

Director Fiduciary Duties: Navigating Insolvency Risk in Newly (COVID-19) Distressed Companies

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As COVID-19 related economic disruptions place unprecedented stress on cash flows, the risk of insolvency is a new and growing concern for many businesses. Against the backdrop of a decades-long growth in corporate debt, boards of directors are making decisions that have the potential for pitting the interests of creditors against the interests of equity shareholders. As the financial health of a business deteriorates, its directors should be cognizant that their fiduciary duties may shift or expand with respect to these different constituencies if and when the company actually crosses over into insolvency.

With a focus on comparing California and Delaware law, this article briefly describes how insolvency can affect directors' fiduciary duties, and discusses ways that directors can minimize the risk of personal liability as those duties shift.

Solvency: Business as Usual

For a solvent company, the fiduciary duties owed by the directors are straightforward. As explained by the Delaware Supreme Court, one of the core principles of corporate law is that the “board of directors has the legal responsibility to manage the business of a corporation for the benefit of its shareholder owners.”^[1] Thus, “the directors owe their fiduciary obligations to the corporation and its shareholders.”^[2] While solvent, the fiduciary duties of a company's directors do not generally extend to its creditors, whose rights are derived instead from the terms of the contracts they negotiate with the company.^[3] Similarly, under California law, the directors of a solvent corporation owe their fiduciary duties to the company and to its shareholders.^[4]

The ‘Zone of Insolvency’

When businesses begin to experience acute financial distress, they are sometimes described as operating in the “zone of insolvency” or the “vicinity of insolvency.” This is a vague concept, and its boundaries are not defined by the law.^[5] Indeed, in Delaware today, the courts are clear that there is no such thing as a “legally recognized zone of insolvency.”^[6]

Nevertheless, “zone of insolvency” is an oft-heard phrase, and creditors have argued that a company's directors

should owe them fiduciary duties when the company is in such a “zone.” Although it may still be an open question in some states, Delaware and California have both squarely rejected this contention. The Delaware Supreme Court, for example, could not be more clear, declaring that “[w]hen a solvent corporation is navigating in the zone of insolvency, the focus of Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation . . . for the benefit of its shareholder owners.”^[7] Similarly, in California, the leading case on point confirmed that fiduciary duties are not owed to creditors “by virtue of [the company] operating in the ‘zone’ or ‘vicinity’ of insolvency.”^[8]

Insolvency: Expanded Duties

In both Delaware and California, however, directors’ duties do expand when the company crosses over into actual insolvency. There are well-established legal tests for determining when a company crosses over into actual insolvency. But these are not bright-line tests; for example, the trigger is not the filing of bankruptcy or other statutory proceedings.^[9] Insolvency requires a fact-based inquiry, and the tests can vary somewhat from state to state.

In Delaware, solvency is generally determined by reference to two tests: (1) the balance sheet test and (2) the equitable insolvency (aka cash flow) test. Delaware courts typically consider both tests, and so long as a business can satisfy either one, the company may be deemed solvent.^[10] Under the balance sheet test, a company is solvent if the reasonable market value of its assets is not less than the stated value of its liabilities.^[11] The equitable insolvency test asks whether the company can meet its present and/or future debts as they come due.^[12]

Likewise, courts in California determine solvency under either (1) the balance sheet test or (2) the “ability-to-pay” test. As in Delaware, California’s balance sheet test looks to whether the sum of the company’s debts is greater than the sum of its assets.^[13] Under California’s “ability-to-pay” test, a company that is generally not paying its debts as they become due (other than as a result of a bona fide dispute) may be presumed insolvent.^[14] Similarly, a company may be deemed insolvent if, due to a challenged distribution to shareholders, it would “likely be unable to meet its liabilities . . . as they mature.”^[15]

