



What do you owe?

What are your fiduciary responsibilities to creditors when your company becomes insolvent?

By Brian J. Hunt

THE LAW HAS LONG GRAPPLED WITH THE PROBLEM OF THE RELIEF available to creditors once a corporation has become insolvent. Before insolvency, creditors have a ready means to protect themselves by obtaining security, altering the terms by which money is lent, and monitoring the borrower's financial status. However, neither creditors nor the law have been fully satisfied with the outcome after the fact.

The solution? One option is to impose a "special circumstance" fiduciary duty on corporate insiders to creditors when the corporation becomes insolvent. Although Illinois law on the topic is sketchy, federal Judge Aspen has ventured to make a statement in this area in *Dexia Credit Local v. Rogan*, 2003 WL 22349111.

About the case - Dexia had issued a \$55 million letter of credit to Edgewater Medical Center (EMC) guaranteeing a bond repayment. In return, Dexia had secured its debt with collateral which included receivables, intangibles, equipment and fixtures. EMC also contracted to satisfy certain financial covenants, including maintaining debt service ratios, capitalization levels and levels of cash on hand. When EMC eventually defaulted on the financial covenants and then the bonds, Dexia was obligated to pay the principal. In turn, Dexia pursued legal remedies against Peter Rogan, EMC's CEO and largest shareholder, and several entities that he controlled.

The allegations - Dexia alleged that EMC's default was due to a complex scheme that involved Medicare fraud, as well as efforts to funnel money out of EMC for personal benefit. Specifically, Dexia alleged that;

1. Although Rogan sold most of his ownership interest in EMC, he continued to directly manage and control the company. At the same time, Rogan established two property companies, EPC and PGR, through which he

retained title to several buildings that were essential to EMC's continued operation.

2. Rogan controlled two nonprofit corporations, Access and Vital, Access being the sole corporate member of Vital, and Vital the sole corporate member of EMC. Rogan, in conjunction with Access and Vital, allegedly approved, and caused the EMC Board of Directors to approve, construction projects and building developments designed intentionally to make EMC's operation highly dependent on the buildings and other real property adjacent to EMC, which Rogan controlled through EPC and PGR. These improvements included installing air conditioning and telephone facilities for EMC on EPC- and PGR-owned real estate.
3. Rogan, Access and Vital caused the EMC Board of Directors to approve a 10-year lease agreement between EMC and EPC, under which rent payments were "exorbitant relative to the fair market value and the rental value" of the property.
4. Rogan, Access and Vital caused EMC to approve payments to PGR for the use of two parking lots, for which it also paid property taxes and other expenses related to the parking lots.
5. Rogan, Access and Vital caused the EMC Board of Directors to fail to exercise an exclusive option to purchase PGR's real property, even though it knew that a failure to do so would "financially disadvantage" EMC and its creditors.

Dexia alleged, amongst other claims, that EPC and PGR colluded with Access, Vital and Rogan in breaching fiduciary duties. In response, EPC and PGR moved to dismiss the action and asserted that Dexia lacked standing to sue for breach of fiduciary duty. In addition, EPC and PGR argued that the pertinent fiduciary duty did not extend to Access and Vital in that the receipt of rent and other payments were merely "business as usual."

Judge Aspen's Position - When it comes to the conduct of closely held corporations, in particular, members and shareholders owe special circumstance fiduciary duties to creditors to the same extent as officers and directors. Noting that the Illinois Supreme Court has not spoken on the issue and that no clear rule has emerged in Illinois, Judge Aspen rejected the proposition that an individual creditor never has standing to sue on a claim of breach of fiduciary duty. Rather, the judge followed precedent from other jurisdictions and held that the question of standing in fiduciary duty cases hinges upon whether the alleged injury is personal to the individual creditor or impacts all creditors alike. This, he stated, was a determination to be made on a case-by-case basis. He then concluded that Dexia had adequately shown that its claim was distinct from other creditors, particularly in light of the "tremendous injury" (i.e. \$55 million) alleged.

With regard to whether EPC and PGR should be held liable for colluding with Access and Vital to breach fiduciary duties and for colluding with Rogan to breach his fiduciary duty, Judge Aspen began by noting that, generally, corporate officers and directors do not owe fiduciary duties to a corporation's creditors. However, he also acknowledged the two exceptions to the rule, which are recognized under Illinois law. First, when a corporate officer or director breaches his or her fiduciary duty by misappropriating funds, and thus damages the relationship between the corporation and its creditors, the creditor can maintain a personal suit against the officer or director. Second, officers and directors have a fiduciary duty to creditors once the corporation becomes insolvent.

Dexia had alleged that Access, Vital and Rogan owed fiduciary duties because

they misappropriated funds from EMC. Furthermore, Dexia alleged that the parties had fiduciary duties to EMC's creditors once Edgewater became insolvent. Based on these allegations, the judge concluded that the claims were sufficient to demonstrate a "special circumstance" fiduciary duty, owed by those who controlled EMC to EMC's creditors.

Also rejecting EPC and PGR's assertion that the fiduciary duty extends only to officers and directors of the corporation and not to the corporation's controlling shareholders or members, Judge Aspen stated that controlling members owe fiduciary duties to their corporations and other shareholders. He remarked that the rule exists because of the great power that controlling members can wield over the corporation and, especially in the context of closely held corporations, members and shareholders owe special circumstance fiduciary duties to creditors to the same extent as officers and directors. Therefore, based on the allegations that Access controlled Vital, that Vital controlled EMC, and that Access and Vital participated in misappropriating funds from Edgewater before and after the insolvency, he concluded that the complaint was sufficient.

Lastly, in turning to the issue of whether EPC and PGR can be held liable for a breach of fiduciary duty by Rogan, Access and Vital, Judge Aspen observed that, under Illinois law, it is possible to bring an action against a person or entity that colludes and/or induces a breach of fiduciary duty. He stated that a person participates in a fiduciary's breach if he or she affirmatively assists in concealing the breach or, by virtue of failing to act when required to do so, enables it to proceed. Despite EPC and PGR's assertion that the rent and other payments were merely business as usual, Judge Aspen felt that Dexia had sufficiently alleged that PGR and EPC knew of Rogan, Access and Vital's misconduct to state a claim for breach of fiduciary duty.

The Court's decision - Based on this analysis, the Court concluded that EPC and PGR could maintain, at this preliminary stage, an action against Rogan, Access and Vital based on the special circumstance fiduciary duty imposed upon them. Doubtless it did not escape Judge Aspen's notice that his reasoning would give the lender a valid claim against those entities that held the only substantial asset: the real estate.

However, we are left to wonder about the ambiguity raised by determining the existence of a special circumstance fiduciary duty on a case-by-case basis. Although a case-by-case determination may help a court address those instances that smack of perversion, it may also present a trap for the unwary officers, directors, members and shareholders who stick with a struggling corporation only to see it ultimately fail. Those insiders who find themselves in such a "special circumstance" are well advised both to take action to protect themselves and to consider how their conduct will appear in hindsight.

About the Author

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