Professional Perspective

Fiduciary Duties for Directors of Distressed, Insolvent, and Bankrupt Companies

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Given the ongoing effects of the Covid-19 pandemic, many industries are bracing for an increase in bankruptcy filings and distressed M&A activity. It is important for directors to understand their fiduciary duties as a company's financial situation evolves and potentially deteriorates. This article seeks to provide insights into a director's fiduciary duties when a company approaches or enters insolvency, and endeavors to provide practical guidance for directors on the application of fiduciary duty best practices in the context of a bankruptcy sale process.

This article focuses on Delaware law with respect to corporations. The laws of other states are consistent in many respects with Delaware corporate fiduciary duty law, but differences exist as well.

After a company becomes insolvent, directors' fiduciary duties extend not only to shareholders, but also derivatively to creditors. While courts have attempted to limit conflicts stemming from serving two or more constituencies that may have very different interests during periods of insolvency, directors frequently face difficult decisions in these situations. These decisions may require a choice between actions intended to benefit shareholders and actions that may be more desirable from a creditor perspective.

After a company files for bankruptcy protection, the risks associated with director decision-making may be regarded as less acute given that the actions of a corporate board or special committee ultimately will be subject to bankruptcy court approval. Given the bankruptcy court's oversight, are directors' fiduciary obligations somehow diminished or otherwise modified?

Consider the following example. The board of a Chapter 11 debtor forms a one-member special committee to oversee a sale process under U.S. Bankruptcy Code Section 363, which provides for expedited sale procedures. Knowing the sale ultimately will require bankruptcy court approval, the one-member committee decides not to engage independent advisers, instead using the company's advisers, and hastily rubberstamps a sale to a company insider acting as a stalking horse bidder.

Outside of a bankruptcy proceeding, this sale process almost certainly would spawn breach of fiduciary duty litigation. But in this illustrative example, the sale was approved by the bankruptcy court, over objections by creditors, seemingly absolving the special committee and others of fiduciary duty liability. While this scenario certainly suggests that the practical risks of fiduciary duty liability are diminished, there is no clear authority that supports the notion that the director's fiduciary duties themselves are diminished.

To the contrary, bankruptcy courts often perform an analysis that tracks a state law breach of fiduciary duty analysis when assessing whether to approve a 363 sale, including a heightened form of scrutiny that largely mirrors the entire fairness standard applicable to an insider sale under state law. Thus, while bankruptcy court approval ultimately may safeguard against fiduciary duty breaches, the failure to follow traditional fiduciary duty best practices could undermine deal certainty or worse.

Director Fiduciary Duties

Generally, Delaware law dictates that board members and other corporate fiduciaries owe duties of loyalty and care to the corporation. The duty of loyalty prohibits self-dealing and requires directors and officers to act with "undivided and unselfish loyalty to the corporation." *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983). The duty of care requires fiduciaries to "use that amount of care which ordinarily careful and prudent men would use in similar circumstances" and "consider all material information reasonably available." *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 749 (Del. Ch. 2005), aff'd, 906 A.2d 27 (Del. 2006).

In breach of fiduciary cases, courts generally apply one of three standards of review, depending on the circumstances: the business judgment rule, enhanced scrutiny, or entire fairness. Under the business judgment rule—the default standard—a court will not second-guess the decision of a fiduciary as long as the conduct may be attributed to a rational business purpose. This forgiving standard generally applies to sales transactions that have been approved by a majority of disinterested stockholders in a fully informed and uncoerced vote. *Corwin v. KKR Financial Holdings LLC*, 125 A.3d 304, 301-12 (Del. 2015).

Enhanced scrutiny will be applied in certain situations involving potential conflicts of interest, including a change of control, a hostile takeover, or proxy contest, final stage transactions, and "situations where the law provides stockholders with a right to vote and the directors take action that intrudes on the space allotted for stockholder decision-making." *Reis v. Hazelett Strip-Casting Corp.*, 28 A.3d 442, 457 (Del. Ch. 2011). In the context of a change of control sale, enhanced scrutiny, often referred to as the *Revlon* standard in this context, dictates that the board's conduct must be reasonable under the circumstances as a good faith attempt to secure the highest value reasonably attainable. *RBC Capital Markets, LLC v. Jervis*, 129 A.3d 816, 849-50 (Del. 2015).

And lastly, when a transaction involves conflicts of interest such as a controller on both sides of the transaction, the highest standard of review is applied—entire fairness. *Flood v. Synutra Int'l, Inc.*, 195 A.3d 754, 756, 760 (Del. 2018). Under this standard, the board must demonstrate that its conduct meets the standards of fair dealing and fair price.

Fiduciary Duties of Directors of Insolvent and Near-Insolvent Companies

Under well-established Delaware law, fiduciary duties of the board of directors of a solvent company run directly to the company, which should be managed for the benefit of its shareholders. In 1991, the Delaware Court of Chancery's decision in *Credit Lyonnais Bank Nederland N.V. v. Pathe Communications Corp*. suggested that if a corporation was in the zone of insolvency or was insolvent, fiduciary duties would extend to creditors, as well as to shareholders.

