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MANAGEMENT RESPONSIBILITIES IN INSOLVENCY SITUATIONS

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MANAGEMENT RESPONSIBILITIES IN INSOLVENCY SITUATIONS:

UNITED STATES

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I. INTRODUCTION

This article provides an overview of the responsibilities of a company's directors in the United States with respect to (i) solvent companies, (ii) companies approaching insolvency, and (iii) insolvent companies. This article also addresses the directors' fiduciary duties and the stakeholders to which such fiduciary duties are owed in each of these three stages.

II. DIRECTORS' FIDUCIARY DUTIES: SOLVENT COMPANIES

In Delaware,[1] directors generally owe two fiduciary duties: (i) the duty of care, and (ii) the duty of loyalty.[2]

The duty of care requires that directors use the amount of care that an ordinarily careful and prudent person would use under similar circumstances and consider all material information reasonably available in making business decisions. *Miller v. Am. Capital, Ltd. (In re NewStarcom Holdings, Inc.)*, Adv. No. 15-50063 (CSS), 2016 Bankr. LEXIS 724, 17-18 (Bankr. D. Del. Mar. 8, 2016).

The duty of loyalty requires that "the best interest of the corporation and its shareholders take precedence over any interest possessed by a director, officer or controlling shareholder and

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[1] Generally, the actions of a board of directors are governed by the laws of the state in which the particular entity is organized or formed. This article will focus on fiduciary duties under Delaware law, which is representative of the law in many U.S. jurisdictions. In addition, Delaware is the favored state of incorporation for U.S. businesses.

[2] In addition, officers of Delaware corporations have the same fiduciary duties as directors. *See e.g., Gantler v. Stephens*, 965 A.2d 695, 708-09 (Del. 2009) ("In the past, we have implied that officers of Delaware corporations, like directors, owe fiduciary duties of care and loyalty, and that the fiduciary duties of officers are the same as those of directors. We now explicitly so hold."); *Amalgamated Bank v. Yahoo! Inc.*, 132 A.3d 752 (Del. Ch. 2016) ("Officers are corporate fiduciaries who owe the same fiduciary duties to the corporation and its stockholders as directors.").

not shared by the stockholders generally." *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993). The duty of loyalty also includes the requirement for directors to act in good faith. *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006).

In some instances, these fiduciary duties may be limited. For example, a corporation may include language in its charter documents exculpating directors from liability for breach of the duty of care. *See* Del. Code Ann. Tit. 8, §§ 102(b)(7). However, a corporation cannot eliminate fiduciary duties and cannot exculpate directors for breach of the duty of loyalty. *Id*. Delaware law governing limited liability companies (LLCs) and limited partnerships (LPs) provides members and partners with greater flexibility,[3] allowing them to expand, restrict, or eliminate fiduciary duties generally in LLC and LP agreements. *See* Del. Code Ann. Tit. 6, §§ 17-1101(d), 18-1101(c). However, Delaware law does not allow the waiver of the implied covenant of good faith and fair dealing from LLC or LP agreements. *See* Del. Code Ann. Tit. 6, §§ 17-1101(d), (f), 18-1101(c), (e).

Directors' business decisions generally are protected by the "business judgment rule." Under Delaware law, the business judgment rule is a "presumption that directors making a business decision, not involving self-interest, act on an informed basis, in good faith and in the honest belief that their actions are in the corporation's best interest." *Stanziale v. Nachtomi (In re Tower Air, Inc.)*, 416 F.3d 229, 235 (3d Cir. 2005) (citation omitted). *See also Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985). In applying this rule, courts "will not disturb the business decisions of loyal and informed directors 'if they can be attributed to any rational

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[3] Indeed, the Delaware statute highlights its policy "to give the maximum effect to the principle of freedom of contract and to the enforceability of" LLC and LP agreements. *See* Del. Code Ann. Tit. 6, §§ 17-1101(c), 18-1101(b).

business purpose.'" *In re ALH Holdings LLC*, 675 F. Supp. 2d 462, 477 (D. Del. 2009) (quoting *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971)).[4]

As a general matter, directors owe these fiduciary duties to the company. Under Delaware law, when a company is solvent, the directors also owe fiduciary duties to equity holders and must manage the company in the best interests of its equity holders. Equity holders have standing to bring both direct and derivative claims (i.e., claims on the company's behalf) against directors for breach of fiduciary duty.

