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Bankruptcy, Restructuring and Commercial Law Advisory: Fiduciary Duties and Insolvency: Limiting Personal Liability in Tough Economic Times

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We all are familiar with the fiduciary duties of care and loyalty owed by officers and directors to their company and its shareholders. When a corporation is struggling financially, however, the parties to whom these fiduciary duties are owed may expand and shift.

Fiduciary Duties of Officers and Directors

There are basically two kinds of fiduciary duties owed by officers and directors:

1. the duty of due care, which requires a fiduciary to act as a reasonably prudent person in the circumstances; and
2. the duty of loyalty, which requires a fiduciary to act in good faith for the benefit of the corporation.

A breach of fiduciary duty can expose an officer or director to personal liability.

Insolvency and the Zone of Insolvency

Generally, courts will find that a corporation is insolvent when it either:

- has liabilities in excess of assets, often called “balance sheet insolvency,” or
- is unable to meet its obligations as they become due in the ordinary course of business, often called “equitable insolvency.”

Identifying the so-called “zone of insolvency” is less exact. Most courts agree that a corporation enters the zone of insolvency when it is on the brink of being insolvent. Practically, it is very difficult to distinguish between the time when a corporation is insolvent or merely in the zone of insolvency.

Expansion and Shift of Fiduciary Duties

Officers and directors always owe fiduciary duties directly to their company and, when the corporation is solvent, those duties also are owed to the corporation’s shareholders. Creditors, on

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the other hand, generally are relegated to their contractual rights against the corporation. When a corporation becomes insolvent, however, creditors replace shareholders as the residual risk-bearers and the fiduciary duties owed to shareholders shift to the corporation's creditors. As the corporation approaches insolvency (*i.e.*, enters the zone of insolvency), many courts find that fiduciary duties are owed to both shareholders and creditors, although such a requirement is not universally recognized. Of note, the Delaware Supreme Court recently questioned this requirement when it held that officers and directors do not necessarily owe fiduciary duties to creditors of a company in the zone of insolvency. Creditors cannot bring breach of fiduciary duty actions to recover individually, but rather, they can only assert derivative claims on behalf of the corporation for such breaches.

Given the lack of precision in defining the zone of insolvency, the hindsight nature of determining insolvency, and the lack of unanimity in the relevant court decisions, officers and directors are cautioned to consider the interests of creditors as soon as the company becomes financially distressed.

Tips for Limiting Exposure to Personal Liability

At all times, but certainly as your company enters the zone of insolvency or actually becomes insolvent, there are measures you can take to limit your risk of personal liability on account of a claim for breach of fiduciary duty. These include the following:

- Verify whether the corporate charter documents or by-laws provide for indemnification of directors and officers, but do not rely upon indemnification when making proper decisions, especially since the company may not have sufficient assets to indemnify you.
- Verify whether applicable corporate law provides for indemnification or limitation of liability for certain decisions and under certain circumstances, but note that no state completely insulates fiduciaries from all liability.
- Obtain sufficient and appropriate directors' and officers' insurance coverage. At the same time, be aware that the bankruptcy of the company may negatively affect the availability of insurance proceeds to officers and directors under certain types of coverage.
- Keep in mind that once the company is in financial distress, all decisions likely will be scrutinized and second-guessed. A subsequent bankruptcy of the company will provide creditors with a convenient forum in which to pursue claims for breach of fiduciary duty.
- Do not take actions that may jeopardize the business judgment rule, which is the presumption that a fiduciary acted on an informed basis, in good faith and with the honest belief that the actions were in the best interests of the company.
- Pay rigorous attention to process and documentation. Retain professionals to advise the company and the board (but do not abdicate decision-making responsibility to such professionals), consider a variety of options in decision making, observe corporate formalities, keep appropriately detailed minutes of meetings, and stay informed.
- Be cautious of overly optimistic financial projections and strategies. A course of action that results in deepening the insolvency of the company and further harming its creditors could subject fiduciaries to liability for breach of duty or, at least serve as a measure of damages for such liability. Become as well-informed as possible and be conservative when assessing projections.

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- As a general matter, take actions (or, when appropriate, refrain from taking actions) which can be objectively justified as benefiting both shareholders and creditors. Avoid taking any action that may impair the likelihood that creditors will be paid their claims when due.

For assistance in this area, please contact one of the attorneys listed below or any member of your Mintz Levin client service team.

Richard E. Mikels
Chairman and Manager,
Bankruptcy, Restructuring and Commercial Law Practice
(617) 348-1691
REMikels@mintz.com

Daniel S. Bleck
(617) 348-4498
DSBleck@mintz.com

Jeffry A. Davis
(858) 314-1503
JADavis@mintz.com

Stuart Hirshfield
(212) 692-6771
SHirshfield@mintz.com

William W. Kannel
(617) 348-1665
BKannel@mintz.com

Paul J. Ricotta
(617) 348-1752
PJRicotta@mintz.com

Kevin J. Walsh
(617) 348-1622
KWalsh@mintz.com