Chapter 2

The Fiduciary Duties of Directors of Troubled U.S. Companies: Emerging Clarity

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When a company finds itself hard-pressed to pay its debts, its officers and directors often must make difficult decisions, frequently under challenging constraints. Many of those choices require a balancing of interests among shareholders, creditors and other constituencies. Officers and directors must make those choices while being guided, at all times, by their duties to the corporation and its stakeholders. In two recent decisions that should provide both greater clarity and comfort to corporate decision-makers, the Delaware Supreme Court addressed many issues relating to the duties of officers and directors. This article examines the legal responsibilities and potential liabilities of directors of insolvent and nearly-insolvent corporations in light of those recent decisions. It also discusses the underlying ethos of the decisions, and briefly contrasts it to those of other legal systems.

I. Principles of Director Responsibility

In the United States, corporations are creatures of state law, and the fiduciary duties of a corporation's directors are defined by its state of incorporation. Because many large U.S. corporations are incorporated in the state of Delaware, which has a strong tradition of well-developed corporate jurisprudence, this article will address Delaware law. There may, however, be differences between Delaware law and the laws of other states within the United States.

U.S. directors have the primary duties of "care" and "loyalty." The duty of care requires that directors exercise the degree of care that "ordinarily careful and prudent men would use in similar circumstances." The duty of loyalty obligates directors to act in good faith in the best interests of the corporation and its shareholders, and to refrain from engaging in activities that permit them to receive an improper personal benefit from their relationship with the corporation. The duty of loyalty prohibits self-dealing and usurpation of corporate opportunities by directors.

In the discharge of their fiduciary duties, directors generally have the benefit of the so-called "business judgment rule." The business judgment rule is a presumption that in making a business decision, the directors of a corporation 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. Absent an abuse of discretion, that business judgment will be respected, and not second guessed by the courts. The burden is on the party challenging the decision to establish facts rebutting the presumption. The justification usually articulated for the business judgment rule is that without it, people would not be willing to serve as directors or take appropriate risks for the benefit of the corporation.

There are, however, circumstances in which directors are not entitled to the presumption afforded by the business judgment rule. Among other things, when a director has a personal interest in a matter, implicating the duty of loyalty, the director (who ideally would be recused) loses the benefit of this presumption, and the director's conduct is measured by a much stricter standard: "entire" or "intrinsic" fairness to the corporation. The burden of proof in these cases rests upon the defendant director to show that his or her conduct satisfies the "entire" fairness test.

A. Duties Run Primarily to the Corporation

Under Delaware law, the duties of directors of a solvent corporation run to the corporation, which is to be managed for the benefit of its shareholders. No fiduciary duties are owed to creditors of a solvent corporation, as confirmed by a recent decision of the Delaware Supreme Court. In *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, the court summarised the duties of directors of solvent corporations thusly:

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."

930 A.2d 92, 99 (Del. 2007). As to the company's owners, directors' duties are analogous to those of a trustee who is obliged to manage a trust in good faith and with the requisite degree of care and loyalty. As long as there is no evidence of a breach of those duties, the decisions of disinterested directors - even if they turn out to have been misguided or mistaken - will generally be insulated from liability by the business judgment rule.

If, on the other hand, there is found to be a breach of those duties, then shareholders have the right to bring claims against the directors on behalf of the corporation (but not necessarily on their own behalf). As the court in *Gheewalla* stated:

It is well settled that directors owe fiduciary duties to the corporation. When a corporation is solvent, then those duties may be enforced by its shareholders, who have standing to bring derivative actions on behalf of the corporation because they are the ultimate beneficiaries of the corporation's growth and increased value. 930 A.2d at 101.

B. Duties of Directors When a Corporation is Insolvent or Nearly Insolvent

Until recently, many (including some judges) believed that the duties

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of directors shifted as a corporation neared insolvency. Boards were routinely advised that entering the so-called "zone of insolvency" was a triggering event for changing duties, and that it might even strip directors of the protection of the business judgment rule. In *Gheewalla* and in *Trenwick America Litigation Trust v. Ernst & Young*, the Delaware Supreme Court authoritatively laid down the law on these topics, providing much-needed guidance to U.S. directors. (Although the opinion in *Trenwick* was penned by the Delaware Court of Chancery, the opinion and its reasoning were expressly affirmed by the Delaware Supreme Court. Statements from *Trenwick* quoted here are from the Court of Chancery's decision.)