In evaluating whether a direct or derivative claim is appropriate, Delaware courts evaluate "[w]ho suffered the alleged harm—the corporation or the suing stockholder individually—and who would receive the benefit of the recovery or other remedy?" *Tooley v. Donaldson, Lufkin & Jenrette*, 845 A.2d 1031, 1035 (Del. 2004). In evaluating who suffered the alleged harm, courts consider whether the plaintiff has demonstrated that it can prevail without showing an injury to the company. *Id*. at 1036. Where an equity holder is directly injured, it retains the right to bring a direct cause of action, and any recovery from such lawsuit will flow directly to the equity holder. *Id*. A derivative claim, on the other hand, lies "if it affects all stockholders equally." *Id*. at 1039. Because derivative claims are brought on behalf of the company, the proceeds of any recovery on such claims inure to the benefit of the company (not the individual equity holder that initiated the litigation). *Id*. at 1036.

[4] However, directors are not always protected by the business judgment rule. For example, courts may apply an "enhanced scrutiny" standard where the directors "faced potential conflicts of interest because of the decisional dynamics present in particular recurring and recognizable situations. . . ." *In re Trados Inc. S'holder Litig.*, 73 A.3d 17, 36 (Del. Ch. 2013). In addition, courts may apply an "entire fairness" standard where the directors "confronted actual conflicts of interest such that the directors making the decision did not comprise a disinterested and independent board majority. . . ." *Id*.

III. DIRECTORS' FIDUCIARY DUTIES: COMPANIES APPROACHING INSOLVENCY

Over the past decade, Delaware courts have issued several opinions clarifying a director's fiduciary duties during the period leading up to a company's insolvency.

Prior to this clarification, courts grappled with identifying the parties that may benefit from a director's fiduciary duties during a time called the "zone of insolvency" which refers to an indeterminate time when a company is in financial distress but not yet insolvent. Courts, academics, and practitioners generally interpreted Delaware law (and in particular, a so-called "famous" footnote in the *Credit Lyonnais* case) to mean that a director's fiduciary duties shifted from equity holders to creditors during the zone of insolvency. *See Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns. Corp.*, Civ. A. No. 12150, 1991 Del. Ch. LEXIS 215, at 108 n.55 (Del. Ch. Dec. 30, 1991) (noting that "directors will recognize that in managing the business affairs of a solvent corporation in the ***vicinity of insolvency***, circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act.") (emphasis added); *Quadrant Structured Prods. Co., v. Vertin*, 102 A.3d 155, 185-86 (Del. Ch. 2014) (noting that, after the *Credit Lyonnais* court used the phrase "solvent corporation in the vicinity of insolvency" in footnote 55, the "debate raged over this concept" until the *Gheewalla* case was published) . In so finding, parties recognized that, while the interests of the company's stakeholders generally may be aligned, there will be times where the interests of creditors and equity holders diverge—where creditors would like the directors to act conservatively to preserve value, but equity holders would like the directors to pursue higher-risk strategies that ultimately may afford them greater value.

In 2007, the Supreme Court of Delaware set forth a bright line test indicating that a director's fiduciary duties do not shift in the zone of insolvency.

> When a solvent corporation is navigating in the zone of insolvency, ***the focus for Delaware directors does not change***: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners.

N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007) (emphasis added). *See also Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 174 (Del. Ch. 2006) ("The incantation of the word insolvency, or even more amorphously, the words zone of insolvency should not declare open season on corporate fiduciaries. Directors are expected to seek profit for stockholders, even at risk of failure. With the prospect of profit often comes the potential for defeat."), *aff'd sub nom. Trenwick Am. Litig. v. Billett*, 931 A.2d 438 (Del. 2007).

Other U.S. jurisdictions generally follow the bright line test set forth in *Gheewalla*, holding that fiduciary duties remain unchanged while a company is in the zone of insolvency. *See e.g., RSL Commc'ns. PLC v. Bildirici*, 649 F. Supp. 2d 184 (S.D.N.Y. 2009) ("the Court concludes that adopting Plaintiff's 'zone of insolvency' theory would provide redundant legal protections to creditors, while impeding corporations' ability to recruit qualified directors, generate capital, and serve their general wealth-maximizing function."), *aff'd sub nom. RSL Commc'ns PLC v. Fisher*, 412 Fed. Appx. 337 (2d Cir. 2011); *Berg & Berg Enters., LLC v. Boyle*, 178 Cal. App. 4th 1020, 1041 (Cal. Ct. App. 2009) (holding that "there is no fiduciary duty prescribed under California law that is owed to creditors by directors of a corporation solely by virtue of its operating in the 'zone' or 'vicinity' of insolvency.'").

IV. DIRECTORS' FIDUCIARY DUTIES: INSOLVENT COMPANIES

Upon the commencement of a bankruptcy case under Chapter 11 of the Bankruptcy Code, the debtor's management and board of directors retain control of the debtor's assets and operations and continue normal business activities, subject to the limitations imposed by the Bankruptcy Code.[5] The debtor becomes a "debtor-in-possession," and the debtor's management and the board continue to have the fiduciary duties to act in the best interests of company, as described above.

