GIBSON DUNN

April 6, 2020

FIDUCIARY DUTIES AND BOARD OPTIONS IN A TIME OF PANDEMIC

To Our Clients and Friends:

NOTE: This Client Alert, which focuses on Delaware law, does not purport to provide an exhaustive guide to the issues directors should consider in times of financial stress.

The rapid spread of COVID-19, increasingly stringent government orders in response, and the profound effects on the global economy have raised concerns among corporate directors about how to adequately discharge their fiduciary duties.

First and foremost, directors can rest assured that the flexibility and protections afforded to them by the business judgment rule remain as vital today as they did before the COVID-19 pandemic. The COVID-19 pandemic does not alter the business judgment deference afforded to decisions made by a well-informed and non-conflicted board that acts in good faith towards what is best for the corporation and its stockholders.

However, directors do need to recognize that as a result of the COVID-19 pandemic, economic, regulatory, and public health related events are unfolding faster than ever. Directors must make decisions on tight timetables and with limited resources. This note is a tool for directors to help them identify some of the issues they should consider to ensure that their decisions are protected by the business judgment rule as they guide their companies during these challenging times.

Ensure Information and Reporting Systems Are Adequate. Directors generally must attempt to assure a reasonable information and reporting system exists as part of their oversight obligations. This is an area that had already become the focus of boards and their advisors over the last 18 months, as recent Delaware cases have criticized boards for failing to properly discharge their oversight obligations.[1]

Most companies already have in place systems for typically encountered business issues, including regularly scheduled management updates. Those systems should be adapted as needed to respond to the current pandemic and its impact on your business. At a minimum, evaluate whether your system involves:

- ***Regular Management Updates***. To satisfy their duties, directors are expected to *require* management to deliver updates about the business to the board on a consistent basis—and to document those requirements where possible. Management is likely gathering information related to COVID-19 and tracking the effects of the pandemic on the organization. Directors should ensure they receive updates with the benefit of that information.

- ***Board Review and Adoption of Relevant Policies***. Directors are often expected to play a role in reviewing policies that a company develops in response to applicable regulations and should oversee policies, among other things, relating to the regulatory response to COVID-19, when appropriate.

- ***Written Materials***. It is not always possible to prepare written materials ahead of a board meeting; however, it is a good practice to provide written materials whenever practicable. While the addition of written materials to update the directors places an additional burden on management, should a board decision later be subjected to judicial review, courts may consider whether directors reviewed *written* materials in making significant corporate decisions. Note that written materials that reflect legal advice should be marked "privileged and confidential."

Maintain Complete and Accurate Board Minutes. Contemporaneously recorded board minutes are generally entitled to a presumption that they accurately reflect the substance of the board's discussions. Whenever practicable, clients should continue to record board minutes contemporaneously with any meeting to ensure that if needed, the board has a written record of its actions. And boards should evaluate how much detail is required under the circumstances: for example, merely referring to a discussion of COVID-19 as an "operational update" is unlikely to provide a sufficient basis to determine whether the directors adequately discharged their fiduciary duties, unless the record reflects that additional written materials were provided to directors that reflect in a more fulsome manner the relevant "operational update."

Be Aware of Privilege Issues. Directors should be especially vigilant about protecting privilege given the range of third-party non-legal advisors that may be assisting clients in responding to the COVID-19 pandemic. While board communications with in-house and outside counsel are generally privileged, the mere presence of an attorney at a board meeting will not cloak a communication in privilege because privilege only attaches to legal advice, including requests for legal advice, and attorney-client communications. Additionally, the presence of third parties at board meetings where legal advice is being provided likely will constitute a waiver of privilege if the third parties (including observers and financial advisors) are not necessary for legal advice discussed. Therefore, directors should evaluate regularly whether third parties should be excused from any portion of a meeting. Directors should also exercise caution when forwarding or disseminating company materials to third parties, because doing so could constitute a waiver of privilege. In addition, communications among the directors that do not involve communications with lawyers are likely not privileged.

