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The Impact of Financial Stress on the Exercise of a Director's Fiduciary Duties

Corporate directors and management owe general fiduciary duties of care and loyalty to the company and its shareholders regardless of the financial viability of the company. However, once the company has entered the amorphous and ill-defined "zone of insolvency," other constituencies, such as creditors, can seek to enforce those duties as well. Generally, directors and management can defend a challenge to their actions by acting in accordance with the "business judgment rule" which creates as presumption the directors acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. However, when companies subsequently fail, creditors will look for any source of recovery and directors' actions are often scrutinized with the benefits and biases of "20/20 hindsight."

Business Judgment is Still the Rule

The analysis of whether a directors and management acted with the requisite duty of care focuses more on the decision-making process and less on actual results. What constitutes adequate diligence in any particular case depends on the particular circumstances and what is appropriate in one situation may be completely meaningless in another. Nevertheless, directors must give thoughtful consideration to the process and then carefully document the analysis.

Financial Stress May Give Creditors Standing to Assert Claims

In effect, the company's assets constitute a trust fund to be maintained by the directors as fiduciaries for the benefit of all of the company's constituencies. The residual stakeholder in the company's assets will generally have standing to bring derivative claims for breach of fiduciary duty. While a company is solvent, the residual stakeholders are the company's shareholders. However, once a company becomes insolvent, the creditors become the residual stakeholders.

Exactly when a corporation becomes insolvent is difficult to determine and no court has provided a clear definition of insolvency. Moving toward insolvency is a gradual process and directors and management are unlikely to know, in real time, when insolvency actually occurs. The courts have suggested that there is a point or "zone," prior to actual insolvency, at which creditors obtain standing to assert fiduciary duty claims. For example, a company with a positive book net worth that does not expect to have liquidity issues until a bond payment is due in six months may be solvent under traditional tests, but nonetheless, may be in the "zone of insolvency."

Years later and with the benefit of hindsight, the following factors will be examined to determine whether a corporation was insolvent or in the "zone of insolvency:"

- inability to raise cash from operations to pay debts as they became due;
- dependence on outside investments;
- lack of access to additional financing;
- liabilities exceeding assets;
- long-term deficit operation;
- negative opinions of outside auditors;
- "disturbing" capital structures, (issuance of additional shares in excess of authorized amount to settle claims for goods and services are indicia of insolvency);
- existing defaults;
- lack of communication with creditors;
- negative changes in payment terms;
- negative stockholder's equity;
- negative retained earnings; and cash drain for non-productive use.

Directors and officers of a distressed company would be prudent to consider their company to be in the "zone of insolvency" *if the company's circumstances cause them to seriously consider the possibility in the first place.*

Deepening Insolvency

It takes time to properly execute fiduciary duties and to consider and develop a strategy to address the challenges facing a distressed company. In the "zone of insolvency," corporate management may be forced to balance constituent interests which are in direct conflict. For example, a risky transaction might increase the value of equity by offering some possibility, however slim, of averting insolvency, but may reduce the corporation's net present value, to the detriment of creditors. Corporate management must undertake a sophisticated analysis of alternatives, but during this process, the company's condition may deteriorate. Trade debt may grow and become more delinquent. Interest expense may accrue at alarming rates. A company facing a liquidity crisis may take on more debt to buy time.

Some courts have held that directors, and officers may be liable for a company's "deepening insolvency" that occurs during this process. However, most courts require a showing of wrongful conduct, i.e., a showing of fraud, as opposed to mere negligence. Indeed, reaffirming the role of the business judgment rule, the Delaware Chancery Court has held that even when a company is insolvent, its directors may, in the appropriate exercise of their business judgment, take actions that, if they fail, result in the company becoming deeper in debt. Nevertheless, the directors do not become the guarantors of the success of the intended restructuring.

Develop, Follow and Document the Process

Ultimately, management and directors can best protect themselves from claims by insuring that any decision results from a sound process.

- Assume all actions will be scrutinized and second guessed;
- Avoid favoring one group, creditor v. equity, and base all decisions on maximizing the wealth-creating capacity of the company;
- Avoid actions that would cause loss of the protection of business judgment rule;
- Act only after obtaining all necessary information (directors can rely on the reports of officers or outside experts);
- Be fully informed as to the developments which led up to the potential transaction or decision;
- Critically examine the information available and ask questions of advisors and management;
- Receive a thorough and candid evaluation of the strengths and weaknesses of a course of action from independent legal and financial advisors (however, directors must not rely on the expert's analysis to the extent they relinquish their own decision making responsibility.);
- In consultation with professionals, establish and follow a deliberative decision-making process;
- Take sufficient time in the analysis, as allowed under the circumstances;
- Insure all material facts are disclosed;
- Carefully document the decision-making process;
- Do not freeze up – no decision is a decision.

Craig H. Millet

Craig Millet is Co-Chair of the National Business Restructuring and Reorganization Practice Group of Gibson, Dunn & Crutcher LLP. Mr. Millet is a partner in the firm's Orange County office and he can be reached at (949) 451 3986 or cmillet@gibsondunn.com.

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