

The Director's Dilemma: An Overview of Director Fiduciary Duties when Insolvency Looms

Alert

03.26.2020

Boards of directors across the U.S. are currently wrestling with existential threats arising from the COVID-19 pandemic. In addition to the logistical and productivity challenges that come with decentralizing entire workforces, entire industries have seen unprecedented decreases in short term demand (or, increasingly, being subject to forced closures as “non-essential businesses”) piled on already-thin margins. Many of these corporations may have insufficient reserves to survive long enough to return to pre-pandemic levels, and the ones that do are having to rapidly reassess and pivot strategically. Boards of directors need guidance to understand which constituencies are owed fiduciary duties when considering their responses to this public health crisis.

This article focuses on the fiduciary duties of directors of a Delaware corporation, because of the large number of companies incorporated in Delaware, the extensive body of case law in Delaware interpreting directors' fiduciary duties and the tendency of the courts in other states to look to Delaware case law when interpreting the corporate laws of their state.

Solvency (and the Zone of Insolvency) vs. Insolvency

As a threshold matter, Delaware law establishes that duties of directors are fundamentally the same whether a corporation is solvent, insolvent or trending towards insolvency, with the goal of pursuing “value maximizing strategies” for the benefit of the corporation and its residual stakeholders. See *Trenwick America Litigation Trust v. Ernst & Young*, 906 A.2d 168 (Del. Ch. 2006). The duties are, generally stated, to act in good faith, with loyalty and due care (subject to the business judgment rule). However, the group of residual stakeholders to which those duties extend changes and pivots on the corporation's financial health. In times of solvency, duties go to the corporation and its shareholders.

The Director's Dilemma: An Overview of Director Fiduciary Duties when Insolvency Looms

At the other end of the spectrum, once a corporation becomes insolvent, the creditors join the shareholders in the group of residual owners as they are the first-in-line beneficiaries of any increase in the residual value of the corporation until it becomes solvent. Accordingly, Delaware law recognizes a creditor's right to make a derivative claim on behalf of an insolvent corporation for breaches of the generally stated fiduciary duties above. See generally *Quadrant Structured Products Co., Ltd. v. Vertin*, 115 A.3d 535 (Del. Ch. 2015). Note, however, this right is derivative only. Creditors of insolvent corporations are not owed direct fiduciary duties, but merely in their capacity as the eventual recipients of the firm's residual value. See *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007). Per *Gheewalla*, creditor interests are more appropriately addressed by statutory and contract law, and creditor's rights protections, rather than fiduciary duties.

The *Quadrant* court further held that directors can “favor certain non-insider creditors over others of similar priority without breaching their fiduciary duties.” Boards therefore have broad discretion to act during troubled times without fear of a creditor's derivative suit, provided the board acts in good faith, exercises reasonable care and does not engage in self-dealing.

In the muddy middle, as corporations move along the spectrum from solvency toward insolvency—the so-called “zone of insolvency”—Delaware courts have firmly rejected the assertion that creditors are owed fiduciary duties, whether direct or derivative. While a line of previous Delaware cases had advanced *in dicta* the proposition that creditors essentially become the residual owners of the corporation at the point when the corporation first crosses from solvency into the zone of insolvency, the *Gheewalla* and *Quadrant* cases rejected this notion.

Thus the key inflection point for fiduciary duties to creditors under Delaware law is when the corporation exits the zone of insolvency and is deemed fully insolvent. Even then, breaches of these duties give rise only to derivative and not direct suits. As simple as these distinctions may seem, however, the next section shows that there is no bright-line test calculating insolvency.

Determining When a Corporation is Insolvent

Delaware courts evaluate insolvency under at least two different rubrics. See *Geyer v. Ingersoll Publ'ns Co.*, 621 A.2d 784 (Del. Ch. 1992). An enterprise is considered insolvent if (a) it is “unable to pay its debts as they fall due in the usual course of business,” also known as the “cash flow test,” and/or (b) “it has liabilities in excess of a reasonable market value of assets held,” also known as the “balance sheet test.” A third test, the so-called “capital test,” analyzes whether a corporate transaction leaves the entity insufficiently capitalized to operate its business. This test has fallen out of favor in D&O litigation following *Quadrant*, but remains relevant for voidable transfer litigation.

The Director's Dilemma: An Overview of Director Fiduciary Duties when Insolvency Looms

Whichever test is used, boards cannot rely on the potential of future positive outcomes to cover up present duty breaches. The *Quadrant* court clarified that the corporation need not be continuously insolvent for a creditor's claim to lie; stated differently, the creditor's standing will not be extinguished if the organization travels back into solvency during the pendency of the suit. The court posited that "a troubled firm could move back and forth across the insolvency line such that a continuing insolvency requirement would cause creditor standing to arise, disappear and reappear again." For obvious reasons, it would be inefficient and potentially unfair to allow for constant reassessment of insolvency status during the life of a lawsuit. The creditor need only establish that the corporation was insolvent at the time the suit was filed and that such creditor continuously qualified as a creditor during the suit.

