ZONE OF INSOLVENCY

Some courts have held that when a company enters the Zone of Insolvency, the directors' duties expand to include creditors of the corporation, in addition to shareholders and the corporation itself. Other courts have compared directors to trustees administering the assets of the corporation for the benefit of the creditors. In either scenario, ***directors of the insolvent corporation must maximize the value of the assets for payment of creditors*.**

When a company is in the zone of insolvency, the absolute priority rule comes into play. Under this rule, applicable in bankruptcy and embedded in the expansion of duty cases, the claims of equity holders would always be below secured and unsecured creditors of the corporation. If value is not sufficient to pay equity, the creditors essentially become the new stakeholders of the company.

There are three financial tests conventially used to assess whether a company is in the zone of insolvency:

The Balance Sheet Test: whether the value of the assets or the enterprise value of the corporation exceeds the liabilities

The Cash Flow Test: whether the corporation has sufficient cash flow to meet its fixed financial obligations as they become due

The Unreasonably Small Capital Test: whether the company has sufficient capital to obtain or support financing for future operations