FOLEY'S NATIONAL DIRECTORS INSTITUTE

2009 WEB CONFERENCE SERIES

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Insolvency Related Issues in the Boardroom

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PART I – Fiduciary Duties of Directors

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Fiduciary Duties of Directors to the Corporation They Control

- To whom are directors' duties owed?
  - Duties are to the corporation. Del. Code Ann. Tit.8, §141(a).
- What do fiduciary duties of care and loyalty mean?
  - Situations

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Duty of Care

- Duty of care governs a director's decisions in managing the corporation
- Focus of this duty is the process by which decisions are made rather than the substance of the decision or its eventual outcome
- How do advisors assist directors in carrying out their duty of care?

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Duty of Care

- What situations arise where "maximizing value" is not enough, e.g. sale may be good for creditors but not equity?
- How do the company's advisors assist directors in discharging this duty?
- What process should directors undertake to demonstrate they are fulfilling their duty of care, e.g. creating a record?

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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 where there is conflict of interest or by the corporate opportunity doctrine
- Can you provide examples of situations where directors breached duty of loyalty?

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The Business Judgment Rule

- What protections do directors have with respect to their conduct?
- The Business Judgment Rule provides an important protection to corporate directors. The Rule is 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. *Aronson v. Lewis, 473 A.2d 805 (Del. 1984).*
- Do directors understand this protection? How does it affect their conduct, if at all?

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Directors of Insolvent Corporations Owe Their Fiduciary Duties to Creditors

- When a corporation becomes insolvent, creditors take the place of shareholders as the residual beneficiaries of any increase in value
- As a result, creditors of an insolvent corporation have standing to maintain derivative claims against directors on behalf of the corporation for breaches of fiduciary duties

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Zone of Insolvency

- Expands situation where directors owe creditors a fiduciary duty beyond those where corporation is actually insolvent, to situations where the corporation was operating "in the zone of insolvency."
- TEST: insolvent in fact v. legally insolvent
- What factors are considered in determining solvency or insolvency?
- Who decides whether the corporation is insolvent?
- What should directors do if they are unsure of whether the corporation is insolvent?

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Direct v. Derivative Claims By Creditors

- Update on recent Delaware law regarding direct or derivative claims by creditors
- Previous cases left the door open for direct claims by creditors but the Delaware Supreme Court closed that door in North American Catholic Educational Programming Foundation, Inc. (NACEPF) v. Gheewalla, 930 A. 2d 92 (Del. Supr. 2007).
- Delaware Supreme Court held that creditors of a Delaware Corporation that is either insolvent or in the zone of insolvency have no right to assert direct claims for breach of fiduciary duty against corporation's directors.

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GHEEWALLA Decision

- How will this decision affect creditors?
- Can they still assert derivative claims?
- The Gheewalla Court suggested that creditors may nevertheless protect their interests by asserting derivative claims but not direct claims for breach of fiduciary duty.

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Deepening Insolvency

- What is deepening insolvency?
- First endorsed by Third Circuit in 2001 decision, *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc.*, 267 F.3d 340 (3d Cir. 2001) ("Lafferty").
- Recent decisions show deepening insolvency, whether articulated as cause of action or theory of damages quickly eroding as independent means of recovery.
- Deepening insolvency really a damage theory of a traditional breach of fiduciary claim exists.

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Corporate Officer Duties

- Delaware Supreme Court recently held on February 14, 2009 in *Gantler v. Stephens*, that officers of Delaware corporations owe the same fiduciary duties as their directors. This principle was implied by other Delaware rulings but has never been held explicitly.
- However, officers, unlike directors, cannot rely on Delaware's exculpation statute to allow the corporation to limit their liability through charter provisions.
- The lesson: unless new legislation amends the current Delaware statute, concerned officers should insist that indemnification agreements and officer insurance are in effect to protect them against liability if they face a claim for breach of fiduciary duty.

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PART II - Corporate Governance Issues in Chapter 11 Bankruptcies

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Shareholder Meetings While in Bankruptcy

- Does a Chapter 11 debtor typically hold shareholder meetings? Can it?
- Can the debtor be forced to schedule a shareholder meeting or does an order directing the scheduling of a shareholder meeting of a chapter 11 debtor violate the automatic stay?
- In *Asher E. Fogel v. U.S. Energy Systems, Inc. et al.*, the Delaware Chancery Court held that the automatic stay did not apply to the scheduling or holding of a shareholder meeting of the debtor.
- The Chancery Court issued an order directing U.S. Energy to schedule a shareholder meeting at the request of a shareholder.

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Impact of U.S. Energy

- Important principles resulting from *U.S. Energy* include:

  1. the Chancery Court may be the proper forum to address corporate governance issues as they may be impacted by the automatic stay;

  2. the filing of the chapter 11 case does not, on its own, divest shareholders of their right to "exercise their rights of corporate democracy," and

  3. absent some clear showing of abuse, which need likely rise to such a level as to "seriously threaten the rehabilitation of the debtor," the rights of the shareholders in respect of shareholder meetings will not be disturbed.

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Corporate Governance in Bankruptcy

- Does typical corporate governance continue post-bankruptcy?
- Are there conflicts between traditional corporate governance rules and bankruptcy laws?
- E.g. sale of a company's assets may require shareholder approval while sale in bankruptcy requires only adherence to Section 363 sale procedures or Section 1129 confirmation requirements if through Plan of Reorganization
- Does control of the corporation change, e.g. appointment of Chapter 11 trustee?

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