In *Gheewalla*, the Delaware Supreme Court opined that the duties of directors, and the beneficiaries of such duties, do not change as insolvency becomes progressively more likely; stated differently, that the "zone of insolvency" has no legal import:

[T]he need for providing directors with definitive guidance compels us to hold that no direct claim for breach of fiduciary duties may be asserted by the creditors of a solvent corporation that is operating 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.

Id. at 101. The court in *Gheewalla* firmly rejected those decisions that implied that there might be some ill-defined moment as a corporation neared (but had not yet reached) insolvency when the scales tipped and the fiduciary duties of directors shifted from shareholders to creditors. The court reasoned that uncertainty might constrain directors from making necessary decisions for fear that their judgment might be second-guessed as having been motivated by a desire to serve the wrong constituency.

The next question to be addressed is, of course, what happens to fiduciary duties once a corporation actually becomes insolvent. While one thing does change - the identity of the ultimate beneficiaries for whom directors' fiduciary duties are exercised - the Delaware decisions focus much more on the continuity and commonality of the relevant fiduciary duties than on the differences. The decisions stress that in all situations - including insolvency - the duty of directors is always to direct the affairs of the corporation so as to maximise its value for the benefit of its stakeholders. When a corporation is solvent, those stakeholders are the corporation's shareholders, and when the corporation is insolvent, "its creditors take the place of the shareholders as the residual beneficiaries of any increase in its value." *Id*. The primary object of the directors' duties remains the same, however - it is the corporation.

Like *Gheewella*, *Trenwick* stressed the continuity of the duties of directors after insolvency more than the discontinuity, and opined that whether the corporation is solvent, insolvent or unknowably in transition, the tasks of directors are essentially the same:

Even when the firm 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.

906 A.2d 168, 175 (Del. Ch. 2006). This, of course, follows logically from the conceptual premise that directors primarily owe fiduciary duties to the corporation itself, and only secondarily to the indirect beneficiaries of their work.

II. Applying the Foregoing Principles of Director Responsibility

A. No Direct Liability to Creditors

It has long been settled that under ordinary (i.e., solvent) circumstances, stakeholders typically have only a derivative (and not direct) right to sue for breach of the fiduciary duties of directors. If they do bring suit against directors, they must do so on behalf of the corporation, and any proceeds of those suits are for the benefit of the corporation.

The court in *Gheewalla* opined that upon insolvency, creditors (who have, after all, taken the place of shareholders as the de facto owners) may likewise bring only derivative - and not direct - suits on behalf of the corporation against directors:

The corporation's insolvency "makes the creditors the principal constituency injured by any fiduciary breaches that diminish the firm's value." Therefore, equitable considerations give creditors standing to pursue derivative claims against the directors of an insolvent corporation. Individual creditors of an insolvent corporation have the same incentive to pursue valid derivative claims on its behalf that shareholders have when the corporation is solvent.

930 A.2d at 101-102. Until *Gheewalla*, it remained an open question whether creditors also had a *direct* right to sue directors after a corporation became insolvent. Some prior Delaware decisions had at least admitted the possibility that creditors might have this right, which *Gheewalla* expressly rejected: "our holding today precludes a direct claim arising out of a purported breach of a fiduciary duty owed to that creditor by the directors of an insolvent corporation." *Id*. at 103 n.43.

The court's reasoning is instructive, for it premised its decision in no small part on the immutable prime directive of directors (both in and out of insolvency) - to maximise the value *of the enterprise*:

Recognizing that directors of an insolvent corporation owe direct fiduciary duties to creditors, would create uncertainty for directors who have a fiduciary duty to exercise their business judgment in the best interest of the insolvent corporation. To recognize a new right for creditors to bring direct fiduciary claims against those directors would create a conflict between those directors' duty to maximize the value of the insolvent corporation for the benefit of all those having an interest in it, and the newly recognized direct fiduciary duty to individual creditors. Directors of insolvent corporations must retain the freedom to engage in vigorous, good faith negotiations with individual creditors for the benefit of the corporation.

