



WISCONSIN SUPREME COURT DECISION IN VIRNICH CONTINUES TO EXPOSE CREDITORS TO RISK OF CORPORATE LOOTING

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A recent Wisconsin Supreme Court decision reinforces the hurdles for creditors attempting to assert breach of fiduciary duty claims against corporate borrowers. The decision, Polsky v. Virnich, 2011 WI 13, upholds the Wisconsin Supreme Court's previous ruling in Beloit Liquidating Trust v. Grade, 2004 WI 39, 270 Wis. 2d 356, 677 N.W.2d 298 and continues to severely limit a creditor's ability to bring claims against a debtor corporation's officers and insiders.

Background on Beloit Liquidating

The following is a summary of the pertinent facts of Beloit Liquidating Trust v. Grade, as set forth by the Wisconsin Supreme Court in the Virnich decision. In Beloit Liquidating, Beloit Corporation filed for bankruptcy. In the years prior to the bankruptcy filing, various officers and directors of Beloit Corporation allegedly mismanaged the corporation and breached their fiduciary duties. A "committee" of unsecured creditors sought the right to bring the breach of fiduciary claims against the officers and directors "on behalf of" the corporation. These creditors eventually received "title" to the corporation's assets through the bankruptcy, including the corporation's claims for breach of fiduciary duty, and the committee commenced suit in Milwaukee County. Shortly thereafter, a "liquidating trust" was created to handle the corporation's remaining assets, and the trust replaced the committee as plaintiff in the action. The trust alleged that the officers and directors of Beloit Corporation breached their fiduciary duties to both the corporation and its creditors. The officers and directors moved for judgment on the pleadings, arguing that the trust failed to state a claim upon which relief could be granted. The circuit court granted the motion. The Supreme Court upheld dismissal of both the trust's claims on behalf of the creditors and the trust's claims on behalf of the corporation itself. The basis for the Supreme Court's ruling was that corporate officers did not owe fiduciary duties to creditors until (1) the corporation became insolvent and (2) was no longer a "going concern."

Background on Virnich

In Virnich, an entity called Communications Products was placed into a receivership under Wis. Stat. ch. 128 upon defaulting on a loan from its largest creditor, American Trust and Savings Bank. The circuit court appointed a receiver to administer the estate of Communications Products for creditors, and the receiver commenced an action against officers, Virnich and Moores, on behalf of the corporation. The receiver presented evidence that Virnich and Moores breached their fiduciary duties to Communications Products by taking excessive compensation and engaging in transactions that benefitted the two men personally at the corporation's expense.

Virnich and Moores moved to dismiss the receiver's complaint arguing, among other things, that the receiver's claims were barred by Beloit Liquidating. The circuit court denied the officers' Motion to Dismiss. The receiver introduced evidence that, in the period 1990-2003, Virnich and Moores used a combination of salaries, management fees, "loans," dividends, and excessive lease rates to extract more than \$10 million from the corporation. Communications Products experienced cash flow problems starting in 2001, then entered a period of acute financial distress, culminating in the loan default and the receivership. The jury awarded \$6.5 million, including \$3.8 million on breach of fiduciary duty claims and \$2.7 million on a conspiracy claim. Virnich and Moores appealed.

The Supreme Court first granted certification of the case, but then vacated the certification on a split vote, remanding to the Court of Appeals. On remand following the vacated certification, the Court of Appeals reversed the jury's award at the circuit court level, relying upon the holding of Beloit Liquidating. It was undisputed that at the time of Virnich and Moores' alleged transgressions, Communications Products was solvent and operating as a going concern. Therefore, the Court of Appeals concluded, "under Beloit Liquidating, any claim for a breach of fiduciary duty to creditors is barred."

The Virnich Decision

The Receiver again petitioned the Supreme Court, which granted certification to address whether Beloit Liquidating prohibits receivers from asserting claims, on the corporation's behalf, of breach of fiduciary duty to the corporation.

The receiver's primary contention was that Beloit Liquidating did not apply and was distinguishable from Virnich because, unlike the plaintiff in Beloit Liquidating, he did not bring claims on behalf of creditors. Rather, the claims brought by the receiver in Virnich were for breach of fiduciary duty *to the corporation*.

The Wisconsin Bankers Association filed a non-party brief that urged the court to modify Beloit Liquidating to provide for fiduciary duties of corporate insiders to creditors when the corporation becomes insolvent, regardless of when the actions supporting such claims were committed. The WBA expressed concerns about Beloit Liquidating undercutting the basic assumption upon which lenders rely when entering into relationships with corporate borrowers: "that insiders owe fiduciary duties to their corporations to act in good faith, to deal fairly in the conduct of corporate business and to avoid improper conflicts of interest at all times, even after insolvency." In addition, the Wisconsin Bankers Association urged the Court to modify its holding in Beloit Liquidating to prevent insiders from keeping an insolvent corporation operating as an ongoing concern for the sole purpose of "legally looting" corporate assets to the detriment of creditors (alleging that Virnich and Moore did exactly that).

In a split decision, the Supreme Court was not persuaded that the receiver's distinction of bringing claims on behalf of creditors versus claims for breach of fiduciary duty to the corporation was a meaningful one; nor was it influenced by the public policy concerns set forth by the Wisconsin Bankers Association that Beloit Liquidating failed to provide any disincentive for corporate officers to refrain from committing self-serving acts against the corporation at the expense of creditors.

Conclusion

Beloit Liquidating and Virnich have important implications for lenders and creditors of corporations in the State of Wisconsin. The decisions place severe limits on (1) the power of receivers under Chapter 128 to act on behalf of corporations and assert any claims the corporations have against insiders and (2) the ability of creditors to assert fiduciary claims against the officers and directors of debtor corporations. Lenders and trade creditors must be mindful of the existence of the "danger zone" that Beloit and Virnich have established where so long as an insolvent corporation is still operating as a going concern, the law does not impose a fiduciary duty upon its directors and officers to act in the best interests of its creditors.