By James C. Bruno and David M. Zorin

Following the Better Path: The Duties of Directors of Insolvent Michigan Corporations Under MBCA Section 834(a)

Delaware has long been used as the standard authority for many corporate law topics and several recent articles have been written addressing the duties of Delaware directors to creditors when the company is at or near insolvency. Scott M. DeWolf, "Avoiding the Pitfalls of Insolvency Liability: Directors' and Officers' Fiduciary Duties to Creditors When the Company Is Insolvent or in the Vicinity of Insolvency," MI Bus LJ, Summer 2002, at 12–16. But, in this area, Michigan has statutes and case law that delineate a course of action that differs from the Delaware approach. This article does not address directors' duties that may arise under federal bankruptcy law. This article assumes that the corporation is insolvent or in the zone of insolvency and focuses on the duties owed by directors of such an "insolvent" corporation.

Michigan

The Michigan Business Corporation Act (MBCA), MCLA Section 450.1101 et seq., restricts the ability of a board to authorize distributions to shareholders in the regular course of business and also imposes restrictions on distributions in dissolution. Under Section 345 of the MBCA, a distribution cannot be made if, after taking into account its affect, the corporation would be unable to pay its debts as they become due or its financial statements show liabilities in excess of assets. In addition, before distributions may be made to shareholders pursuant to a dissolution, MBCA Section 855(a) requires a corporation to first pay or make adequate provisions for its debts, obligations, and liabilities. MBCA Section 855(a) does not, however, mandate that all debts must be paid before distributions can be made or provide that all shareholders or debt holders be treated the same. The MBCA does not adopt the concept that the directors are trustees for all corporate assets and have fiduciary obligations to creditors. In fact, MBCA Section 834(a) specifically rejects this "trust fund doctrine" idea, "The directors of the corporation are not deemed to be trustees of its assets." In addition, MBCA Section 122(3), which states that the Uniform Fraudulent Conveyances Act is not applicable to distributions under the MBCA, provides additional evidence that the MBCA (including MBCA Section 345 and Section 855(a) discussed above) is a complete and comprehensive expression of director duties in Michigan relating to creditors. In Michigan, absent binding agreement or statutory provisions to the contrary, a solvent corporation is always free to choose and prioritize which of its obligations it will pay when and how much is to be allocated. Other than the dissolution provision in MBCA Section 345 and Section 855a discussed earlier, there are no prohibitions against corporations making the same business decisions when they are insolvent. This statutory construct is consistent with judicial precedent.

Michigan courts have long supported the proposition that corporations may decide how to allocate resources to fulfill their obligations. In dismissing various claims brought by a creditor of an insolvent corporation, the court opined that the defendant corporation "had the right to favor one bona fide creditor over another bona fide creditor." *Winters v Bear Creek Investments, Inc,* No. 226494 (Mich App, March 12, 2002). The right of a corporate Board to give preferences is not affected by whether or not the creditor is also a shareholder. A shareholder-creditor is not automatically treated differently than a nonshareholder creditor, but the directors do have the ability to prefer a shareholder-creditor without violating any obligations to other creditors. A much earlier case, *Bank of Montreal v JE Potts Salt & Lumber Co,* 90 Mich 345; 51 NW 512, 513 (1892) clearly espouses several ideas addressed in this article and is still good law in Michigan on the applicability of the "trust fund doctrine," including the ability of a corporation to prefer shareholders to creditors, as well as preferences between creditors. In refusing to hold assignments made by an insolvent corporation illegal, the court held that:

> *The corporation had the same right to prefer one creditor over another that an individual has... nor is it the law of this state that, as soon as a corporation becomes insolvent, the directors of the corporation become trustees for*

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all the creditors alike, in such sense as to prevent their giving valid security by way of preference to one of the stockholders or directors. It being insolvent, such action must result in the payment of some to the exclusion of others. Bank of Montreal v JE Potts Salt & Lumber Co, *at 513.*

Delaware

Unlike Michigan, Delaware does not have statutes that expressly reject the Trust Fund Doctrine. In fact, Delaware case law has embraced the principles of the Trust Fund Doctrine in varying degrees. Upon a corporation's insolvency, Delaware opinions such as *Credit Lyonnais Bank Nederland, NV v Pathe Communications Corp,* 1991 Del Ch Lexis 215 and *Geyer v Ingersoll Publications Co,* 621 A2d 784 (Del. Ch. 1992) follow the premise that:

a corporation's actual or imminent insolvency alters a board's fiduciary duties in that the constituency to whom the board owes fiduciary duties is expanded... directors of a corporation that is insolvent must choose a course of action that best serves the entire corporate enterprise rather than any single group interested in the corporation. Geyer *at 789.*

Delaware courts have sought to place responsibility on directors for approving transactions or distributions that are deemed to not adequately consider the interests of corporate creditors and disproportionately undervalue their claims. *In re Strength Steel, Inc,* 269 BR 560, 569 (Bankr D Del, 2001) emphasizes that when a corporation is insolvent, the directors have a fiduciary duty to "maximize the value of the assets for payment of the unsecured creditors."

Analysis

The Delaware decisions constitute directors as trustees of all corporate assets who must distribute these assets in a way that balances the interests of all creditors as well as shareholders. The line of authority defining and interpreting the duties of corporate directors towards creditors in Delaware seems to provide more confusion than clarification. Many issues remain unsettled under the Delaware law, such as: Must creditors interests be given the same weight as shareholders? If so, in what situations? What is considered a fair and reasonable allocation? These and many other questions cannot be definitively answered. It seems unwise to force them into situations that often cannot be effectively resolved to equitably balance the interests of all involved parties. Because the current framework in Delaware lacks clear guidelines, directors are unable to determine with any certainty how their actions towards shareholders and creditors will be interpreted by the courts. Michigan statutes and case law continue to reject any idea of directors as guardians of all who have an interest in the success of the corporate entity and allow directors to act in a way consistent with their obligations towards the owners and the corporation.

The goal of this system is not to treat shareholders and creditors equally, but to treat them consistently in accordance with clearly established priorities established by MBCA Section 345. This allows directors to focus on their responsibilities to their corporation and its shareholders without fear that their decisions will be scrutinized to determine adverse impact and breach of any possible fiduciary duty to creditors. In contrast to Delaware, the directors of a Michigan corporation should feel more secure that statutes and case law are in agreement concerning where the directors ultimate responsibility lies, with the shareholders. The greater certainty of Michigan law on this point should be helpful in recruiting directors of Michigan corporations.

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James C. Bruno is a shareholder of Butzel Long at its Detroit office. He is a past chair of the State Bar of Michigan's Business Law Section and past co-chair of the section's Corporate Laws Committee. He earned a J.D. and M.B.A. from the University of Michigan.

David M. Zorin is an associate in the Bloomfield Hills office of Butzel Long concentrating his practice in the areas of real estate, corporate and transactional matters. He is also a Certified Public Accountant and member of the State Bar of Michigan and Michigan Association of Certified Public Accountants.