Note that other jurisdictions have limited the doctrine further, and only permit derivative suits by creditors when a corporation is insolvent *and* "has ceased to carry on business, and does not intend to resume[.]" [*Aurelius Capital Master, Ltd. v. Acosta*, 3:13-CV-1173-P, 2014 WL 10505127, at *4 \(N.D. Tex. Jan. 28, 2014\)](#) (quoting *Lyons-Thomas Hardware Co. v. Perry Stove Mfg. Co.*, 86 Tex. 143, 158, 24 S.W. 16, 21 (1893)). In those jurisdictions, directors should expect even more latitude to act during crisis time without the spectre of a creditor-initiated suit.

The previous sections provided a brief overview of what duties are owed and how to determine when they shift between groups of stakeholders happens. The final section provides additional color on the scope of discretion within which directors of an insolvent corporation can operate while still avoiding derivative claims by creditors.

Limits of Creditor Derivative Suits & Best Practices for Current Decision-Making

Despite the existence of the derivative claim for creditors, in reality Delaware boards of directors have broad discretion to act without significant fear of breaching fiduciary duties. For example, *Trenwick* held that directors "are expected to seek profit for stockholders, even at risk of failure," regardless of the organization's solvency status. Delaware does not recognize the amorphous theory of "deepening insolvency," meaning that directors cannot be held liable for continuing to operate an insolvent entity in the good faith belief that they may achieve profitability, even if their decisions ultimately lead to greater losses for creditors.

Further, the holdings of *Quadrant* should embolden, not discourage, directors to engage in business activities that they, in good faith, believe to be in the best interest of the corporation, even if the actions increase risk for all or only a certain portion of the corporation's stakeholders. Combined with the *Trenwick* precedent above, directors may consider a broad range of options to address insolvency.

The Director's Dilemma: An Overview of Director Fiduciary Duties when Insolvency Looms

The scope of discretion is not unlimited, though, and a small likelihood of success will not discourage all creditor-plaintiffs if the right incentives or particularly egregious behavior exists. For example, despite the existence of Delaware case law on point, [a recent lawsuit](#) filed in New York state courts by a trust representing more than 100 former Toys 'R' Us creditors accused directors and members of management of breach of fiduciary duty, misrepresentations, negligence and fraudulent concealment. This suit is presently pending, and may add color to the business judgement rule as it applies to creditor derivative suits.

During these times of uncharted waters, directors of insolvent or distressed corporations should recommit to faithfully discharging their duties of care and loyalty, including good faith, oversight and disclosure. At minimum, directors need to be properly and continuously informed of material and relevant information affecting the corporation, and should seek appropriate legal and financial advice to ensure they are. For instance, the directors of corporation with a questionable solvency status should pay special attention to decisions relating to the declaration of dividend payments because of the significant liability they may face if a corporation pays an unlawful dividend or in the event that such a dividend pushes the company into insolvency. Under Delaware law, dividends can only be paid out of surplus or net profits. Directors can minimize such exposure by relying on the books of the corporation and financial experts. Thus, directors of a troubled corporation will want to receive a significant amount of valuation and financial analysis before declaring a dividend.

Of course, under the best circumstances, directors often face lawsuits alleging breaches of fiduciary duty that seek to impose personal liability. Boards should ensure that management maintains an appropriate D&O liability insurance program under all circumstances. Moreover, boards should be mindful that the prospect of insolvency sometimes prompts insurers to non-renew policies, including D&O liability insurance policies.

D&O Policy Considerations

While D&O policies ordinarily will not provide coverage for claims made against the insured after expiration of the policy period and non-renewal, a board should consider employing three strategies to preserve coverage for post-policy period claims based on alleged wrongful acts occurring during or before the policy period. The first strategy is to notify the insurer of any existing claims, which might include demand letters and lawsuits, among other things. Subsequent claims that are based on the same or related facts of the noticed claims would then be eligible for coverage, regardless of when those later claims are asserted. The second strategy is to give notice of circumstances to the insurer. So long as the notice is given before the policy period expires, any future claim arising out of the reported circumstances will be eligible for coverage. The third strategy is to purchase "run-off" (or "tail") coverage. Run-off coverage applies to claims made against the insured during the run-off period (sometimes called an "extended reporting

The Director's Dilemma: An Overview of Director Fiduciary Duties when Insolvency Looms

period” or “discovery period”) that are based on alleged wrongful acts occurring before the end of the policy period. By reaffirming a commitment to act in the corporation’s best interest and adopting policies and practices to ensure they are fully apprised of material financial and operations information, boards of directors in Delaware corporations stand the best chance of avoid lawsuits for breaches of fiduciary duties. By ensuring appropriate D&O liability insurance coverage in the first place, and then employing strategies to mitigate the effect of an insurer’s non-renewal of coverage, boards stand the best chance of maintaining the possibility of insurance coverage for claims made after a policy is non-renewed.

RELATED CAPABILITIES

Corporate Finance