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WEATHERING THE STORM

Fiduciary Duties of Officers and Directors in Troubled Company Situations

Directors and officers managing corporations, especially when the corporation is insolvent or operating in insolvency situations, need to be cognizant of their fiduciary duties. This alert provides a brief overview of these fiduciary duties, including practical considerations in the exercise of these duties.

Fiduciary Duties When a Corporation is Solvent

Fiduciary duties of directors arise under the law of the state of the corporation's formation, and include the duty of care and the duty of loyalty, which are generally owed to the corporation and its shareholders. Therefore, if a director breaches one of the duties, shareholders have standing to bring a cause of action on behalf of the corporation (called a derivative action) against the director for breach of the duty. While a corporation is solvent, creditors of the corporation generally have no standing to bring derivative or direct actions against directors. Creditor rights are generally governed by contract, such as a credit agreement or promissory note which create no obligations on the directors.

The duty of care requires that directors exercise the degree of care, "which ordinary, careful and prudent persons would use in similar circumstances."

The duty of loyalty requires directors to act in good faith and in the best interests of the corporation and its shareholders. This duty prohibits directors from receiving an improper personal benefit from their relationship with the corporation, self dealing, and usurpation of corporate opportunities.

In exercising their fiduciary duties, directors have the benefit of the business judgment rule. The business judgment rule is a presumption that, in making a business decision, the directors 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. The exercise of a valid business judgment will be respected by the courts and provides a fundamental defense in litigation challenging a director's actions.

However, there are circumstances in which directors are not entitled to the defense of the business judgment rule, such as when a director has a personal interest in a matter that comes before the board, implicating the director's duty of loyalty. In such cases, care must be taken by the board in connection with the approval process in order to maintain the applicability of the business judgment rule or courts will review the transaction with heightened scrutiny to make sure the decision is intrinsically fair to the corporation.

In addition to the business judgment rule, most states have enacted statutes that permit the corporation to provide in its charter or bylaws an exculpation provision that insulates a director from liability stemming from an alleged breach of the duty of care (including acts constituting negligence). These exculpations are generally enforced so long as there is no breach of the duty of loyalty, there is no knowing violation of law, and the director did not receive a personal benefit.

Fiduciary Duties When a Corporation is Insolvent or Near Insolvency

The general rule is that directors and officers of a solvent corporation do not owe any fiduciary duties to the corporation's creditors. However, an exception to this rule arises when a corporation is insolvent. In the context of an insolvent corporation, courts generally hold that creditors (in addition to shareholders) have standing to bring derivative actions against directors of the insolvent corporation for breach of their fiduciary duties. Courts have articulated at least two tests for determining insolvency, which include: a corporation's inability to pay its debts as they become due in the ordinary course of business; or when liabilities exceed the reasonable market value of assets held. A recent opinion from the Delaware Supreme Court has clarified that in either the insolvency or zone of insolvency contexts, creditors do not have standing to bring direct claims against the corporation's directors by asserting damage to the creditor for breach of fiduciary duty.

After a company has filed bankruptcy and before the confirmation of a Chapter 11 plan, the debtor-in-possession or trustee has authority to bring an action against its former directors for breach of fiduciary duty where the action could have been asserted directly by the corporation or as a derivative action prior to bankruptcy.

In addition, a liquidating trust created upon confirmation of a Chapter 11 plan may also bring a direct action against a corporation's former directors for breach of fiduciary duty as long as the trust is the representative of the corporation and has been given authority to prosecute such actions on behalf of the corporation. The United States Court of Appeals for the Fifth Circuit recently issued an opinion that outlines how such a liquidating trust should frame its complaint in order to overcome dismissal. The case, *Torch Liquidating Trust v. Stockstill*, involved an action for breach of fiduciary duty brought by a trust that was created at confirmation of a company's Chapter 11 plan to prosecute claims against former officers and directors and to distribute the proceeds to creditors. The Fifth Circuit explained that the liquidating trust did not need to bring a derivative suit on behalf of shareholders or creditors because it had standing to bring a direct suit against the officers and directors since it had been appointed as a representative of the bankruptcy company's estate. Despite finding that the liquidating trust had standing, however, the Fifth Circuit upheld dismissal of the complaint because the liquidating trust failed to plead that the alleged breach of fiduciary duty caused damages to the company, as opposed to shareholders and creditors.

Practical Considerations When Exercising Fiduciary Duties

In either the solvency or insolvency contexts, courts generally hold that the business judgment rule and charter exculpation provisions still apply. Accordingly, it is important for directors of both solvent and insolvent corporations to understand their fiduciary duties, the effect of the business judgment rule, and how to stay within the bounds of any available charter exculpation provision. The following are some practical considerations when making decisions as a director:

Duty of Loyalty

- First, avoid conflicts of interest or transactions where directors may have a personal interest.
- In any interested transaction, rely on independent decision-makers who are not influenced by personal or extraneous considerations. Use an independent committee of directors, with its own separate legal counsel, financial advisors and other professionals to consider and approve conflict transactions. Make sure they negotiate the terms and understand their obligations.

- Consider alternatives.
- Keep proper records. Document all efforts to overcome conflicts and preserve independence.

Duty of Care and Proper Exercise of Business Judgment

- Take the time to understand the company, its financial statements, and the industry. Ask questions.
- Prepare for meetings in advance. Obtain and review advance copies of agenda, board materials, and presentations. Read all materials provided. Be informed.
- Attend all meetings. At the meetings, make sure to participate actively, ask questions, and challenge assumptions.
- Require expert and professional advice and evaluations. Seek information from CPAs, attorneys, investment bankers, and others as needed.
- Make sure sufficient time is taken for proper evaluation.
- Require board committees with clear mandates, where appropriate.
- Provide input on board minutes. Insist on appropriate board minutes that document evaluation and due diligence process.

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