Regularly Evaluate Solvency. Businesses that were previously on strong financial ground are now facing financial challenges of a size and speed that was not contemplated prior to the COVID-19 pandemic. Businesses already facing financial stress will likely face even greater financial stress, potentially pushing them closer to insolvency at a faster rate. Directors should evaluate how often they need to receive reports on the financial condition of their business.

- ***Fiduciary Duties Expand to Cover Creditors.*** The board of directors owes fiduciary duties to the corporation. Generally, when a corporation is solvent, the beneficiaries of those fiduciary duties are the stockholders; creditors do not benefit from fiduciary duties and instead are instead

afforded protection through contracts and other sources of creditor rights. But when a corporation becomes insolvent, under Delaware law, creditors become the primary beneficiaries of those fiduciary duties, and this shift will require that boards take into account the interests of creditors as well as stockholders when making strategic decisions. Even when fiduciary remedies extend to creditors, they are still be subject to the default business judgment rule *if the underlying actions were taken by non-conflicted directors*. Note that under Delaware law, LLC operating agreements can include broad waivers of fiduciary duties, so boards of those entities may want to confirm whether applicable waivers are in such operating agreements.

- ***Insolvency May Prohibit Scheduled Actions***. Certain board decisions made before the COVID-19 pandemic may require re-evaluation to account for the company's post-COVID-19 financial status. For example, the board may have approved an extraordinary capital expenditure prior before to the COVID-19 pandemic (*g.*, opening a new factory), which it is prudent to revisit given the current climate. Or the board may have declared a dividend prior to the pandemic, but before paying a dividend, certain state statutes require that the corporation have sufficient assets such that the payment would not leave the corporation insolvent. Should the board determine the company is sufficiently stressed that it cannot issue a dividend, that may create legal peril if the dividend was previously declared. The prior declaration of a dividend may have created an irrevocable debtor-creditor relationship between the corporation and its stockholders, and the only lawful option might be to postpone the record date (if it has not yet passed) and payment date until a future date when adequate funds become lawfully available for distribution to stockholders. This is just one of the many previously approved board actions that boards may need to reassess after being fully informed about the company's financial condition.

Check Your D&O Insurance. Evaluate whether you have sufficient coverage. Confirm whether your insurance policy has, or whether you need, Side A coverage (direct coverage for directors and officers who the company is unable or unwilling to indemnify) or Side B coverage (reimbursement to the company for indemnity payments made on behalf of directors and officers). Evaluate whether your policy has exclusions that would vitiate coverage in the event the company files for bankruptcy.

Key Employee Retention Plan. Evaluate whether steps should be taken to retain key management. Particularly in cases where the company is in distress, typical equity grants may be insufficient as a retention tool. Further, key employees may consider a future promise of retention payments to be too speculative or risky in light of the company's financial stress. One strategy that may mitigate the risk is to make an upfront cash retention payment to key employees, with a written agreement that the employee will keep the payment if by a designated milestone the employee has not been fired for cause or did not resign without cause.

---

[1] *See* Gibson, Dunn & Crutcher LLP, *Delaware Supreme Court Revisits Oversight Liability* (July 29, 2019), https://www.gibsondunn.com/delaware-supreme-court-revisits-oversight-liability/.

Gibson Dunn's lawyers are available to assist with any questions you may have regarding developments related to the COVID-19 pandemic. For additional information, please contact any member of the firm's Coronavirus (COVID-19) Response Team, the Gibson Dunn lawyer with whom you usually work, or the authors:

Authors: *Shireen Barday, Mary Beth Maloney, Dennis Friedman, Eduardo Gallardo, Robert Klyman, Jonathan Fortney and Patrick Hayden*

© 2020 Gibson, Dunn & Crutcher LLP

Attorney Advertising: The enclosed materials have been prepared for general informational purposes only and are not intended as legal advice.