Insolvency “places the creditors in the shoes normally occupied by the shareholders – that of residual risk-bearers.”^[16] In the hierarchy of distributions, shareholders are presumptively “out of the money” as creditors are paid first from the residual assets of the company. For that reason, Delaware brings creditors, along with the shareholders, within the scope of directors’ fiduciary duties.^[17] In an insolvent corporation, creditors have standing, alongside the shareholders, to bring derivative claims on behalf of the insolvent company to recover for alleged harm to the business caused by the directors’ alleged breaches of fiduciary duties. Critically, however, the fact of insolvency does not create or confer any new rights on the part of the creditors to assert *direct* claims on their own behalf against corporate directors for any losses.^[18]

California follows a different approach. In the leading case, the court reasoned that, because California’s governing statute defines directors’ fiduciary duties as running to the corporation and its shareholders, “there is no broad, paramount fiduciary duty of due care or loyalty that directors of an insolvent corporation owe the corporation’s creditors solely because of a state of insolvency.”^[19] Nevertheless, California has long recognized the so-called “trust fund doctrine” under which “all of the assets of a corporation, immediately on its becoming

insolvent, become a trust fund for the benefit of all of its creditors in order to satisfy their claims.”^[20] In short, under California law, insolvency does not flip the locus of directors’ fiduciary duties from shareholders to creditors, and does not give rise to any duties to creditors that are “paramount” to the duties owed to the corporation itself (and its shareholders). Instead, “the scope of any extra contractual duty owed by corporate directors to the insolvent corporation’s creditors is limited in California . . . to the avoidance of actions that divert, dissipate, or unduly risk corporate assets that might otherwise be used to pay creditors claims [including] acts that involve self-dealing or the preferential treatment of creditors.”^[21]

Considerations for Directors in the COVID-19 World

Ever since the COVID-19 pandemic started to spread around the globe, business leaders have faced myriad unexpected dangers (and sometimes opportunities) that require attention and quick decisions under exceptionally stressful and rapidly evolving conditions. How directors may best discharge their fiduciary duties in this extraordinary environment will depend on the particular circumstances they face, and they should seek counsel to help guide them through a given situation. As a general matter, some of the things directors can do are:

- Actively monitor the performance of the business and work with management to identify risks that COVID-19 poses for the company and how best to manage those risks.
- For public reporting companies and companies raising capital, consider the company’s disclosures and guidance regarding the risks and impacts of COVID-19 on the business.
- Pay close attention to changes in the company’s financial condition, with particular focus on liquidity. Is the company at risk of insolvency? Is it still solvent?
- Monitor the company’s financial and other contractual obligations and understand management’s plans to meet those obligations in the near term.
- Critically assess the need for, sources of, and effect of additional fundraising.
- Evaluate carefully the effect of deploying the company’s cash, particularly for payments of dividends and repurchases of company securities, where directors may have statutory personal liability for authorizing these transactions beyond statutory limits.^[22]
- Look to whether the company has policies to prevent insider trading during this period of volatility, and whether compliance with those policies is being properly monitored.
- Be alert for activist shareholders or others positioning to take or increase corporate control, and consult with counsel on steps that might be taken to address vulnerabilities.
- Obtain relevant, adequate information from management, seek input from company advisers and experts where appropriate, and document these informational efforts in board materials.
- Be alert for and expressly address real or perceived conflicts of interest in making decisions, and ensure that all

decisions are made with appropriate process protections and by independent and disinterested directors.

- Maintain corporate formalities and good records, including timely and complete written meeting minutes, even with respect to virtual communications and meetings held on short notice.

Protections Against Personal Liability

Even when directors scrupulously discharge their duties, unhappy lenders and investors may bring claims seeking to impose personal liability for corporate losses on the directors. Just the cost of defending against these claims can be substantial. It is therefore entirely appropriate for the company to take action to eliminate or reduce the threat of these claims.

The corporate laws of Delaware and California, like most states, mandate corporate indemnification of directors who are successful in the defense of any claims made against them based on their service as directors.^[23] Additionally, in both states, corporations are permitted to advance defense costs if the individual directors promise to repay the advances if they are later found not to have met the minimum standard of conduct for indemnification (generally summed up as good faith compliance with the duty of loyalty).^[24] Of course, the trouble with corporate indemnification and advancement is that an insolvent company, by definition, is unlikely to have sufficient funds to protect the directors.

