Keeping Fiduciary Duties in the Crosshairs When Your Company is in Financial Distress

By Kevin G. Hroblak, Esq.

The historic downturn in the economy has negatively impacted the financial statements and operations of many companies. The directors and officers of those companies undoubtedly are focused on improving financial performance, rehabilitating operations, and navigating the company through the financially turbulent times. They must not lose sight, however, of the fiduciary duties they owe to the company they serve, including special duties that arise when a company becomes "insolvent."

The potential for personal liability for directors and officers increases as a company's financial performance declines. Such liability may result from claims for breach of fiduciary duty, mismanagement, fraud, negligent misrepresentation, corporate waste, and, under some state wage laws, for unpaid employee wages and taxes. Understanding the duties that are owed and discharging those duties in a manner to maximize the value of the company as a whole will help avoid personal liability. Fundamental Duties of Corporate Fiduciaries

When a company is solvent, directors and officers owe fiduciary duties of care, loyalty, and good faith to the company they serve and its shareholders. *See, e.g. generally In re Walt Disney Derivative Litigation,* 906 A.2d 27, 67 (Del. 2006).

Accordingly, directors and officers must act honestly and fairly, avoid acting for personal gain or for the interest of another, and act with the care that a person in a like position would reasonably believe to be appropriate under similar circumstances. Directors and officers must also be active, informed, and avoid making decisions that demonstrate a deliberate indifference or a conscious disregard of their duties and the potential harm that may result to the company. The core objective of directors and officers of a solvent company is to create and increase wealth for the company's shareholders by complying with their duties of care, loyalty, and good faith.

Shift in Focus to Include Creditors

When a company becomes insolvent, however, while the duties of loyalty, care, and good faith remain in place, the focus broadens to include the interests of creditors of the company in addition to the shareholders. *See Gheewalla v. N. Am. Catholic Educ. Found., Inc.,* 930 A.2d 92, 101 (Del. 2007). The principal reason for this shift is that when a company is insolvent, the creditors, not the shareholders, are the primary beneficiaries of the assets of the insolvent company.

The duties of the directors and officers of a company governed by Delaware law do not shift to include the interests of creditors until the company is, in fact, insolvent. See id. Some courts have held, however, that the duties of directors and officers expand to include creditors when the company is in the "zone of insolvency." Regardless of the legal distinction, it is a prudent practice for directors and officers to understand the expanded nature of their duties when management, the board, or financial advisors begin raising questions about the solvency of a company, or if usual indicators of insolvency exist. These common indicators include debts being valued in excess of assets, insufficient cash to meet financial obligations as they become due and payable, and/or insufficient capital to obtain or support financing for future operations.

Heightened Scrutiny over Strategic Alternative Decisions

In addition to the considerations of creditors that arise when a company becomes insolvent, directors and officers must also be aware that they will be subject to a heightened level of scrutiny over decisions that involve a sale or merger, change of control, the adoption of defensive measures in response to a threat on corporate control, or where actual self-interest is present. *See Paramount Communications v. QVC, Inc.,* 637 A.2d 34 (Del. 1994); *Unocal Corp. v. Mesa Petroleum Co.,* 493 A.2d 946 (Del. 1985); *Revlon, Inc. v. MacAndrews & Fortis Holdings, Inc.,* 506 A.2d 173 (Del. 1986).

The proper discharge of the obligations of directors and officers, including those subject to the enhanced scrutiny, revolves around maximizing the value of the enterprise, becoming informed, making reasonable — though not necessarily perfect — decisions, and avoiding acting for the benefit of others to the detriment of the company. This heightened standard applies to certain decisions, including embarking on a sales process, changing of control of the company, and decisions surrounding the filing of bankruptcy, among others. There are protections that can be implemented to mitigate the individual officer or director's exposure, including obtaining fairness opinions for transactions, getting professional advice with respect to decisions, and engaging in a full and complete process to vet alternatives and understand fully the implications resulting from each strategic option.

Business Judgment and Exculpatory Protections

Consistent with the above considerations and the proper discharge of their fiduciary duties, directors and officers should take action that enables their business decisions to be made on a fully informed basis, without self-interest, in good faith, and in the honest belief that the decisions are in the best interest of the company and its shareholders and creditors, as applicable. These elements, if satisfied, give rise to the

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"business judgment" rule, which is a rebuttable presumption that will generally protect the decisions of a board of directors so long as the directors are disinterested. *See Aronson v. Lewis,* 473 A.2d 805, 812 (Del. 1984), overruled on other grounds, *Brehm v. Eisner,* 746 A.2d 244, 255 (2000). If one who challenges the decision of directors successfully rebuts the business judgment presumption, such as with evidence of a breach of duty of loyalty or good faith, or a conflict of interest, the burden shifts to the directors to prove the "entire fairness" of the decision or transaction at issue. *See Emerald Partners v. Berlin,* 787 A.2d 85, 91 (Del. 2001).

In addition to business judgment rule protections, a corporation may choose to control the potential liability of directors through limitations in its certificate of incorporation or charter. See 8 Del. Code § 102(b)(7). Certain state statutes, including Delaware, allow a company in its corporate documents to bar the recovery of monetary damages from directors if the claim is based solely on a violation of the duty of care. These exculpation provisions do not generally apply to officers, however, and also do not absolve directors of liability for a breach of good faith or loyalty, or for conducting a transaction for an improper benefit. .

Practical Tips to Minimize Liability

In most circumstances, if a company's board and officers do not act solely in favor of equity holders during a time of insolvency, but do act to maximize the value of the corporate enterprise, their duties likely will be discharged appropriately. To navigate financially turbulent times and reduce the potential for liability, directors and officers should consider doing the following:

- Retain independent counsel (as opposed to company counsel) for the board and any committee of the board charged with decision making to advise the directors on their duties and the proper discharge of such duties;
- Establish a special committee to develop, plan, implement, and oversee strategic alternatives such as an out-of-court restructuring, bankruptcy filing, merger or acquisition, sale, recapitalization, or liquidation;
- Retain outside counsel for the company as well as financial advisors to advise the company on transactions, strategic alternatives, financing, and corporate governance, and conduct an internal investigation, if necessary;
- Resist the temptation to resign, as some experts view this as abandonment in derogation of fiduciary obligations, and an absent director or officer may forego certain benefits such as releases that may be later obtained;
- Hold and attend regular meetings at which management and advisors provide full and complete information on which to base a decision. More frequent meetings should be held as the company's financial distress becomes increasingly dire. Diligence is the hallmark of care;
- Document the board meetings thoroughly in minutes and circulate minutes for review promptly after the meetings. All decisions, information, advice, and the basis for decisions should be included in the minutes to support an informed decision;
- Engage in regular consultation, if appropriate, with creditor constituencies;
- Avoid dividends, payments on insider loans, and other distributions to shareholders unless repayment on insider loans is fully disclosed and it is designed to maximize the company's value;
- Assess the adequacy of Director & Officer insurance coverage, including any coverage exclusions that may be applicable under the circumstances; and
- Analyze and amend, if appropriate, the corporate documents to provide for indemnification and exculpation to the fullest extent allowable by law.

While there are many pitfalls for directors and officers to traverse when a company is financially distressed, if proper preparation and guidance is followed, the potential exposure, both to the company and individual officers and directors, can be reduced. Proper corporate governance is not simply a collection of legal theories and principles, rather, it is a necessity for directors and officers who risk personal assets to lead and manage a company.

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