Id. at 103. As the court in *Trenwick* rightly pointed out, there is no logical reason to extend to owner-creditors a direct right to sue when that same right is generally denied to equityholders when the corporation is solvent:

[I]t is not immediately apparent to me why, if the common law were to begin to dole out in insolvency special, non-contractual "ward" rights to certain constituencies that transformed in a material way the obligations of directors, creditors would be the primary object of that (difficult to legitimize) act of judicial invention.

906 A.2d at 195 n.75.

B. No Cause of Action for "Deepening Insolvency"

In its next ruling in line with these overarching themes, the Delaware Supreme Court roundly rejected a judge-made cause of action known as "deepening insolvency" that had found its way into a few prior decisions. For several years, inventive lawyers had sought

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to impose liability on directors and other parties for what they characterised as the tort of deepening insolvency. This never carried a precise meaning, but was generally used as a pejorative to describe acts that caused corporations to become insolvent or to become more insolvent than they had previously been. The theory was that these acts made it more difficult for creditors to be repaid, and that creditors should therefore receive compensation from those responsible.

The court in *Trenwick* eloquently dispatched this purported cause of action:

Delaware law does not recognize this catchy term as a cause of action, because catchy though the term may be, it does not express a coherent concept. 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. at 174. This ruling yet again rejects any marked distinction between the obligations of directors of solvent and insolvent corporations. Approving a transaction consistent with the duties of care and loyalty is not actionable merely because it may be at or over the tipping point of the balance between assets and liabilities.

C. Directors May Pursue Strategies That Carry Risk and Continue to Be Protected By the Business Judgment Rule

Another important takeaway of the recent Delaware decisions is that appropriate and calculated risk-taking by directors of both insolvent and solvent enterprises has been affirmed and supported. As the court in *Trenwick* noted:

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.

Id. Disinterested directors therefore continue to be substantially protected from *ex post facto* second-guessing by courts and other constituencies by the business judgment rule, even if the corporation is insolvent. *Trenwick* put to rest any doubts about the applicability of the business judgment rule to decisions made by directors of an insolvent corporation:

If the board of an insolvent corporation, acting with due diligence and good faith, pursues a business strategy that it believes will increase the corporation's value, but that also involves the incurrence of additional debt, it does not become a guarantor of that strategy's success. That the strategy results in continued insolvency and an even more insolvent entity does not in itself give rise to a cause of action. Rather, in such a scenario the directors are protected by the business judgment rule. To conclude otherwise would fundamentally transform Delaware law.

Id. at 205.

The applicability of the business judgment rule to insolvent or nearly insolvent corporations had previously generated some controversy because of a (largely theoretical) concern that directors of nearly-insolvent corporations would, based on a misunderstanding of the law, engage in inappropriately high-risk strategies to try to restore value to equity. If directors of a company that is barely solvent owed no duties to creditors, it was worried, nothing would prevent directors from betting all of the corporation's assets on a 20:1 horserace in a desperate gamble to increase shareholder recoveries.

There are several answers to this concern. As an initial matter, whether a corporation is solvent by ten dollars or insolvent by a hundred is a topic on which various parties could - and in fact virtually always do - vehemently disagree. Indeed, in addition to the complexity, uncertainty and subjectivity that arguably permeate the *factual* valuation analysis of solvency, the *law* presents additional uncertainties. Under U.S. law, there are at least three alternative ways of defining insolvency, each of which carries with it substantial difficulties in calculation. The first holds that a corporation is insolvent when it is unable to pay its debts as they become due in the ordinary course of business. Second, under the balance sheet insolvency definition, insolvency is defined to occur when liabilities of the corporation exceed the reasonable market value of assets held. But there is often great uncertainty about the true market value of corporate assets. Third and finally, some U.S. courts have adopted an even more nebulous definition of insolvency by holding that a corporation may be considered insolvent if a transaction leaves it with unreasonably small capital with which to conduct its business. Thus, to attempt to place a great deal of significance on the precise moment of insolvency is quite dangerous, and no properly advised board would take a reckless gamble premised on the assumption that the company was barely solvent.

