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Checklist

Fiduciary Duties in the Zone of Insolvency

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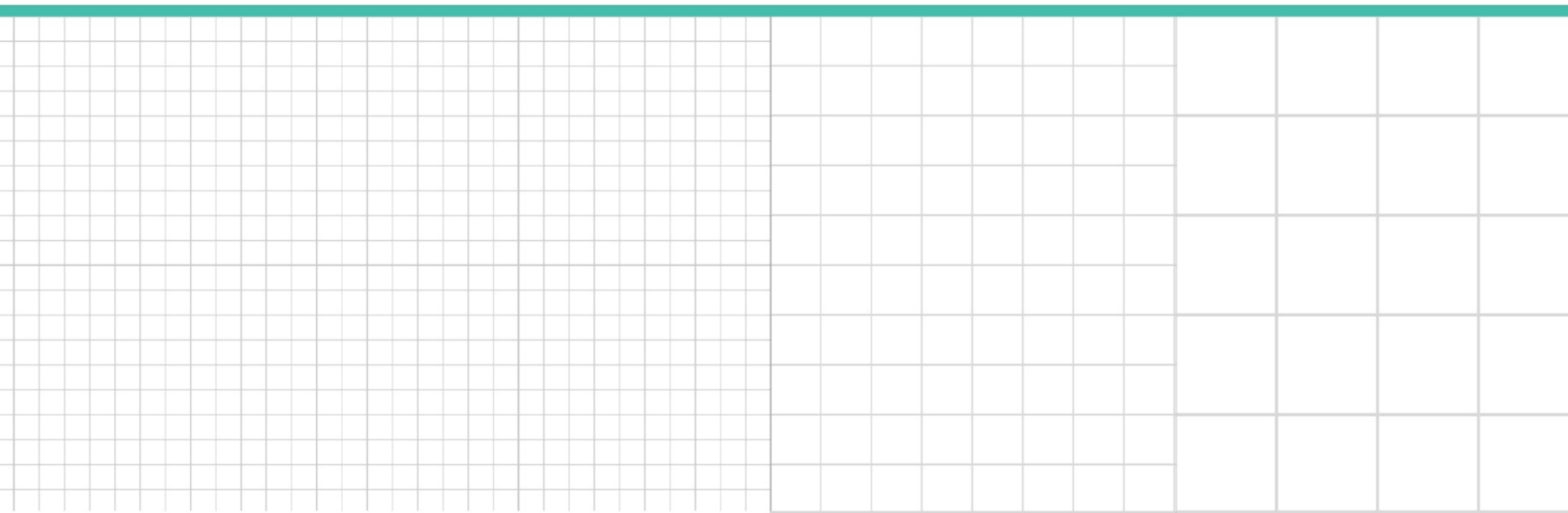

Fiduciary Duties in the Zone of Insolvency

Contributed by Frank Aquila, Melissa Sawyer and Ashlyann Harrison, Sullivan & Cromwell

Boards of directors must reexamine their fiduciary duties during the novel coronavirus pandemic, especially if their corporation is at risk of becoming insolvent. The economic impact of the coronavirus pandemic has resulted in increased concern over the beneficiaries of directors' fiduciary duties of corporations in the "zone of insolvency:" corporations that are financially troubled, but not yet insolvent. The nine guiding principles outlined below are essential to ensuring that directors properly exercise their fiduciary duties.

Background: Fiduciary Duties Expand in Troubled Firms

Generally, under Delaware law, directors owe the corporation and its stockholders a fiduciary duty of care, which requires directors to make good faith decisions in the best interest of the corporation, based on all material information reasonably available to directors, as well as a fiduciary duty of loyalty, which requires directors to prioritize the interests of the corporation and its stockholders over the directors' personal interests. If a corporation is solvent, a director's duty of care and duty of loyalty are owed to the corporation and its stockholders.

In North American Catholic Education Programming v. Gheewalla *(2007)*, the Delaware Supreme Court confirmed that the beneficiaries of a director's fiduciary duties remain limited to the corporation and its stockholders—not the company's creditors—even if the corporation is operating in the "zone of insolvency." Accordingly, in such circumstances a corporation's creditors do not have standing to assert any claim for breach of a director's fiduciary duties.

However, once a corporation actually becomes insolvent, the beneficiaries of a director's fiduciary duties expand to include the corporation's creditors, who have standing to file derivative, but not direct, claims against directors on behalf of the corporation for breaches of fiduciary duties.