For a number of years, boards were advised that the "zone" of insolvency was an inflection point triggering expanded duties to creditors. When a company was in the zone of insolvency, creditors could bring direct fiduciary duty claims against that company's board of directors. It was not until 2007, when the Delaware Supreme Court issued the *Gheewalla* decision, that it was clarified that directors' fiduciary duties do not shift to creditors as a company enters the zone of insolvency, rejecting the approach taken by *Lyonnais* and its progeny. *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007).

When the company actually is insolvent, the *Gheewalla* court found that creditors have standing to assert derivative claims against directors on behalf of the corporation for breach of fiduciary duties. This is because during insolvency, creditors are "the principal constituency injured by any fiduciary breaches that diminish firm value." In other words, the board of an insolvent corporation must still act in the best interest of the enterprise and seek to maximize the value of the company, but its fiduciary duties run to all of a company's stakeholders, including creditors.

Importantly, the court found that a creditor of an insolvent company cannot bring a direct claim against directors for a breach of fiduciary duty. The *Gheewalla* court reasoned that to "recognize a new right for creditors to bring direct fiduciary claims against those directors would create a conflict between those directors' duty to maximize the value of the insolvent corporation for the benefit of all those having an interest in it, and the newly recognized direct fiduciary duty to individual creditors."

While *Gheewalla* provided clarity on the board's fiduciary duties in insolvency, board members were still left to figure out how to navigate the complexities that naturally arise when the interests of shareholders and creditors diverge during insolvency.

The Delaware Court of Chancery provided clarity on this issue in *Quadrant Structure Products Co. Ltd. v. Vertin*, 115 A.3d 535 (Del. Ch. 2015). In *Quadrant*, creditors brought a derivative claim against the board of an insolvent company for its decision to amend operating guidelines to permit riskier and more speculative investments rather than pursuing a conservative strategy and preparing for liquidation. The court rejected the creditors' claim, finding that directors "cannot be held liable for continuing to operate an insolvent entity in the good faith belief that they may achieve profitability, even if their decisions ultimately lead to greater losses for creditors." Thus, after *Quadrant*, directors of an insolvent corporation still are permitted to pursue business strategies aimed at maximizing enterprise value.

Despite the seemingly broad latitude afforded to directors of insolvent corporations under *Quadrant*, the fact remains that the point of insolvency is a triggering event that requires directors to start considering the interests of creditors. As a practical matter, there is no bright-line test for determining when a company becomes insolvent, so it is advisable for directors to start considering the interests of creditors when a company is in the "zone of insolvency."

Courts generally determine insolvency using one of three traditional tests: the balance sheet test (whether assets exceed liabilities), the cash flow test (whether the company can pay its debts as they become due), or the unreasonably small capital test (whether, while technically solvent, the company lacks capital to remain solvent in the short-term).

As a company gets close to meeting one or more of these tests, directors must continue their pursuit to maximize the value of the enterprise, but they should not do so without considering the interests of creditors, who gain the ability to bring derivative claims at the point of insolvency. Thus, directors of increasingly distressed companies are best advised to consult legal and professional advisers who can assist them with navigating difficult decisions that may lie ahead.

Fiduciary Duty Principles in Bankruptcy

Despite the well-developed body of law defining a director's fiduciary duties in financially distressed companies, less case law exists describing how a director's fiduciary duties apply once a company has filed for bankruptcy under Chapter 11. There is no dispute that directors of a debtor in possession (DIP) retain certain fiduciary obligations, but the exact nature of those obligations, and the appropriate standard of review that should be applied to evaluate the board's conduct, merits examination.

There is less detailed case law addressing fiduciary duty challenges in Chapter 11 given the amount of judicial oversight that is injected into the decision-making process once a company files a petition for bankruptcy. This is not entirely surprising. As a practical matter, the approval of a business sale transaction by the bankruptcy court generally includes a judicial determination that the transaction satisfies applicable standards including, typically, the business judgment standard.

But even if the risk of director liability for breach of fiduciary duty claims is diminished in a bankruptcy transaction, the failure to follow proper governance standards still can have consequences, including rejection of a sale transaction by the bankruptcy court. So what standards and principles should directors and their advisers consider when making major business decisions in a bankruptcy proceeding?

In short, the same Delaware corporate governance standards appear to provide guideposts that should inform post-petition decisions. Boards of corporations in Chapter 11 generally will be protected by the business judgment rule, unless special circumstances, such as an insider transaction, exist. In these special circumstances, the court will apply some form of enhanced scrutiny to evaluate the director's conduct.