Moreover, transactions do not commonly fall so neatly into a "high-risk, high-reward" category in which the interests of shareholders and creditors diverge markedly. In many of the day-to-day decisions reached by a corporation's directors, the interests of the possible residual beneficiaries - shareholders and creditors - are aligned. As the court in *Trenwick* noted:

Even when a corporation is solvent, the notion that the directors should pursue the best interests of the equityholders does not prevent them from making a myriad of judgments about how generous or stingy to be to other corporate constituencies in areas where there is no precise legal obligation to those constituencies. I do not understand this complexity to diminish when a firm is insolvent simply because the residual claimants are now creditors.

Id. at 195 n.75. Finally, Delaware and federal law impose constraints on a corporation's ability to pursue reckless transactions, including both the duty of care and related doctrines of corporate waste, illegal dividends and fraudulent transfer.

For these reasons, in the real world, there is little reason to fear that well-advised directors would "bet the farm" on a risky strategy solely because they believed their duties ran exclusively to almost-out-of-the-money shareholders. If anything, directors are likely to be yet more prudent about how they act to maximise the value of the corporation when they (1) are not sure which one of two groups might ultimately sue them; (2) cannot know what date a judge will later determine as the onset of insolvency; and (3) know that bankruptcy often brings with it a searching examination, by courts and committees alike, of pre-filing decision making.

D. Freedom to Pursue the Best Interests of the Corporation

Implicit in Delaware law and in the recent decisions of Delaware courts is a degree of trust in the faithfulness of directors. It would make little sense to give continued authority and discretion to

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directors (as well as the protections of the business judgment rule) if one had no faith in their capacity or willingness to discharge their obligations to a company, even one that has become insolvent. Delaware law therefore assumes that the directors of a corporation, even one that is insolvent, will fulfill their duties of care and loyalty and make decisions based upon the relative merits of the available strategies, with a view towards the welfare of the corporate enterprise as a whole. As the court in *Trenwick* noted:

Delaware law imposes no absolute obligation on the board of a company that is unable to pay its bills to cease operations and to liquidate. Even when the company is insolvent, the board may pursue, in good faith, strategies to maximize the value of the firm. As a thoughtful federal decision recognizes, Chapter 11 of the Bankruptcy Code expresses a societal recognition that an insolvent corporation's creditors (and society as a whole) may benefit if the corporation continues to conduct operations in the hope of turning things around.

Id. at 204. This presumption is at the very bedrock of Chapter 11 (governing the court-supervised reorganisation of U.S. companies), which provides that, except in relatively rare situations, the sitting board and management - "the very people who got us here in the first place" - remain in control, albeit with judicial oversight.

This approach may reflect, in part, an assumption made by U.S. law about the nature and causes of insolvency. While there are certainly corporations that become insolvent as a result of fraud or gross mismanagement, there are many other cases where the financial reversal is seemingly not caused by egregiously incompetent or fraudulent conduct. By way of example, there have been waves of filings in particular industries (steel, legacy airlines, automotive supply, to name a few) by a majority of the entire industry's capacity.

For a corporation that has been grossly mismanaged or defrauded, it makes sense for the law to impose liability on directors and to replace them or supervise their acts as closely as possible. But for other companies, directors are, despite insolvency, largely free to continue to make decisions under the aegis of the business judgment rule. In many cases, this is advantageous for all stakeholders because it gives directors additional flexibility to address the debts of the corporation and to reorganise its operations.

Perhaps the clearest example of this continuing trust is vesting in the corporation the decision to commence - or not to commence - court-supervised reorganisation proceedings. Many countries impose an obligation on directors to submit to a court-supervised restructuring proceeding and turn the enterprise over to new decision-makers once a corporation becomes insolvent. Under German law, for example, once a corporation becomes insolvent, directors are obliged to file for bankruptcy without undue delay or, at the very latest, within three weeks of statutory insolvency. The penalties for directors who fail to file promptly upon the event of insolvency may be severe, possibly including liability to the company and directly to creditors. Similarly, under French law, directors must file a declaration of insolvency within forty-five days of insolvency. Directors who fail to do so may become subject to an order prohibiting them from managing any company for up to five years, or to a judgment requiring them to make up all or part of the debtor's liabilities, particularly those incurred in the period of insolvency.

