



FOLEY & LARDNER LLP

Fiduciary Duties of Directors of Troubled Companies

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The Fiduciary Duties of Directors

- Duties are to the corporation
- Dual duties of care and loyalty
- Directors' decisions are presumptively protected by the business judgment rule

Duty of Care

- A director's duty of care requires him or her to use the care of a reasonably prudent and informed person in the exercise of their responsibilities
- Focus of this duty is primarily the process by which decisions are made rather than the substance of the decision or its eventual outcome

Duty of Loyalty

- Requires that directors act in the best interests of the corporation, subordinating other interests to that of the corporation
- Requires good faith belief that actions taken are in the corporation's best interests
- Duty implicated whenever there is conflict of interest

The Business Judgment Rule

- The Business Judgment Rule creates 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.
- A director is entitled to the protection of the rule unless it is demonstrated that the director breached his or her fiduciary duties.

Breach of Duties

- To breach duty of care, director must be found to have acted with gross negligence
- To breach duty of loyalty, director must be found to have acted in bad faith or with intentional disregard of duties
- If a director is found to have breached a duty, then the director has the burden of demonstrating the “entire fairness” of the decision at issue.

Further Limitation on Liability By Statute and By-Law

- Most corporations have adopted, or should, a bylaw that incorporates Sec.102 (b)(7) of the Delaware statute, which is designed to insulate directors from personal liability unless they are found to have breached their fiduciary duty of loyalty: no personal exposure for breach of duty of care. Massachusetts law does not, by statute, provide a comparable safe harbor for directors. The 102(b)(7) safe harbor is not available for officers as officers.

When Insolvency Looms

- Directors and officers of solvent corporations do not owe fiduciary duties to the creditors of the corporation
- When a corporation becomes insolvent, directors' fiduciary duty shifts to the corporation's creditors because creditors are then deemed to be the primary stakeholders
- As a result, creditors of an insolvent corporation have standing to maintain derivative, but not direct, claims against directors on behalf of the corporation for breaches of fiduciary duties

Insolvency

- Fair value of assets is less than liabilities “with no reasonable prospect that the business can be successfully continued in the face thereof”; or
- Inability to meet maturing obligations as they fall due in the ordinary course of business

Zone of Insolvency

- Is it, or isn't it?
- As a matter of law, directors of a corporation in the zone of insolvency **do not** owe fiduciary duties to the corporation's creditors
- But, once in the zone directors invite creditor second guessing in lawsuits if board decisions are made without regard to creditors' interests

Critical Decisions In Distress

- Course changing board decisions for companies in trouble not surprisingly create the greatest potential exposure for directors
- Particularly vulnerable decisions are:
 - Refinancing of indebtedness to insiders
 - “Bridge” financing by insiders
 - Sale of assets to insiders or related parties.

Fundamental Steps in Avoiding Liability

- ❑ If they exist, rely on truly independent directors for any decisions implicating other directors with conflicts of interests
- ❑ Even if alternatives appear quixotic, explore them enough to confirm that
- ❑ Do not rely solely on interested officers and directors for critical data and analysis
- ❑ Use outside experts for impartial evaluation unless completely unfeasible, particularly in absence of independent directors
- ❑ Fully document board efforts to arrive at an informed, thorough decision and to demonstrate that disinterested board, not advisors and not conflicted parties, made the decision.

Guiding Principle

Whether in the zone of insolvency or trying to determine the fate of a clearly insolvent entity, directors' decisions should be demonstrably based on their best business judgment, without regard for their personal interests, made in good faith and with full regard for the best interests, taken together, of all stakeholders—shareholders, creditors and, whenever possible, employees.

Postscript

Common Statutory Liabilities

- Directors may have personal liability for corporate obligations under certain state or federal statutes, including
 - Statutes providing for collection and payment of “trust fund” taxes, e.g., sales taxes and income tax withholdings.
 - Nonpayment of wages laws (criminal)
 - WARN Act
 - ERISA