For example, in *In re Integrated Resources, Inc.*, a Chapter 11 debtor sought authorization to enter into a breakup fee and expense reimbursement agreement with a potential funder of a reorganization plan. 147 B.R. 650 (S.D.N.Y. 1992). The agreement was opposed by the debtor's bond holders, who argued that the debtor's negotiations with the bidder were tainted because management had self-interested discussions with the bidder about maintaining their managerial roles post-reorganization.

The court found no evidence of self-dealing—the debtor and bidder never reached agreement on future management—and thus held that the directors' conduct would be evaluated under the business judgment rule, stating explicitly that Delaware business judgment rule principles "have vitality by analogy in Chapter 11."

Fiduciary Duty Principles in Section 363 Sales

Section 363 sales have distinct advantages—in particular, they permit the debtor to transact an expedited sale of assets free and clear of any liens, claims, and encumbrances outside of the plan confirmation process, which is particularly helpful to a debtor faced with rapidly deteriorating assets—*i.e.*, the "melting ice cube" problem. But despite these potential advantages, creditors and other stakeholders often object to 363 sales based on concerns that a fast-tracked 363 sale process short circuits the procedural and substantive safeguards embedded in the ordinary Chapter 11 reorganization plan confirmation process. In light of the expedited nature of 363 sales, bankruptcy courts have developed a specific framework to determine whether or not to approve the sale.

In *In re Lionel Corp*—the seminal case on this issue—the Second Circuit held that a court may approve a 363 asset sale if the debtor has articulated "a good business reason to grant such an application." 722 F.2d 1063, 1070-71 (2d Cir. 1983). Since *Lionel*, courts have elucidated several additional factors to consider when deciding whether to approve a 363 sale, including whether:

- The sale price was fair and reasonable
- There is a need for an expeditious sale
- The buyer is a good faith purchaser
- Adequate notice was given
- Sound business judgment was exercised

In re Flour City Bagels, LLC, 557 B.R. 53, 77 (Bankr. W.D.N.Y. 2016).

The *Lionel* test is a deferential standard that has been analogized to the business judgment rule. *In re W.A. Mallory Co., Inc.*, 214 B.R. 834, 836 (Bankr. E.D. Va. 1997). In fact, courts have stated that in "evaluating whether a sound business purpose justifies the use, sale or lease of property under section 363(b), courts consider a variety of factors, which essentially represent a 'business judgment test.'"

However, application of heightened scrutiny also can arise in the context of asset sales under Section 363 of the Code. While the business judgment standard is the default standard, heightened scrutiny will be applied when there is an appearance of a conflict, such as when the proposed sale would benefit an insider.

Although not always expressly stated, this heightened scrutiny standard mirrors the entire fairness test that is applied in the non-bankruptcy context. Much like the entire fairness test, the heightened scrutiny test requires the court to make an independent determination as to whether the sale price and process was entirely fair. This requires the debtor to submit sufficient evidence demonstrating that the sale was entirely fair.

For example, in *In re Family Christian, LLC,* 533 B.R. at 628, the court rejected a 363 sale, in part, because "none of the proponents of the sale … have presented this court with evidence upon which the court can make an informed decision regarding the relationship of the sale price to the value of the assets being sold." Thus, while a 363 sale to an insider is not prohibited, and in certain circumstances may be the best option, a DIP runs the risk of having the sale rejected by the bankruptcy court if the board does not take certain steps, such as seeking advice from independent advisers regarding the fairness of the sale.

The evidence needed to support a 363 sale to an insider is not uniformly articulated in the case law and naturally will vary based on the specific facts of the case, but given that bankruptcy courts often reference or adopt the rules of conduct generally applicable to corporate fiduciaries, the state law entire fairness standard provides a useful measuring stick.

Better Safe than Sorry

While a board's fiduciary duties do not change as the company enters the so-called zone of insolvency, the point of insolvency is not clearly defined and is usually determined with the benefit of hindsight. As such, a prudent fiduciary should start considering creditors' interests when a company potentially could be considered insolvent.

After a company files a bankruptcy petition, the case law addressing the contours of a board's fiduciary duties is somewhat less well-defined. In addition to the various duties delineated in the Code, the board of a DIP also will be accountable for certain fiduciary duties prescribed by applicable non-bankruptcy law. Thus, particularly in the context of a 363 sale, the debtor's board should strive to meet the best practices set by Delaware or other applicable state law.

Importantly, boards of debtor companies should recognize that sales to insiders or controllers will face higher scrutiny even within a bankruptcy process. In particular, if circumstances permit, directors should consider the use of an independent committee to evaluate the sale, especially if the sale is being made to an insider. Likewise, care should be taken to ensure that the committee is truly independent, and if possible, the committee should be afforded the opportunity to seek guidance from independent legal and financial advisers.

Ultimately, the key takeaway for directors of a corporation in Chapter 11 is that bankruptcy courts often do not stray far from traditional fiduciary best practices in determining whether to approve a sale. Accordingly, appropriate “belt and suspender” procedures to ensure compliance with fiduciary duties should be strongly considered to avoid an unfavorable outcome.

