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corporate governance client alert
a review of directors' fiduciary duties beyond sarbanes

fourth in a series of four editions:

directors' duties to creditors of financially distressed companies

a review of directors' fiduciary duties beyond sarbanes: introduction to the series

Prompted by a host of corporate and accounting scandals, President Bush signed the Sarbanes-Oxley Act ("Sarbanes") into law on July 30, 2002, the most sweeping piece of securities legislation enacted by Congress since the Great Depression of the 1930s.

Sarbanes signals a trend toward increased scrutiny of apparent conflicts of interest and breaches of fiduciary duty. This has prompted us to remind our clients of certain well-established common law duties owed by directors and officers to their companies and stockholders.[1]

The following topics are addressed in Curtis' *A Review of Directors' Fiduciary Duties Beyond Sarbanes*.

edition 1 – Revisiting Dual Directorships
In our first edition, we discussed the problems faced by directors in the U.S. who simultaneously serve on the boards of a parent company and its subsidiary and who must fulfill the fiduciary duties attendant to each position.

edition 2 – Revisiting Third-Party Liability
This edition addressed the potential liability of tender offerors, parent companies and other controlling stockholders that transact or otherwise deal with directors of a counterparty.

edition 3 – Heightened Fiduciary Duties of Certain Officers
This edition examined the duties owed by officers, and the possibility that officers, because of their greater familiarity with, and proximity to, the workings of the company, may be subject to a higher standard than directors.

edition 4 – Directors' Duties to Creditors of Financially-Distressed Companies
This edition discusses whether a director's fiduciary duties shift from equityholders to debtholders when a company becomes financially distressed.

[1] The following commentary focuses primarily on Delaware law due to the persuasiveness of Delaware court decisions in the area of corporate governance.

introduction: recent developments in delaware law

It is a well-settled principle of Delaware law that directors of a solvent company owe fiduciary duties to the company's stockholders. It is equally settled that directors of a solvent company do not owe fiduciary duties to the creditors of that company. What has been unclear, however, particularly in recent years, is the extent to which directors owe fiduciary duties to the creditors of a company that is nearing insolvency and, as such, is said to be in the "zone of insolvency," or to the creditors of a company that actually is insolvent.

The proposition that such duties may exist was alluded to in 1991 by the Delaware Court of Chancery in *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*[2] In a footnote to its opinion, the court stated that "the possibility of insolvency can do curious things to incentives, exposing creditors to risks of opportunistic behavior and creating complexities for directors."[3] Moreover, the directors of a company that is nearing insolvency should consider "the community of interests," which goes beyond stockholders to include creditors.[4]

Following *Credit Lyonnais*, corporate directors did not receive definitive guidance from the courts with respect to fiduciary duties potentially owing to creditors. Similarly, creditors have not had clear standing to bring "direct" or "derivative" actions against directors for breach of fiduciary duty.

The Delaware Supreme Court, however, recently addressed these issues and provided guidance to directors and creditors. In *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, the court determined two points of law: first, that no new duties should be imposed upon directors of a company in the zone of insolvency, and, second, that creditors of insolvent companies may bring "derivate" suits against directors but may not bring "direct" actions against directors for breach of fiduciary duty.[5]

With respect to companies in the zone of insolvency, the court reasoned that creditors are adequately protected by the agreements they have negotiated with such companies and directors should owe fiduciary duties only to those parties most in need of attention – namely, the stockholders and company itself.[6] Once a company is insolvent, however, the court reasoned that creditors become the "principal constituency" of directors' fiduciary obligations and, therefore, must have standing to sue on behalf of the company for the breach of such duties.[7]

key concepts: zone of insolvency

Before addressing the duties owed by directors of companies in different states of financial distress, it is useful to distinguish the "zone of insolvency" from actual insolvency. Insolvency has been defined by the courts to occur when a company has either (a) "a deficiency of assets below liabilities with no reasonable prospect that the business can be successfully continued in the face thereof," or (b) "an inability to meet maturing obligations as they fall due in the ordinary course of business."[8] The zone of insolvency, however, has not been defined and therefore remains an amorphous concept.[9]

In *Credit Lyonnais*, the Delaware Court of Chancery referred to companies operating in the "vicinity of insolvency," but did not explain whether and under what circumstances a company should bear that designation. In the years following *Credit Lyonnais*, Delaware courts largely avoided arriving at a precise definition of the "zone of insolvency."