In Quadrant Structured Products Co., Ltd. v. Vertin *(2015)*, the Delaware Chancery Court reinforced the *Gheewalla* decision, by holding that creditors have standing to assert a derivative claim for breach of a director's fiduciary duties if the corporation is insolvent at the time the claim is filed and the corporation has outstanding debts due to the creditor. At the same time, the Chancery Court further clarified that directors will not be liable for breaches of fiduciary duties if they act in good faith to maximize the profitability of the corporation, even if its creditors sustain losses as a result of such actions.

Despite the challenges presented by the coronavirus pandemic, the *Gheewalla* and *Vertin* decisions serve as a reminder that directors who exercise reasonable business judgment and act in good faith to protect the interests of their corporations and stockholders will be protected from personal liability, even if the corporation enters the "zone of insolvency."

The following principles set forth key issues directors should consider to ensure that they exercise their fiduciary duties at all times, but particularly in response to the coronavirus pandemic and in circumstances of financial instability.

1. Be Informed of Material Business and Legal Developments

In times of uncertainty, directors may need to make critical, time-sensitive decisions. To exercise their duty of care properly under challenging circumstances, directors must be informed regularly of all material information related to key risks and challenges the corporation is facing as a result of the coronavirus pandemic. Directors should receive regular updates from the corporation's management team regarding key risks caused by the pandemic, including information relating to the corporation's financial statements, changes to financial projections and credit outlook, changes in operations management, the safety and health of an increasingly remote workforce, and communications and engagement with stockholders and other key stakeholders, such as employees, creditors and customers.

Management should be prepared to provide recommendations for minimizing these risks, and directors should ensure that appropriate monitoring and reporting systems are in place to track the effect of the pandemic on the corporation. Directors should also engage external advisers as appropriate to provide guidance and supplement the knowledge and experience of directors and management with respect to applicable state and federal law, as well as changes in the regulatory framework governing the corporation, and to ensure that the corporation is taking appropriate actions based on the risks faced by the corporation.

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2. Monitor and Evaluate the Corporation's Finances and Solvency

In times of financial instability, directors are best able to assist management in navigating financial challenges if they understand the financial condition of the corporation, including circumstances that could result in the corporation being deemed insolvent. An insolvency determination is a fact-specific inquiry and is usually determined using one of the following tests:

- The asset test, which looks to the corporation's balance sheet to determine whether the corporation's assets exceeds its liabilities
- The cash flow test, which looks to whether the corporation has enough cash flow to meeting its financial obligations when due
- The capital test, which considers whether the corporation has sufficient capital to secure financing for continuing operations

To evaluate a corporation's solvency properly, directors must receive regular reports from management on the corporation's financial condition and ensure that they understand the corporation's financial statements, projections and indebtedness, including the availability of lines of credit, the corporation's obligations under material credit agreements, and the corporation's credit compliance history. Directors should revisit the practicality of significant capital expenditures and business plans approved prior to the pandemic and actively question assumptions relating to the feasibility of business plans and projections based on the corporation's short-term and long-term objectives. Such plans and projections should be revisited frequently as the continuing economic impact of the pandemic unfolds.

Although creditors do not have standing to make derivative claims relating to directors' fiduciary duties unless the corporation is actually insolvent, directors should carefully evaluate the perception and financial impact of any action or transaction that may have a negative impact on the corporation's financials, especially those that increase the corporation's likelihood of becoming insolvent. The board should consult with external advisers as appropriate on financial contingency planning and before approving material transactions, especially transactions that may benefit stockholders while jeopardizing the corporation's ability to pay its creditors, such as the distribution of dividends or share repurchases.

3. Consider Forming a Pandemic-Response Working Group

Given the scope of the economic impact of the coronavirus pandemic, directors should plan to meet by telephonic or virtual communication as often as appropriate to discuss and approve responsive management actions. In some cases, however, it may be more practical for the directors to exercises their fiduciary duties by delegating certain oversight responsibilities relating to the coronavirus pandemic to a working group of directors. The members of any such working group should include directors with expertise and experience best suited for overseeing this crisis and limited competing external demands on their time.

4. Maintain Accurate and Detailed Records

As always, companies should memorialize directors' actions and decision-making through proper record keeping. Board minutes should provide an accurate and detailed, as appropriate, account of directors' considerations, actions and recommendations with respect to material risks facing the corporation, review of monitoring and reporting systems related to those risks, deliberation on recommendations provided by management, and external advisers and any insolvency-related matters. The board should consult with external legal advisers to ensure minutes reflect proper and sufficient notation of board deliberations.