By contrast, U.S. law does not require directors to file the company for bankruptcy at any particular time, or at all. U.S. directors are required to direct the company into bankruptcy proceedings only if they believe that the residual stakeholders of the corporation will benefit from a court-supervised restructuring - otherwise, they are free to attempt to restructure outside of court. When making the choice between an in-court reorganisation and an out-of-court reorganisation, disinterested directors will be protected by the business judgment rule as long as their decision is made in good faith after the exercise of due care.

The freedom to choose among in-court and out-of-court restructuring options is often an important benefit to creditors and other stakeholders. The hard and soft transaction costs associated with a formal bankruptcy or insolvency proceeding can be substantial. In the United States, a large corporation that files for bankruptcy can easily incur professional expenses that run to the tens or even hundreds of millions of dollars, for administering the bankruptcy case and restructuring the company and its obligations and operations. A corporation must pay not only for its own professionals, but also, among others, the professionals for an official committee of creditors appointed by the court to represent the interests of creditors during the bankruptcy proceeding. In addition to these direct costs, the mere act of announcing that a corporation has sought protection under bankruptcy laws may impose substantial costs on it. Suppliers may be reluctant to provide goods on the terms provided before filing for bankruptcy, and customers, unwilling to accept the company's assurances that it will be able to satisfy its obligations to them, may take their business to competitors. Bankruptcy proceedings can also be a substantial distraction for management, whose attention is diverted from the business to the court proceedings, which often resemble full-blown litigations.

There are of course many cases in which the tools of Chapter 11 - including the breathing room provided by the automatic stay, the right to reject contracts, and the possibility of paying claims in equity or cents on the dollars - vastly outweigh its soft and hard costs. Unlike many other legal systems, which force the decision, U.S. law generally allows the board to decide which path is best for the enterprise. Because of the continued vitality of the business judgment rule (even in the insolvency context) and the relative rarity of personal liability, the directors of U.S. corporations have a freer hand to restructure the corporate enterprise without resorting to a formal bankruptcy proceeding.

E. Little Practical Effect on Decision Making?

While only time will tell, under most circumstances it may be that these recent cases will have little practical impact on director decision-making (although they will doubtless have the practical effect of reducing litigation against directors). They greatly reduce the importance of the so-called "zone of insolvency," which courts formerly used to describe a period within which the fiduciary duties of directors were thought to shift, or began to shift, from shareholders to creditors. Delaware and many other courts should not henceforth attach any significance to the zone of insolvency. Moreover, as noted above, the Delaware courts do not consider the moment of insolvency as causing a radical shift in fiduciary duties since, both before and after insolvency, those duties run, first and foremost, to the corporation.

Although the exact moment of insolvency is likely to be unknown (or, at the very least, hotly disputed), a corporation can be expected to at least know that it is approaching troubled waters. In such event, directors must begin to take into account the interests of creditors and other stakeholders even if they do not have any formal duties to them until insolvency actually occurs. In the real world, the zone of insolvency exists whether courts recognise it or not because of the uncertainty in calculating the precise moment of insolvency. A prudent and well-advised board of directors will therefore consider the effect of their actions on creditors - and not just stockholders - well before a U.S. court would recognise a formal duty for them to do so. Thus, as we routinely advise boards of troubled companies, an undue focus on "are we there yet" is of rather limited utility. Rather, the guiding star must always remain maximising the value of the

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enterprise, with decisions arrived at after appropriate deliberation upon sufficient information.

III. Conclusion

Troubled companies require leaders willing to, and free to, make hard and thoughtful decisions about the future of the corporate enterprise. U.S. law recognises this need, and recent decisions by Delaware courts have contributed substantially to a legal regime that allows directors to do their jobs without undue fear that their reasonable decisions will be second-guessed by courts and creditors. The Delaware Supreme Court, implicitly acknowledging that the actual advent of insolvency may not even be ascertainable, has all but stated that its arrival is of rather limited import - because the duty to maximise the value of the enterprise remains the prime directive at all times. These decisions also recognise, appropriately, that deepening insolvency is no tort, and that when a corporation becomes insolvent, the primary beneficiaries of the corporation's assets and operations are its creditors, who thereafter can bring (only) derivative actions for breaches of fiduciary duties. We are encouraged by these developments, and believe that the clear dictates of these decisions, which wiped away a fair amount of confusion, will contribute to better decisions by directors and more comfort for creditors. All ultimately benefit from precise rules and coherent doctrines governing director responsibility.

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