvents, and operates outside of the bankruptcy fiefdom, at fire sale prices; at least initially.

Lawsuits >

Investor, shareholder, counterparty, creditor and employee lawsuits are likely to skyrocket around the Bear Stearns take-under or this type of resolution model. For example, JP Morgan Chase will have access to $6-7B allocated to a litigation fund. These lawsuits will further define the gray lines that exist in **"zone of insolvency"** litigation (i.e.: conflicting duties owed by directors and officers to shareholders, creditors, employees and other interested parties). The emerging and heightened duties owed when making decisions in the zone of insolvency will focus much litigation around the ***decision-making-process***. The broad issue may be defined as: what duties are owed to whom, when insolvency is foreseeable? A flood of coming lawsuits will determine whether or not (fiduciary) duties were owed to shareholders, creditors, employees, counterparties or other interested parties, which required the

filing of an actual “bankruptcy” instead of the perfection of a secret take-under fire sale. Other issues that must be answered may include: whether or not Directors and Officers (Board of Directors) owe a heightened or fiduciary duty to shareholders, creditors, employees, counterparties or other interested parties when facing insolvency which requires inclusion of such parties in the decision making process?

Corporate Fiduciary Duties >

Similarly with all jurisdictions, directors and officers manage the corporation (entity) for the shareholders. For example, in California, Corporations Code 300 states in pertinent part:

> (a) … the business and affairs of the corporation shall be managed and all corporate powers shall be exercised by or under the direction of the board. The board may delegate the management of the day-to-day operation of the business of the corporation to a management company or other person provided that the business and affairs of the corporation shall be managed and all corporate powers shall be exercised under the ultimate direction of the board.

When the company is clearly solvent, the duty of care (to act prudently) and the duty of loyalty (to refrain from self-dealing) are clearly focused on the entity and the shareholders. As found in most jurisdictions, by way of example, California Corporations Code 309 (a) defines the statutory duty of care and loyalty as:

> (a) A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be **in the best interests of the corporation and its shareholders** and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances. [Emphasis added]

Extension of Duties Owed > Threshold Question: Zone of Insolvency >

Historically in California and Delaware, the general rule is that directors owe a fiduciary duty of care and loyalty to the entity and its shareholders; but not to creditors or warrant holders (Simons v Cogan (Del 1988) 549 A2d 300. However, in times of insolvency, or when operating within the zone of insolvency, a question remains: whether or not additional duties or heightened duties arise to others, namely creditors.

An inclusive resolution strategy can be implemented by bringing creditor, shareholder, investor, counterparty, employees, or conflicting self interest groups into the "decision-making-process" at the time of assessment or acknowledgment of the zone of insolvency.

In times of historic illiquidity, credit impairment, and economic downturn, compounded by the existence of historic levels of securitized mortgage backed securities (MBS) facing serious devaluation, credit rating downgrades and uncertain insurance coverage, managers (and the Board of Directors) must discern whether they are in the zone of insolvency, and whether or not they owe duties to more remote constituencies, such as creditors, counterparties and employees. To make this determination, they must ascertain whether they are solvent or operating within the zone or vicinity of insolvency (Geyer v Ingersoll Publications (Del Ch 1992) 621 A2d 784). With no clear definitions of the ‘zone of insolvency’, directors and officers are very often operating within the zone, whether they recognize it or not. California Civil Code 3439.02 states:

(a) A debtor is insolvent if, at fair valuations, the sum of the debtor's debts is greater than all of the debtor's assets.
(b) A debtor which is a partnership is insolvent if, at fair valuations, the sum of the partnership's debts is greater than the aggregate of all of the partnership's assets and the sum of the excess of the value of each general partner's nonpartnership assets over the partner's nonpartnership debts.
(c) A debtor who is generally not paying his or her debts as they become due is presumed to be insolvent.
(d) Assets under this section do not include property that has been transferred, concealed, or removed with intent to hinder, delay, or defraud creditors or that has been transferred in a manner making the transfer voidable under this chapter.
(e) Debts under this section do not include an obligation to the extent it is secured by a valid lien on property of the debtor not included as an asset.

When operating in the grey area of the 'zone of insolvency', directors and officers may owe additional (fiduciary) duties to creditors, and by analogy, others such as investors, and employees (North American Catholic Education Programming Foundation, Inc., v. Gheewalla, (Del 2007) 930 A2d 92 at 101). The board is often vulnerable to legal attack for not fully acknowledging and addressing or protecting, the interests of these other parties when operating in the zone of insolvency. By failing to address, resolve or safeguard these inherent conflicts of interests among these conflicting diverse self-interests, the board may assume liability - for failure to do so.