5. Anticipate Stockholder Activism and Takeover Activity

Market volatility caused by the pandemic has resulted in depressed stock prices for many corporations, making them increasing vulnerable to well-funded investors and potential acquirors seeking to purchase sizable, and in some cases controlling, equity stakes in corporations. In December 2019, in a ruling for the K-Bar Holdings LLC v. Tile Shop Holdings, Inc. case, the Delaware Court of Chancery determined that a group of stockholders presented a colorable claim against a board of directors for failing to act in the best interest of the corporation's stockholders, when a group of stockholders (including three directors) took advantage of the corporation's depressed stock price, and increased its equity state from 29% to 42%, without any responsive action by the board.

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Directors should work with the company's management team to proactively implement or update takeover preparedness programs including:

- Preparing takeover defense materials, such as a stockholder rights plan
- Implementing a stock watch program to monitor and flag large purchases of company stock
- Outlining a communication and engagement plan for key stockholders

The board should seek guidance from external counsel with respect to implementing and refreshing their takeover preparedness programs.

6. Evaluate Director Indemnification and Insurance Protections

During times of financial uncertainty and distress, directors are at increased personal risk with respect to their oversight responsibilities as a result of an increased risk for litigation. Therefore, it is critical that the corporation provides adequate indemnification and insurance protection for directors. To the extent possible, ensure that the corporation's organizational documents, including the certificate of incorporation and bylaws, provide for expense advancement and reimbursement, indemnification and exculpation for directors in line with best market practices.

Corporations and directors should also carefully review the terms of their D&O insurance policies to ensure they provide adequate coverage, including coverage for risks heightened by the coronavirus pandemic, such as data privacy and security risks associated with information technology systems supporting a remote workforce. Supplemental coverage should be purchased as needed.

In addition, directors should review and understand any limitations to indemnification and insurance coverage in the event of bankruptcy or restructuring events. To the extent necessary, directors should consider requesting an indemnification agreement with the corporation to supplement coverage provided by the corporation's organizational documents and insurance coverage.

7. Scrutinize Related-Party Transactions

As companies work to maintain or increase liquidity during the pandemic, they may consider certain strategic corporate opportunities, including related-party transactions. As directors evaluate such transactions, it is imperative that directors monitor carefully any action that could be perceived as self-dealing as such transactions will be subject to additional scrutiny by investors and courts in the event of litigation. Directors should proactively disclose any potential conflicts of interest, including any conflicts of interest of external advisers, to the board and recuse themselves from decisions relating to such conflicts. The board should take extra care to ensure that the evaluation process, terms, and pricing for any related-party transactions are above reproach by ensuring such transactions comply with the corporation's conflict of interest and related-party transaction policies, consulting with external advisers regarding the fairness of the transaction and seeking stockholder approval as appropriate.

8. Refrain From Hasty Resignations

The global economic, health, and safety impact of the coronavirus pandemic may cause some directors to consider resigning due to competing demands on their time as a result of their obligations as directors and officers across multiple business organizations, as well as issues concerning the health and safety of the directors and their families. Under most circumstances, a director may resign at any time; however, directors must be mindful that the timing of the resignation could result in a breach of their fiduciary duty of loyalty—which is generally not exculpable or indemnifiable—if the resignation harms, or has the potential to harm, the corporation or its stockholders. To protect themselves from personal liability with respect to resignation, especially in connection with an insolvency event, directors should consult with an external legal adviser prior to tendering their resignation and, after consultation, consider providing a written explanation for their resignation to the board.

9. Be Attentive to Social Capital Management

Much has been written about corporate purpose, sustainability and stakeholder governance in the past year. For many corporations, these concepts are highly compatible with a director's fiduciary duties to stockholders in the midst of the pandemic. A corporation's human capital management practices and attention and outreach to stakeholders like customers and the broader community may be fundamental to preserving long-term value, including the corporation's

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reputation as an employer and the respectability of its brands. In due course, directors should consider communicating their efforts in this regard to stockholders, whether in their 2021 proxy statement, 2020 off-season stockholder engagement meetings or otherwise.

The coronavirus pandemic has resulted in unprecedented global business disruption and immediate financial hardship for corporations. As boards of directors guide their corporations through these challenging and unpredictable times, it is imperative that directors act pragmatically and follow sensible corporate governance practices, including the advice of knowledgeable external advisers, to limit the risk of personal liability and protect the beneficiaries of their fiduciary duties.

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