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Vigilance Now Can Help Avoid Scrutiny Later: Fiduciary Duties in the Midst of a Global Pandemic

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Faced with constantly evolving circumstances in these challenging times, officers and directors should not lose sight of what is arguably their most important corporate role—that is, as a fiduciary. The question, particularly as a corporation's financial situation changes and restructuring is being considered, is: Who is that fiduciary duty owed to? Unfortunately, the answer depends on whether the corporation is insolvent or near insolvent, which is why being vigilant now will help avoid scrutiny by creditors later.

Director's Fiduciary Duties While Operating Insolvent Companies

Directors and officers of Delaware corporations stand in a fiduciary relationship to the corporations they serve, *see Malone v. Brincat*, 722 A.2d 5, 10 (Del. 1998), and their fiduciary duties fall into three categories: care, good faith, and loyalty, *see Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993).[1] "[T]he general rule is that directors do not owe creditors duties beyond the relevant contractual terms." *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 99 (Del. 2007). When solvent, creditors do not have standing to pursue fiduciary claims, as the power to do so rests with the corporation's shareholders. *Id*. at 101. However, "[w]hen a corporation is *insolvent* . . . its creditors take the place of the shareholders as the residual beneficiaries of any increase in value." *Id*. Stated differently, when a corporation is insolvent, its directors and officers still owe their fiduciary duties to the corporation, but a new group of interested parties—creditors—gain standing to enforce those fiduciary duties. *Quadrant Structured Prod. Co. v. Vertin*, 102 A.3d 155, 176 (Del. Ch. 2014) ("The fiduciary duties that creditors gain derivative standing to enforce are not special duties to creditors, but rather the fiduciary duties that directors owe to the corporation to maximize its value for the benefit of all residual claimants.")

At What Point Do Creditors Gain Standing To Scrutinize Fiduciary Decisions?

"A creditor's standing to maintain a derivative action against a corporation's directors arises at the precise moment that the corporation passes from solvency to insolvency." I*n re Tribune Co. Fraudulent Conveyance Litig*., No. 11-MD-2296 (RJS), 2018 WL 6329139, at *7 (S.D.N.Y. Nov. 30, 2018), *reconsideration denied*, No. 11MD2296 (DLC), 2019 WL 549380 (S.D.N.Y. Feb. 12, 2019) (emphasis added) (applying Delaware law). Given current economic conditions, it is conceivable that a corporation's financial situation could change overnight, particularly since there are at least two ways of proving that a company is insolvent: the "balance sheet" test and the "cash flow" test.

Under the balance sheet test, an entity is insolvent if it "has liabilities in excess of a

[1] The state of incorporation and the structure of the corporation will dictate the substantive law applied.

reasonable market value of assets held." *Trenwick Am. Litig. Tr. v. Ernst & Young, L.L.P.*, 906 A.2d 168, 195 (Del. Ch. 2006), aff'd sub nom. *Trenwick Am. Litig. Tr. v. Billett*, 931 A.2d 438 (Del. 2007). "In a mature company, the existence of 'a great disparity between assets and liabilities ... at least raises an issue of material fact as to whether the company was insolvent' sufficient to survive a motion to dismiss." *Quadrant Structured Prod. Co.*, 102 A.3d at 177. Under the cash flow test, a company is insolvent if it is unable to pay its debts as they fall due in the usual course of business. *Id*.

What Types of Decisions Can Creditors Challenge That Shareholders Otherwise Might Not?

Corporations that are forced (or choose) to enter bankruptcy will be–and in many instances should be–subjected to intense scrutiny by various interested parties, most notably creditors and creditors' committees, armed with procedural capabilities not otherwise available in general civil litigation. We focus on creditors because they are in a unique position to assert claims that might otherwise go ignored or unnoticed by shareholders–especially shareholders of closely held corporations.

Federal Rule of Bankruptcy Procedure 2004 permits for an examination of an entity relating "to the acts, conduct, or property or to the liabilities and financial condition of the debtor." A party examining a debtor (or an entity related to a debtor) under Rule 2004 may compel depositions and the production of documents. Fed. R. Bankr. P. R. 2004(c). Rule 2004 investigations are broad in scope. Courts have compared the scope of Rule 2004 investigations to fishing expeditions. *In re Millennium Lab Holdings II, LLC*, 562 B.R. 614, 626 (Bankr. D. Del. 2016) ("Unlike traditional discovery, which narrowly focuses on the issues germane to the dispute, the scope of Rule 2004 is broad and unfettered, and has been likened to a 'fishing expedition' and an 'inquisition.'"). Accordingly, through the appropriate use of Rule 2004 in a bankruptcy case, creditors may discover and assert potential breach of fiduciary duty claims that shareholders either did not know about or ignored because they had no interest in pursuing them.

The following are examples of fiduciary decisions that have been challenged by creditors:

- Increasing inventory levels
- Reorganizing corporate structures
- Executive compensation, severance, and expense reimbursement
- Failure to abide by corporate formalities
- Asset acquisition or sales
- Stock purchases or sales
- Facility closures or relocations

Indeed, even the circumstances surrounding the decision to file (or not to file) bankruptcy can be scrutinized, as can decisions made during the bankruptcy case itself.

Directors and Officers Should Act Now as If Their Decisions Will Be Challenged Later

"The best defense is a good offense" is an appropriate adage in this context. Corporations should establish robust internal policies and procedures to properly scrutinize decisions made when the corporation's financial footing is uncertain. Moreover, directors and officers should strongly consider proactively engaging counsel to help evaluate the potential costs and benefits of pursuing a restructuring through Chapter 11. Such evaluation must include the capability to investigate and uncover potentially problematic decisions made within the applicable look-back period in the appropriate jurisdictions. The restructuring arm must work hand in hand with the investigatory team to account for and address all potential obstacles to a successful restructuring. While history cannot be rewritten, directors and officers can mitigate risks by understanding what decisions, if any, may give rise to a challenge, and potentially address those decisions before they become impediments to in-court or out-of-court restructuring. In the event that fiduciary decisions are challenged, counsel should have the resources to vigorously address claims and, where necessary, litigate those claims in the context of a Chapter 11 filing.

There is no one-size-fits-all restructuring and no uniform game plan for conducting a comprehensive internal investigation. It is important to engage counsel (legal, financial, crisis management, tax, real estate, and others) at the earliest signs of financial distress to identify your company's best option and implement an optimal restructuring strategy. Vigilance now is not a bar to having decisions scrutinized later, but in the uncertain times corporations face, it is the prudent way to discharge one's fiduciary duties.

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