Indeed, nearly thirteen years after *Credit Lyonnais*, the Delaware Court of Chancery revisited the definition of the "zone of insolvency" in *Production Resources Group, L.L.C. v. NCT Group, Inc.*, only to state that the "zone of insolvency" is "imprecise and hard to define."[10] The court determined that it did not need to "explore the metaphysical boundaries of the zone of insolvency,"[11] noting the inherent complexity of such an exercise.[12]

directors' duties to creditors of a company in the zone of insolvency

As noted in the introduction to this article, the Delaware Supreme Court has refused to recognize a fiduciary duty

[2] 1991 WL 277613 (Del. Ch. December 30, 1991).
[3] *Id.* at n. 55.
[4] *Id.*
[5] 2007 WL 1453705, *7-*9 (Del. May 18, 2007).
[6] *Id.* at *6.
[7] *Id.* at *7.
[8] *Id.* at *5.
[9] *Id.* at n. 20. Presumably, the zone of insolvency is co-extensive with the period of time during which it is reasonably likely that the company will become insolvent but before either of the two tests for actual insolvency may be satisfied.
[10] 863 A.2d 772, n. 56 (Del. Ch. 2004).
[11] *Id.* at 790.
[12] *Id.* at n. 56.

owed to creditors by directors of a company operating in the zone of insolvency. The court addressed this as a question of first impression, commenting that while judicial opinions and scholarly articles had discussed the issue, the court had never before answered it directly.[13]

In reaching its decision, the court reasoned that stockholders rely on directors to protect stockholder interests and therefore directors must be bound to them by fiduciary obligations, while creditors' interests are protected by negotiated agreements, fraud laws and bankruptcy laws.[14] In light of these contractual protections, creditors do not need the security of a fiduciary relationship with the company's directors to ensure fair treatment. Indeed, the Delaware Chancery Court in *Production Resources Group* stated that imposing duties upon directors to protect creditors might be an exercise in filling "gaps that do not exist."[15]

The Delaware Supreme Court further noted that imposing additional fiduciary duties on the directors of a financially troubled company could be counterproductive. Companies operating in the zone of insolvency are often in need of effective and proactive leadership; allowing "direct" claims by creditors against directors for breach of fiduciary duty could hinder the directors' ability and incentive to take remedial steps. The court asserted:

> "When a solvent corporation is navigating in the zone of insolvency, the focus of 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."[16]

Under the court's rationale, any benefit that would result from creating a fiduciary relationship between directors and creditors of a company in the zone of insolvency would be significantly outweighed by the economic inefficiency caused by altering the focus of its directors, for whom it is crucial to remain focused on the interests of the stockholders and the financially distressed company itself.

directors' duties to creditors of an insolvent company

Unlike the zone of insolvency, actual insolvency is well defined. As discussed above, Delaware courts, though not recognizing a right of creditors to bring "direct" claims against insolvent companies, had not completely foreclosed the possibility of imposing such a right. For example, in *Production Resources Group*, the Court of Chancery held that it was "not prepared to rule out" the possibility of "direct" claims for breach of fiduciary duties brought by creditors of insolvent companies.[17]

The Supreme Court of Delaware rejected this possibility and held that such "direct" claims are not permissible.[18] In refusing to recognize a fiduciary relationship between directors and creditors of an insolvent company, the court expressed concern that recognition of this duty would create uncertainty for directors who must "exercise their business judgment in the best interests of the insolvent corporation."[19]

Nevertheless, the Supreme Court of Delaware did permit creditors to bring "derivative" suits (i.e., suits on behalf of another) against directors of insolvent companies for the breach of a fiduciary duty.[20] Importantly, "derivative" claims must be brought by creditors on behalf of the company, and as such are based on duties owed by the directors *to the company*, not to the creditors themselves. The rationale for permitting creditors of an insolvent company to bring "derivative" claims is that creditors are the parties most interested in the effective management of corporate assets and the disposition of those assets during the bankruptcy process; in fact, creditors need the ability to prevent directors from causing an insolvent company to waste its assets.[21] To protect this interest, creditors now have the right to bring "derivative" actions.

conclusion and recommendation

Directors of financially distressed companies are placed in a difficult position: they must protect the interests of the company while simultaneously being prepared to strip the entity of its assets to properly satisfy creditors. Recognizing this tension, the Delaware Supreme Court has

[13] *North American Catholic Educational Programming Foundation, Inc.*, 2007 WL 1453705 at *5.
[14] *Id.* at *6.
[15] *Production Resources Group, L.L.C.*, 863 A.2d at 790.
[16] *North American Catholic Educational Programming Foundation, Inc.*, 2007 WL 1453705 at *7.
[17] 863 A.2d at 800.
[18] *North American Catholic Educational Programming Foundation, Inc.*, 2007 WL 1453705 at *9.
[19] *Id.* at *8.
[20] *Id.* at *7.
[21] *Id.*

instructed directors that their fiduciary obligations run only to the company; creditors, even those permitted to bring "derivative" claims, are not owed any duties. Directors of insolvent and near-insolvent companies therefore should maintain their focus on the ultimate benefit of the company, which will give them the freedom to negotiate with creditors without fear of violating their fiduciary duties.

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about curtis

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