While the directors' fiduciary duties do not change upon the company's insolvency, when the company is solvent, equity holders have the ability to enforce those fiduciary duties but, when a company becomes insolvent, creditors have the ability to enforce those fiduciary duties. *Gheewalla*, 930 A.2d at 101 ("When a corporation is *insolvent* . . . its creditors take the place of the shareholders as the residual beneficiaries of any increase in value.") (emphasis in original); *Quadrant Structured Prods. Co.*, 102 A.3d at 172 (same). Even when a company is insolvent, "directors are free to pursue value maximizing strategies, while recognizing that the firm's creditors have become its residual claimants and the advancement of their best interests has become the firm's principal objective." *Trenwick Am. Litig. Trust*, 906 A.2d at 175.

The Delaware Chancery Court has repeatedly held that directors may engage in business activities that they believe, in their business judgment, are in the best interests of the company,

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[5] In contrast, the appointment of a trustee is required in cases under chapter 7, 12, and 13 of the Bankruptcy Code. In some chapter 11 cases, the bankruptcy court may limit the authority of management and the board, and may order the appointment of a chapter 11 trustee "for cause, including fraud, dishonesty, incompetence or gross mismanagement of the affairs of the debtor" or "if such appointment is in the interests of creditors, any equity security-holders and other interests of the estate...." *See* 11 U.S.C. §1104(a). The appointment of a trustee in a chapter 11 case is an extraordinary remedy as there is a strong presumption that the debtor will retain control over its business and affairs. As an alternative to ordering the appointment of a trustee in chapter 11 cases where parties question the prepetition activity of the debtor, a court may order the appointment of an examiner to conduct an investigation into the company's prepetition activities. *See* 11 U.S.C. §1104(c).

even if those activities increase risk for some or all of the company's stakeholders.[6] In fact, the Delaware Chancery Court recently held that the business judgment rule applies, not only to independent directors making risky business decisions in an effort to maximize the company's value, but to non-independent directors as well. In *Quadrant Structured Prods. Co.*, the Delaware Chancery Court applied the business judgment rule to the board's decision to pursue a relatively more risky business strategy to benefit its sole stockholder, where the company was insolvent, the directors were dual-fiduciaries to creditors and equity holders, and two of the five directors held positions in the stockholder's company. *Id*. at 192 ("If a creditor-plaintiff could sue derivatively and establish a lack of director independence and disinterestedness by alleging that the director who owned equity or who owed duties to a large stockholder adopted a risky business strategy to benefit the common stock, the directors of an insolvent corporation would face precisely the same type of fiduciary conflict that *Gheewalla* sought to avoid.") The Court distinguished between (i) actions designed to confer "direct and specific benefits" to the directors themselves or to particular constituency, and (ii) actions designed to increase the value of the firm as a whole. *Id*. at 187-188. In a case involving "direct and specific benefits", the entire fairness test would apply. However, "when directors make decisions that appear rationally designed to increase the value of the firm as a whole, Delaware courts do not speculate about whether those decisions might benefit some residual claimants more than others" and the business judgment rule applies. *Id*.

[6] *See e.g., Quadrant Structured Prods. Co.*, 102 A.3d at 185-86 (noting that "Delaware law does not require the Board to shut down [the company's] business and manage towards a near-term dissolution for the benefit of creditors" and "[n]otwithstanding a company's insolvency, the directors continue to have the task of attempting to maximize the economic value of the firm.") (citation omitted); *Shandler v. DLJ Merch. Banking, Inc.*, C.A. No. 4797-VCS, 2010 Del. Ch. LEXIS 154, at *55 (Del. Ch. July 26, 2010) ("Even when [the company] was insolvent, the board was entitled to exercise a good faith business judgment to continue to operate the business if it believed that was what would maximize [the company's] value."); *Trenwick Am. Litig. Trust*, 906 A.2d at 174-75.

Notwithstanding the shift in the residual beneficiaries, Delaware courts recently limited creditors' rights to bring lawsuits against directors of insolvent companies, holding that "individual *creditors* of an *insolvent* corporation have *no right to assert direct* claims for breach of fiduciary duty against corporate directors[]" and may only bring "derivative claims on behalf of the insolvent corporation or any *other* direct nonfiduciary claim . . . that may be available for individual creditors." *Gheewalla,* 930 A.2d at 103. See also *Quadrant Structured Prods. Co.,* 102 A.3d at 172 ("Because the creditors of an insolvent corporation join the class of residual claimants, 'equitable considerations give creditors standing to pursue derivative claims against the directors of an insolvent corporation.'") (quoting *Gheewalla* at 102). Thus, while equity holders may bring direct or derivative claims for breach of fiduciary duty, a creditor may only bring derivative claims for breach of fiduciary duty once the company is insolvent.

