D&O Fiduciary Duties to an Insolvent Company

Michael P. O'Neil

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Outline

- Quick hit, not comprehensive; corp vs LLC; RAC memo.
- Fiduciary Duties Applicable to Solvent Companies.
  - Duties of Care and Loyalty.
  - Business Judgment Rule.
- The so-called “Zone of Insolvency;” genesis earlier this year.
- Fiduciary Duties Applicable to Insolvent Companies.
- Discharging Fiduciary Duties in Insolvency.
- How Taft Can Help Troubled Companies.

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Duties of Care and Loyalty

- The **duty of care** requires directors and officers to make informed decisions in good faith and in the best interests of the company. Gets harder with troubled company: greater time commitment and intensity.
- The **duty of loyalty** requires directors and officers not to engage in self-dealing and to put the interests of the company ahead of their own. Example.

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Business Judgment Rule

- Generally, courts evaluating board decisions will, initially apply the business judgment rule (BJR).
- Rebuttable presumption. The BJR is a rebuttable presumption that in making decisions directors act in accord with their fiduciary duties. Deferential.
- Burden on plaintiff. To rebut the presumption, a plaintiff has the burden of presenting evidence that directors were at least grossly negligent in not becoming adequately informed or were motivated by interests other than those of the company's stockholders as a whole (or acted in bad faith by consciously disregarding a known duty).
- Effect of failure to rebut. If the BJR is not rebutted, Delaware courts will not second-guess a board judgment unless found to be not rational.
- Nonrational decisions. To make that finding, a court must conclude that the board's decision cannot be attributed to any rational business purpose related to the company.

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Fiduciary Duties Applicable to Companies in the so-called "Zone of Insolvency"

- The term "zone of insolvency" was in vogue for a while to describe a company that is still solvent but is approaching insolvency. I want you to scrub it from your vocabulary.
  - Many years ago, late 90s early 2000s, some court decisions (*Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp)* held for the first time that creditors can bring direct claims against board members for breach of fiduciary duty when the corporation is insolvent or in the "zone of insolvency."
  - That's not been the case for some time. The Delaware Supreme Court clarified in 2007 that **the key inflection point for fiduciary duties is actual insolvency, not the zone of insolvency**. Upon actual insolvency, fiduciary duties are still owed to the corporation (rather than being expanded to include creditors) but creditors can seek leave to bring derivative claims for breach of fiduciary duty.

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Fiduciary Duties Applicable to Insolvent Companies

- When a company is insolvent, meaning it's not able to pay its creditors in full, the directors and officers **still owe their fiduciary duties of care and loyalty to the company.**
  - However, upon actual insolvency, as in a bankruptcy or receivership filing, creditors can seek standing to bring derivative claims for breach of fiduciary duty against directors and officers.
  - Creditors **cannot bring direct claims** for breach of fiduciary duty.

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Fiduciary Duties to Creditors? No

- "It is well established that the directors owe their fiduciary obligations to the corporation and its shareholders. While shareholders rely on directors acting as fiduciaries to protect their interests, creditors are afforded protection through ***contractual agreements, fraud and fraudulent conveyance law, implied covenants of good faith and fair dealing, bankruptcy law, general commercial law and other sources of creditor rights***. Delaware courts have traditionally been reluctant to expand existing fiduciary duties. Accordingly, '**the general rule is that directors do not owe creditors duties beyond the relevant contractual terms**.'"
  - *N. Am. Catholic Educ. Programming Found, Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007).

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Discharging Fiduciary Duties in Insolvency

- With that refresher in mind, how should directors and officers best discharge fiduciary duties for a company that has become insolvent?
- Generally, the focus should be on **maximizing enterprise value without taking undue risk**, which will maximize recovery for creditors as the new residual rights holders.
  - Maximizing value may also benefit stockholders but care should be taken if pursuing an upside for stockholders puts creditor recoveries at greater risk. Temptation for sponsor's directors to hold out for some recovery for equity.
  - Directors should assess all aspects of the company's business, seek input from legal and financial advisers where helpful, hold Board meetings as often as needed, follow good corporate process, and continue to avoid conflicts of interest.

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Discharging Fiduciary Duties in Insolvency

- This will allow directors to enjoy the protection of the **business judgment rule**.
- Even in difficult situations, maximizing value may mean continuing operations — even though that burns cash — for a limited period, to allow the company to complete a sale that the directors believe is likely to close and produce significant value for creditors.
- In other cases, it may mean winding down (or even shutting down) operations quickly to conserve cash, especially if any asset sale is not expected to generate more than the cash required to pursue it.

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Examples

- BIP Quadrant 4 System Debt Fund LLC v. Thondavadi (In re Quadrant 4 System Corp.), 624 B,.R. 237 (Bankr. N.D. Ill. 2020): Under **Illinois** law, finding debtor's allegations that non-executive directors knew or should have known of pervasive fraud by CEO and CFO were insufficient to overcome the business judgment rule. “[W]ithout reason to suspect crimes, corporate directors need not ‘assume ... that all corporate employees are incipient law violators who, but for a tight rein, will give free vent to their unlawful propensities.’”
- *Levin v. Miller*, 900 F.3d 856 (7th Cir. 2018): Under **Indiana** law, finding officers did not have a duty to hire an expert to second-guess the Board’s judgment to file bankruptcy before transferring tax refund to subsidiaries. “Officers had no right – much less a duty – to pursue a course of action that directly contradicted the Board’s clear instructions.”

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Examples

- *CMH Liquidating Trust v. Anderson (In re Comm.Memorial Hosp.)*, 2018 WL 3746466 (Bankr. E.D. Mich. Aug. 2, 2018): Under **Michigan** law, liquidating trustee sufficiently alleged breach of fiduciary duty claims against debtor's former directors and officers that resulted in the debtor's operating losses in the three years prior to filing bankruptcy. "the allegations in the Amended Complaint reference Defendant directors' failure to act even in the face of information that put them on notice of the need to take action. ***The business judgment rule affords no protection where directors have abdicated their authority or failed to act, absent a conscious decision not to do so***."

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Examples

- *PC Funding, LLC v. BMO Harris Bank N.A. (In re Petters Co., Inc.)*, 603 B.R. 424 (Bankr. D. Minn. 2019): Finding under **Minnesota** law, “when a corporation is insolvent, its derivative claims include claims to recover for harm to its creditors. Plaintiff may pursue the estate's derivative claims for harm to all creditors similarly situated.”
- *Pidcock v. Goddard (In re SII Liquidation Co.)*, 2014 WL 5325930 (Bankr. N.D. Ohio Oct. 17, 2014): Finding that while the CRO appointed in bankruptcy case did not owe a duty to the debtor’s creditors under **Ohio** law, CRO owed fiduciary duties to the bankruptcy estate and creditors under Bankruptcy Code.

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How Taft Can Help Troubled Companies

- Bankruptcy is always last option; a means to an end
- Distressed M&A or self-liquidation.
  - Wind-down checklist helps identify issues.
- Forbearance 90/180 days.
- Hire turnaround advisors; 13 week cash flow becomes critical.
- UCC Article 9 sales; surrender agreement.
- Put any unpaid Taft A/R on hold, but keep current on future services. In forbearance, lender unlikely to permit payment of old A/R anyhow.

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