The law is not settled in this area, and is uncertain in many respects. But in jurisdictions imposing such duties, directors and officers are better advised to include such diverse groups in the decision-making-process. Similar to the administration of a bankruptcy estate, creditor groups are entitled to participate in the litigation of all such issues. For example, did the Bear Stearns merger team have a duty to invite its major creditors, investors, counterparties or employee representatives to the negotiation table to avoid violating these (possibly) heightened duties? No opinion is drawn herein. The author acknowledges that there may be a business judgment defense argument that the Bear Stearns merger was in part motivated by the Feds to avoid a potential broad market meltdown that would have caused total loss to the company (and economy).

Zone of Insolvency in the Mortgage Meltdown > Key Questions >

Zone of Insolvency is the grey-matter of this tumultuous issue. What exactly is the zone of insolvency, and how do directors and officers know they are operating within it? Are the decisions of directors and officers (Board) always susceptible to attack when operating in economic times of foreseeable financial stress when credit and liquidity are uncertainty or much less available then in prior (good) times? What about banks, lenders and investment banks (like Bears Stearns) who have great amounts of Mortgage Backed Securities (MBS) on their books that are subject to probable high default rates, huge write-downs, and additional capital (call) requirements; are they operating in the zone of insolvency? What about their counterparties, especially when probable Rating Agency downgrades are foreseeable? What about holders of securitized MBS and commercial back mortgage securities (CMBS) that are facing probable write-downs, and downgrades from rating agencies, and hold "representations and warranties" from known thinly capitalized mortgage lenders, who have either gone out of business or are likely to do so at any time, and may (or may not) have insurance to cover the losses? These fact patterns and many others may support the elements of numerous causes of action that are generally accepted and/or emerging.

Causes of Action > Personal & Entity Level Liability >

There are many potential causes of action that may ensue to seek redress consistent with the theme conduct of recklessness, gross negligence or intentional conduct intended to defraud the creditors (or

others) from assets sufficient to cover the foreseeable debts owed, or to defraud the creditors (or others) of a remedy. Causes of action that may encompass such theme facts may also include, breach of contract, fraud, breach of fiduciary duty, by derivative actions (North American Catholic Education Programming Foundation, Inc., v. Gheewalla, (Del 2007) 930 A2d 92 at 102), and fraudulent transfers, conspiracy to defraud creditors (others), Unfair Business Practices (California Business & Professions Code §17200), sham sale liability, RICO, and Deepening Insolvency ((Bankr. D. Del. 2003) Official Comm. of Unsecured Creditors v Credit Suisse First Boston 299 B.R. 732, 750-52). Creditors may be entitled to use derivative actions, as authorized by most courts, however, direct actions are not generally authorized as yet.

A deepening insolvency cause of action or damages element occurs when the directors and officers incur additional debt while operating in the zone of insolvency, in an attempt to bridge the insolvency gap into the solvency zone. A few courts have indicated that they would or may allow such redress or direct claim. ((Bankr. D. Del. 2007) Miller v McCown De Leeuw & Co., Inc. (In re The Brown Schools), 368 B.R. 394, and Jetpay Merchant Services, LLC. v. Miller, 2007 WL 2701636, 7 (N.D. Tex. Sept. 17, 2007).

Some cases arising out of the Delaware General Corporation Law 271 should serve as a reminder that creditors (and other like parties) who are defrauded out of repayment or assets by which to be redressed, or legal or equitable remedies, will have authority to pursue such claims. For example, the sale, lease or exchange of assets without fair consideration, or made with “disparity (is) so great as to shock the conscience of the court or warrant the conclusion that the majority was actuated by improper motives, thereby working injury to the minority…” (Massaro v Fisk Rubber Corp. 36 FSupp 382 (D Mass 1941), California General Corporation Law at 1000, 1001, and 1100, CSC California Law Affecting Business Entities). The provisions of this section are for the benefit of the stockholders and creditors and they alone can object to the transfer (Gunther v. Thompson, 211 Cal 631).

Moreover, failing to adopt a plan to pay creditors (Delaware General Corporation Law 280, 281; California General Corporation Law, 2004-2011, CSC California Law Affecting Business Entities) may result in further action against the purchaser and seller. “Creditors may pursue the corporate assets into the hands of the transferee corporation when, on the sale of corporate assets, no provision is made for the payment of corporate debts. (McKee v. Standard Minerals Corp. 156 A 193 (Ch Ct 1931); Colonial Ice Cream Co. v Southland Ice Utilities Corp., 53 F2d 932 (CD Cir 1931).

For pleading, law & motion and damages purposes, litigators may very well seek cases limited to facts that indicate that the directors and officers have failed to acknowledge that they are operating in the zone of insolvency, and failed to address, resolve or include creditors, counterparties, investors or employees from participating in the resolution of the these diverse interests. These cases with successful expert testimony would tend to show that the directors and officers acted recklessly, with gross negligence or with the intention to defraud creditors (or others), and/or to wrongfully destroy such remedies.