The shift from fiduciary duties benefiting equity holders to benefiting creditors may have little practical effect in a director's day-to-day activities because directors often are unable to determine when exactly insolvency occurs.

There are two traditional tests for evaluating whether a company is insolvent: (i) the balance sheet test, and (ii) the equitable insolvency test. Under the balance sheet test, the debtor is insolvent if the sum of its liabilities is greater than the sum of its assets. *Mellon Bank, N.A. v. Metro Commc'ns, Inc.*, 945 F.2d 635, 648, 636 (3d Cir. 1991) (citing 11 U.S.C. §101(32)); *Geyer v. Ingersoll Publ'ns Co.,* 621 A.2d 784, 789 (Del. Ch. 1992). Under the equitable insolvency test, a company is insolvent if it is unable to pay its debts as they come due in the ordinary course of business. *VFB LLC v. Campbell Soup Co.,* 482 F.3d 624 (3d Cir. Del. 2007) (equitable insolvency is "the general inability of the corporate debtor to meet its pecuniary liabilities as they mature, by means of either available assets or an honest use of credit.") (citation omitted); *Geyer v. Ingersoll Publ'ns Co.*, 621 A.2d at 789.[7]

While a director may know that the company is in financial distress, it may not be able to pinpoint the exact moment when the company turns from solvent to insolvent. For this reason, a prudent director should consider the interests of creditors as soon as the company starts showing signs of financial distress. Moreover, as discussed above, directors generally can avoid or limit liability by making decisions at all times with the goal of maximizing the value for the entire corporate enterprise.

Once the company files a chapter 11 petition, breach of fiduciary duty actions against directors will not automatically be stayed due to the company's bankruptcy. To extend the stay to non-debtor parties, including directors and officers of the debtor, a party must show, in the Fourth Circuit, that unusual circumstances exist (*i.e.*, "there is such identity between the debtor and the third-party defendant that the debtor may be said to be the real party defendant and that a judgment against the third-party defendant will effect be a judgment or finding against the debtor[]"), or in the Second Circuit, that a claim against the non-debtor would have an immediate adverse economic consequence for the debtor's estate. *See A.H. Robins Co. v. Piccinin*, 788 F.2d 994, 999 (4th Cir. 1986); Summary Order, *Residential Capital, LLC v. Fed. Hous. Fin. Agency (In re Residential Capital, LLC)*, No. 12-3342, (2d Cir. July 15, 2013) [ECF No. 94] (citing *Queenie Ltd. v. Nygard Int'l.*, 321 F.3d 282, 287 (2d Cir. 2003)).

[7] The Delaware Chancery Court recently rejected the "irretrievable insolvency" test for determining whether a creditor is eligible to bring a derivative lawsuit. The irretrievable insolvency test, which generally is used by Delaware courts when determining whether to appoint a receiver, requires "a deficiency of assets below liabilities with no reasonable prospect that the business can be successfully continued in the face thereof." *Quadrant Structured Prods. Co., v. Vertin*, 115 A.3d 535, 557 (Del. Ch. 2015) (citation omitted).

V. DEEPENING INSOLVENCY

"Deepening insolvency" is a term used to describe a situation where directors make decisions that ultimately result in the company becoming more deeply insolvent. Courts, including those in Delaware and most other U.S. jurisdictions, do not recognize deepening insolvency as a cause of action. *See Trenwick Am. Litig. Trust*, 906 A.2d at 174.

> Even when a firm is insolvent, its directors may, in the appropriate exercise of their business judgment, take action that might, if it does not pan out, result in the firm being painted in a deeper hue of red. The fact that the residual claimants of the firm at that time are creditors does not mean that the directors cannot choose to continue the firm's operations in the hope that they can expand the inadequate pie such that the firm's creditors get a greater recovery. By doing so, the directors do not become a guarantor of success. Put simply, under Delaware law, "deepening insolvency" is no more of a cause of action when a firm is insolvent than a cause of action for "shallowing profitability" would be when a firm is solvent. Existing equitable causes of action for breach of fiduciary duty, and existing legal causes of action for fraud, fraudulent conveyance, and breach of contract are the appropriate means by which to challenge the actions of boards of insolvent corporations.

Id.

While deepening insolvency may not be recognized as a valid cause of action, some courts have held that deepening insolvency is a valid theory of damages for breach of duty of loyalty claims. *See Miller v. McCown De Leeuw & Co. (In re The Brown Schs.)*, 386 B.R. 37, 46 (Bankr. D. Del. 2008). Where this theory applies, damages for breach of the duty of loyalty may increase dramatically.