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CLIENT ALERT

Q&A: The Effects of Financial Distress on Fiduciary Duties

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During this time of economic upheaval amidst the COVID-19 pandemic, many corporate borrowers are faced with the inability to service debt obligations, and creditors may seek to hold corporate officers and directors accountable as a result. In these uncertain times, it is wise to review the fiduciary duties of corporate directors and officers and the effects of financial distress on such duties.[1] The following Q&A provides guidance on this issue from a Delaware law perspective, as Delaware is the most commonly cited jurisdiction for corporate governance. Note that the laws and regulations in different states may impose different (and even conflicting) requirements with respect to fiduciary duties during times of financial distress, and the laws of a different jurisdiction may apply.

What are fiduciary duties?

Directors' and officers' fiduciary duties include the following:

- Duty of Care – The duty of care requires fiduciaries to exercise the "care which ordinarily careful and prudent men would use in similar circumstances."[2]
- Duty of Loyalty – The duty of loyalty obligates a fiduciary to act in "good faith" and refrain from putting his or her interests ahead of those of the corporation.[3] In short, the duty of loyalty is intended to ensure a director or officer does not act in its own self-interest, but rather in the best interest of the company.

What is "financial distress?"

Financial distress comes in many forms, of which solvency of a company is one. There are three commonly used tests to determine the solvency or insolvency of a company:

1. Balance sheet test – "[A]n entity is insolvent when it has liabilities in excess of a reasonable market value of assets held."[4]
2. Cash flow test – "An entity is insolvent when it is unable to pay its debts as they fall due in the usual course of business."[5]

3. Capital adequacy test – An entity is insolvent when it has inadequate capital to meet its (1) operating expenses, (2) capital expenditure requirements, and (3) debt repayment obligations.

What is the effect of solvency on the fiduciary duties of directors and officers?

When a company becomes insolvent, claims related to the fiduciary duties owed by the officers and directors are made available to creditors, on a limited basis. After a corporation becomes insolvent, creditors, "as the true economic stakeholders in the enterprise," gain standing to assert derivative breach of fiduciary duty claims.[6] Importantly, however, creditors never have *direct* standing to sue for breach of fiduciary duties, even when the company is insolvent. [7]

Although creditors have derivative standing to sue for breach of fiduciary duty, Delaware courts have held that "deploying fiduciary duties to protect creditors should be a final resort, not a first response."[8] In fact, even in an insolvency situation, directors and officers are afforded deference to use their business judgment in taking calculated risks in the pursuit of value-maximizing strategies in distressed situations.[9] Therefore, while insolvency may provide a window for creditor derivative claims, creditors may be limited in the pursuit of such fiduciary duty claims, instead focusing on other remedies available, like certain contractual protections, the implied covenant of good faith and fair dealing, and fraudulent conveyance laws.[10]

What is the "zone of insolvency" and what is its effect in Delaware?

In certain cases (outside of Delaware), the company need only be in the "zone of insolvency" in order for directors and officers to have an extended duty to creditors.[11] While there is no generally accepted definition of "zone of insolvency," courts have described the zone of insolvency as the time period when insolvency is reasonably foreseeable, or when a transaction creates an unreasonable risk of insolvency.[12]

Importantly, however, most states, including Delaware, have expressly renounced the "zone of insolvency" as the point in time at which fiduciary duties include creditors, focusing on the point of insolvency instead.[13] Generally, as a result, creditors of a solvent company operating in the zone of insolvency are left to rely on the protections of contractual terms as well as other sources of creditors' rights.[14] Therefore, directors and officers of Delaware corporations need not pay the "zone of insolvency" much mind.

Summary Takeaways

Overall, in Delaware, directors and officers are free to make decisions and take actions which they in good faith believe are in the best interest of the company regardless of the company's financial condition. So long as directors and officers make informed decisions and remain cognizant of their duties of loyalty and care, available creditor claims are limited.

Lauren Randle, a former attorney at the firm, also contributed to the article.

[1] Note that an analysis of liability of the management of a limited liability company requires a review of the operating agreement to understand the relevant waivers.

[2] *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 749 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006) ("*Disney I*").

[3] *Id.*; *Quadrant Structured Prods. Co. v. Vertin*, 115 A.3d 535, 549 (Del. Ch. 2015) ("*Quadrant II*").

[4] *Quadrant II*, 115 A.3d at 539.

[5] *Geyer v. Ingersoll Publ'ns Co.*, 621 A.2d 784, 789 (Del. Ch. 1992).

[6] *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007). *Id.* at 94 ("[C]reditors of a Delaware corporation that is either insolvent or in the zone of insolvency have no right, as a matter of law, to assert direct claims for breach of fiduciary duty against the corporation's directors."); *id.* at 103 ("[W]e hold that individual *creditors* of an *insolvent corporation* have *no right to assert direct* claims for breach of fiduciary duty against corporate directors.") (emphasis in original).

[7] *Id.* at 94 ("[C]reditors of a Delaware corporation that is either insolvent or in the zone of insolvency have no right, as a matter of law, to assert direct claims for breach of fiduciary duty against the corporation's directors."); *id.* at 103 ("[W]e hold that individual *creditors* of an *insolvent corporation* have *no right to assert direct* claims for breach of fiduciary duty against corporate directors.") (emphasis in original).

[8] *Quadrant Structured Prods. Co. v. Vertin*, C.A. No. 6990-VCL, 2015 WL 6157759, at *10 (Del. Ch. Oct. 20, 2015) ("*Quadrant III*").

[9] *Trenwick Am. Litig. Tr. v. Ernst & Young*, 906 A.2d 168, 174-75 (Del. Ch. 2006), *aff'd sub nom. Trenwick Am. Litig. Tr. v. Billett*, 931 A.2d 438 (Del. 2007); *see also Quadrant II*, 115 A.3d at 546-47.

[10] *Id.* at *11.

[11] *See, e.g.*, *Dooley v. O'Brien*, 244 P.3d 586, 591 (Ariz. Ct. App. 2010); *Estate of Jackson v. Gen. Elec. Capital Corp*. (*In re Fundamental Long Term Care Inc.*), 507 B.R. 359, 380-81 (Bankr. M.D. Fla. 2014); *Tow v. Amegy Bank*, 976 F. Supp. 2d 889, 904 (S.D. Tex. 2013); *In re Rama Grp. of Cos*., 496 B.R. 307, 314 (Bankr. W.D.N.Y. 2013); *Bachrach Clothing Inc. v. Bachrach* (*In re Bachrach Clothing Inc.*), 480 B.R. 820, 828 (Bankr. N.D. Ill. 2012).

[12] *See, e.g.*, *Miramar Resources, Inc. v. Shultz* (*In re Shultz*), 208 B.R. 723, 729 (Bankr. M.D. Fla. 1997) (holding that fiduciary duties to creditors arise upon the "brink of insolvency," where an impending transaction will render the corporation insolvent); *Brandt v. Hicks, Muse & Co.* (*In re Healthco Int'l, Inc.*), 208 B.R. 288, 302 (Bankr. D. Mass. 1997) (finding a breach of fiduciary duties to creditors on the part of the directors occurs when the directors voted in favor of a transaction that leaves the corporation insolvent or with unreasonably small capital).

[13] *Id.* at 546 ("There is no legally recognized 'zone of insolvency' with implications for fiduciary duty claims. The only transition point that affects fiduciary duty analysis is insolvency itself.").

[14] *Gheewalla*, 930 A.2d at 101.

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