The defenses of such actions will revolve around the general limitations of corporate duty rules holding that no duty is due such remote parties, no direct action for a deepening insolvency cause of action or as damages exists, invocation of the Business Judgment Rule defense and the factual expert defense argument that the circumstances were merely foreseeable business risks.

However, one thing is for certain: one of the hottest areas of litigation that will arise from the mortgage meltdown will be over insurance coverage. Bad faith actions against carriers should see a rise as disputes over coverage, exclusions, and notice requirements materialize. One example of where a vast landmine of coverage disputes reside is in the buyback or repurchase demand and litigation area.

Related Insurance Coverage & Litigation >

Several types of insurance policies might afford coverage to various buyers or beneficiaries of such mortgage industry related policies, including corporate directors and officers, investment banks, investors, pension funds, assignee trusts, REMICS, owners of mortgage backed securities, shareholders, employees, lenders, and in some cases, borrowers. Coverage may be available for investigations, litigation, defense or indemnity. Directors and Officers (D&O), Errors & Omissions (E&O), Commercial General Liability (CGL), Employment Practices Liability (EPL), Credit Risk, Accounts Receivable or Private Mortgage Insurance (MI), and Investors Residential Value (IRV) insurance policies may be in play.

Whether or not directors and officers (Board of Directors) are required to give notice of a 'potential' claim to their carrier(s) or whether certain exclusions preclude coverage, will be hotly contested as investigations and lawsuits are filed and coverage requests are made. There are very short claims notice requirements (i.e. 10 days) in many of these policies, which may act to preclude coverage (in some states). There are many policy provisions that may preclude coverage or be counter intuitive to good business judgment. Moreover, this uncertainty, and/or potential or actual loss of coverage may add to the argument that the entity operated within a zone of insolvency, and therefore owed a higher or expanded duty (i.e. to creditors).

The Zone of Coverage >

Special Warning: "BuyBacks" & Potential Waiver of Insurance Coverage >

The unwary investment bank or investor demanding subprime defaulted buybacks from the unwary lender or originator, may preclude insurance coverage when adverse positions are taken which outright deny or prove that there is no liability (debt) under the repurchase agreement or buyback demand because certain credit risk policies (MI) have clauses which require the buyer to be in actual debt to gain policy coverage. So the lender industry norm of 'dispute and deny' when faced with buyback demands, may very well jeopardize insurance coverage.

Disputes might better seek further information and evidence of such demands on a loan by loan and document by document level, without an outright denial of such indebtedness, but at the same time, trigger a notice of potential claim to the carrier; but only after consultation with an expert (bad faith and mortgage industry) insurance litigator.

Furthermore, directors and officers must consider whether insurance may or may not be available for such underlying buybacks or its related litigation as a factor in determining whether the company is operating in the zone of insolvency with heightened duties, and how that might affect creditors, counterparties, investors, employees and other interested parties; including the availability of insurance (loss) coverage to each diverse related interest. Buyers of insurance must act quickly when facing investigations, buyback demands, disputes or litigation, to ascertain how to act within the zone of coverage.

Directors and officers must act immediately to seek the advice of expert insurance litigation attorneys – or face the potential of uninsured losses, personal and/or entity level liability.

Resolution of Conflicting Priorities > New Optimal Best Practices Safe Harbor >

For those cases where directors and officers include creditors, counterparties, investors, or employees to participate in the resolution of such diverse interests, such efforts of inclusion may tend to preclude such actions altogether, limit liability and lessen or preclude findings of intent or malice. Moreover,

such inclusive participatory resolution strategy practices are or will become the safe harbor or optimal best practice as it benefits all related interests.

An inclusive resolution strategy can be implemented by bringing creditor, shareholder, investor, counterparty, employees or conflicting self interest groups into the **"decision-making-process"** at the time of assessment or acknowledgment of the zone of insolvency. This will also serve the interests of all related parties. However, **confidentiality** may be necessary when structuring an inclusive participatory resolution strategy. Otherwise, filing for bankruptcy protection may be the preferred step for the 'prepared' entity (directors and officers).

The Zone of Coverage Meets the Zone of Insolvency >

The author recommends that the industry consider immediate steps to ascertain optimal best practices that enhance the likelihood that related participants are operating within the "zone of coverage" before "fair value" valuations (FASB 157, etc.) more accurately recognize loss severity due to insecure or uncertain related insurance coverage (procedures), that can be used to support the argument that the entity was (knowingly) operating within the zone of insolvency; finding extended (fiduciary) duties and uninsured liabilities owed not only to first parties, but to third parties, such as creditors, and others.

Richard Ivar Rydstrom is a California attorney practicing in Southern California. He is the Chairman of the Coalition for Mortgage Industry Solutions out of DC. He has been published by the 110th Congress on the State of the Economy and Challenges Facing the Middle Class, Homeownership, and the Mortgage Meltdown. Mr. Rydstrom created solutions for the mortgage banking industry and consumer including:

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