Fiduciary Duties of Directors of a Financially Stressed Company

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Overview

• This is preliminary briefing on the fiduciary duties of the directors of a financially stressed corporation.
• It is not intended to touch on all aspects of fiduciary duties and corporate governance in the context of a board's decision-making for a financially stressed corporation.
• The directors may wish to have a follow-up presentation in connection with any transaction that they may consider.
A board for a financially distressed company has important responsibilities and fiduciary duties.

Delaware law provides substantial protections from second-guessing to board members who take their responsibilities seriously, and operate in an informed, good faith manner.

To avail themselves of those protections, directors must adhere to two types of fiduciary duties: the duty of care and the duty of loyalty.
• **Duty of Care**: Duty to act on an informed basis and in a deliberate manner.
  • Directors must exercise a degree of care that ordinarily careful and prudent people would use in similar circumstances.
  • The duty of care requires acting in an informed and deliberate manner.
  • Directors may rely in good faith on information, opinions, reports, and statements, including financial information, prepared or presented by (i) officers or employees, (ii) lawyers and other advisors, and (iii) board committees (DGCL §141(e)).
• The duty of care is evaluated under a gross negligence standard.
  • Gross negligence is defined by Delaware courts as “reckless indifference to or a deliberate disregard of the whole body of stockholders or actions which are without the bounds of reason.”
  • When a director acts with gross negligence, the protections of the business judgment rule (discussed below) no longer apply.
• Even when directors have been grossly negligent, liability for non-disloyal conduct may be extinguished by an exculpatory provision in the certificate of incorporation.

• Delaware courts have made it clear that a claim for monetary damages against a director based solely on a violation of the duty of care must be dismissed if the corporation’s charter contains an exculpation provision.
  • Note: An exculpation provision eliminates liability for monetary damages, but does not eliminate a director’s duty of care. Therefore, a plaintiff could still be entitled to equitable remedies, such as injunctive relief or rescission, upon a breach of a director’s duty of care.
• **Duty of loyalty:** Duty to act with undivided and unselfish loyalty to the corporation.
  • Directors must act in good faith and in the best interests of the corporation regardless of any personal interest.
  • The duty of loyalty may be violated when a director or officer:
    • Has a material interest in the transaction.
    • Takes action in bad faith.
  • The benefit received by a director in a transaction to qualify as “material interest” must be “of a sufficiently material importance ... as to have made it improbable that the director could perform her fiduciary duties ... without being influenced by her overriding personal interest.” *In re Trados Inc. S’holder Litig.*, 2009 Del. Ch. LEXIS 128, at *22 (Del. Ch. July 24, 2009).
  • Bad faith includes intentional acts contrary to known duties, sustained or systemic failure to exercise oversight, intentional acts with a purpose other than advancing the interests of the corporation, acts intentionally designed to violate the law, and other egregious misconduct.
Breach of the Good Faith Element of Duty of Loyalty (Cont’d)

• Personal liability for breaches of the duty of loyalty (including not acting in good faith, regardless of a personal financial interest in the transaction in question) cannot be exculpated by provisions in a company’s charter documents.

• Indemnification is not available for breaches of the duty of loyalty or for acts not in good faith.
Impact of Financial Distress

- Insolvency does not change the nature of a director’s fiduciary duties or the standard by which a director’s conduct will be judged.
- Insolvency does increase the number of constituencies that can challenge a director’s actions by giving creditors standing to bring derivative claims against directors for breach of fiduciary duty.
To Whom Do Directors of Delaware Corporations Owe Fiduciary Duties – Turns on Solvency of the Corporation

• **Fiduciary Duties – Solvent Corporations**
  • Directors owe fiduciary duties to the corporation’s stockholders and the corporation.
  • Directors of a solvent corporation do not owe fiduciary duties to creditors. The rights of creditors are protected through contractual agreements, various provisions of state or federal law, and other similar remedies.

• **Fiduciary Duties – Insolvent Corporations**
  • When a corporation is insolvent, its creditors become the corporation’s residual beneficiaries. The corporation's insolvency “makes the creditors the principal constituency injured by any fiduciary breaches that diminish the firm's value.” *North Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 101-102 (Del. 2007).

  • Note that Delaware courts look to insolvency as the tipping point for including creditors as the beneficiaries of fiduciary duties, not the “zone of insolvency.”
    • “The only transition point that affects fiduciary duty analysis is insolvency itself.” *Quadrant Structured Products Company v. Vertin*, 102 A.3d 155 (Del. Ch. 2014).
Consequently, the constituencies which the directors should consider in the proper exercise of their fiduciary duties expand to include the corporation’s creditors in addition to its stockholders.

Corporations do not have fiduciary duties to individual creditors, and generally creditors only have the right to sue derivatively for breach of fiduciary duty claims. *North Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 103 (Del. 2007) (holding that creditors may sue directors of insolvent corporations derivatively but not directly).
When is a Corporation Insolvent under Delaware Law?

Delaware law recognizes two tests: the balance sheet test and the cash flow test. Because the tests developed from common law, they are not entirely clear.

- **Balance sheet test**: generally, liabilities in excess of reasonable market value of assets; but some courts add no reasonable prospect that the business can be successfully continued in face thereof; other courts hold that there no requirement of irretrievable insolvency.
  - Unless liquidation is imminent, assets are valued at fair market value on “going concern” basis, assuming conversion to cash over reasonable time frame.
  - Liabilities are counted at face value.
  - Contingent liabilities are counted but must be discounted by the probability of their occurrence.
  - Generally, liquidation costs, including pension plan termination liability, are not counted.
• **Cash flow test**: generally, inability to pay debts as they come due; but it is unclear whether the test is present-looking (actual defaults) or forward looking (clear that debts will not be paid in the future).

• In situations where the issue of solvency is not free from doubt, the most prudent course of action is to satisfy the fiduciary duties that flow from insolvency.
Balancing competing interests:

- When a corporation is distressed or insolvent, the interests of creditors and shareholders may diverge.
- Directors should choose a course of action that they believe best serves the corporate enterprise rather than particular stakeholders.
- In deciding whether to continue business or liquidate, the directors must seek to maximize the insolvent corporation’s long-term wealth creating capacity.
- When directors of an insolvent corporation make decisions that increase or decrease the value of the firm as a whole and affect providers of capital differently only due to their relative priority in the capital stack, directors do not face a conflict of interest simply because they own common stock or owe duties to large common stockholders.
Considerations – No Duty to Liquidate or Continue Operating

• Assuming that decisions are made on an informed, good-faith, disinterested basis, “directors are not liable for decisions they make and actions they take in an effort to prolong the corporation’s viability, even in the face of bankruptcy.” *In re Midway Games*, 428 B.R. 303, 315 (Bankr. D. Del. 2010).

• Delaware law gives protection against challenges to a board’s decision on when/whether to file for bankruptcy if the board’s decision was informed, in good-faith, and disinterested. See *In re Troll Commc’ns, LLC.*, 385 B.R. 110, 122 (Bankr. D. Del. 2008) (“Deepening insolvency has been rejected as a valid cause of action or a theory of damages under Delaware law.”).
Tips

• Consider the disinterestedness and independence of each of the directors and document any steps taken to ensure that approval of transaction is not tainted by self-interest.

• Consult professional legal and financial advisors frequently and with ample time to consider their advice and analysis.

• Engage in multiple board discussions and record the board’s deliberations with any proposed transaction.

• Vigorously negotiate provisions and terms of any proposed transaction.

• Document in board minutes discussions concerning the value and benefits to creditors of any proposed transaction.