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Recent Cases Examine Board's and Officer's Duties to Financially Troubled Companies

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All corporate directors and officers owe duties to their companies and their shareholders. The most important of these "fiduciary" duties are the duties of loyalty and due care. But when a corporation encounters serious financial distress, its directors and officers may find that they no longer owe their fiduciary duties just to the shareholders of the corporation, but also to its creditors. The idea is that a company's financial difficulties can reach a point beyond which there is little prospect of value for its equity holders. At that point, creditors become the claimants to the company's residual value and thus, become like the shareholders of a successful company.

The concept of a fiduciary duty to creditors, which had been recognized for many years in limited circumstances, took on much broader significance in 1991 when a Delaware judge wrote that directors of companies operating in the "vicinity" or "zone" of insolvency may owe duties to the company's creditors. (Because so many U.S. companies are incorporated in Delaware, the opinions of its courts on corporate questions have long exerted nationwide influence.) Since that opinion, lawyers advising boards of troubled companies have been forced to consider a confusing body of law dealing with the zone of insolvency, "deepening insolvency," and duties to creditors generally. Recent cases from the Delaware courts have brought some much-needed clarity to these concepts, but other cases arising from the current difficult economic environment show that officers and directors must continue to consider their possible duties to creditors very carefully.

First, in the 2007 *Trenwick* case, the Delaware Supreme Court considered a claim of "deepening insolvency." The theory was that directors of a failing corporation breach their duties to creditors if they negligently or fraudulently prolong the life of a business and take on additional debt. The court rejected this theory as an independent basis for suing the directors. The ruling did, however, leave open the possibility that the concept of deepening insolvency could increase the damages against board members who have breached their traditional duty of loyalty in a transaction where they have a conflict of interest.

Then, in another 2007 case called North American Catholic Education Programming Foundation, Inc. v. Gheewalla, the Delaware Supreme Court rejected the zone of insolvency theory. The court held that creditors may assert claims only when a corporation is actually insolvent, as opposed to operating in the zone or vicinity of insolvency. Perhaps more importantly, the court also held that creditors may never recover directly against directors for breaches of their fiduciary duties, even when the company is actually insolvent. Creditor claims may be brought only in a "derivative" action, where any recovery goes to the corporation itself for the benefit of all claimants rather than to the creditor asserting the claim. In addition, in the 2008 case of Nelson v. Emerson, a lower Delaware court held that directors of an insolvent company may cause the company to stay in business, and even engage in risky business ventures, if they believe the effort has a reasonable chance to succeed. "It is settled Delaware law," the court said, "that an insolvent company is not required to turn off the lights and liquidate when the company's directors believe that continuing operations will maximize the value of the company."

These developments have made it easier for directors and officers to act to save struggling companies without fear of violating conflicting fiduciary duties to shareholders and creditors. Nonetheless, the potential for exposure to claims by creditors of an insolvent corporation remains a concern for board members, especially in connection with the sale of a troubled company or its assets. For example, in the 2008 Bridgeport Holdings case, a federal bankruptcy court in Delaware refused to dismiss a claim against the directors of an insolvent company who were alleged to have approved a sale of the company's assets without appropriately determining the value of the assets, even though there was no claim of self-dealing on the part of the directors. On the other hand, in much-publicized litigation surrounding the acquisitions of Bear Stearns and Wachovia Corporation, courts in New York and North Carolina took positions favorable to the directors in considering fiduciary-duty challenges to board actions taken amidst financial crisis. Overall, although the legal trend may be to give greater leeway to directors and officers of failing and financially troubled companies, they must remain vigilant in the performance of their traditional duties, always bearing in mind the possibility of claims by creditors.