Two other measures are available to protect directors, however, even in insolvency. First, most companies have exculpation clauses in their articles of incorporation that shield directors from out-of-pocket loss due to claims of a breach of the fiduciary duty of care (but not for the duty of loyalty).^[25] Second, and perhaps most importantly, good corporate liability insurance may be purchased by the corporation,^[26] including coverage designed to pay directors' legal defense costs (a form of loss) for defending against allegations of "wrongful acts." In particular, "Side A" coverage is designed to protect directors even when the corporation cannot or will not indemnify them, such as during insolvency. Depending on the terms of the policy, Side A coverage may begin paying covered losses (including defense costs) without any deductible or self-insured retention.

Directors should consult with legal counsel and the company's insurance broker to assess the quality of coverage for times of corporate financial distress.

Endnotes

[1] *Malone v. Brincat*, 722 A.2d 5, 9 (Del. 1998).

[2] *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 99 (Del. 2007). As a general matter, officers of a Delaware corporation owe the same fiduciary duties as do its directors, though officers may not enjoy the full panoply of protections afforded to directors (such as the exculpation clauses in corporate charter documents). See *Gantler v. Stephens*, 965 A.2d 695, 708-09 (Del. 2009).

[3] *Simons v. Cogan*, 549 A.2d 300, 304 (Del. 1988); *Big Lots Stores, Inc. v. Bain Capital Fund VII, LLC*, 922 A.2d 1169, 1180 (Del. Ch. 2006); *Katz v. Oak Industries Inc.*, 508 A.2d 873, 879 (Del. Ch. 1986).

[4] Cal. Corp. Code § 309; *Berg & Berg Enters., LLC v. Boyle*, 178 Cal. App. 4th 1020, 1037, 100 Cal. Rptr. 3d 875, 891 (2009), *rev. denied*, 2010 Cal. LEXIS 1461 (Feb. 3, 2010).

[5] See *Gheewalla*, 930 A.2d at 98 n.20; *Production Res. Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772, 789-90 & n.56 (Del. Ch. 2004); see also *Berg & Berg*, 178 Cal. App. 4th at 1037 (referring to “that ill-defined sphere known as the ‘zone of insolvency’”).

[6] *Quadrant Structured Prods. Co. v. Vertin*, 115 A.3d 535, 546 (Del. Ch. 2015).

[7] *Gheewalla*, 930 A.2d at 101 (emphasis added); see also *Quadrant*, 115 A.3d at 546 (“The only transition point that affects fiduciary duty analysis is insolvency itself.”).

[8] *Berg & Berg*, 178 Cal. App. 4th at 1041 (“we hold that there is no fiduciary duty prescribed under California law that is owed to creditors by directors of a corporation solely by virtue of its operating in the ‘zone’ or ‘vicinity’ of insolvency”).

[9] *Geyer v. Ingersoll Publ’ns Co.*, 621 A.2d 784, 787-789 (Del. Ch. 1992).

[10] *Quadrant*, 115 A.3d at 556.

[11] See *Trenwick Am. Litig. Trust v. Ernst & Young L.L.P.*, 906 A.2d 168, 195 n.74 (Del. Ch. 2006).

[12] *Mellon Bank, N.A. v. Official Comm. of Unsecured Creditors of R.M.L., Inc. (In re R.M.L. Inc.)*, 92 F.3d 139, 156 (3d Cir. 1996); See *Production Res. Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772, 782 (Del. Ch. 2004).

[13] Cal. Civ. Code § 3439.02(a).

[14] Cal. Civ. Code § 3439.02(b).

[15] Cal. Corp. Code § 501.

[16] *Production Res. Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772, 791 (Del. Ch. 2004).

[17] *Id.* (citing *Geyer*, 621 A.2d at 789).

[18] *Gheewalla*, 930 A.2d at 103.

[19] *Berg & Berg*, 178 Cal. App. 4th at 1041.

[20] *Id.* at 1040 (quotations and citations omitted).

[21] *Id.* at 1041.

[22] Del. Gen. Corp. Law § 174; Cal. Corp. Code § 316.

[23] Del. Gen. Corp. Law § 145(c); Cal. Corp. Code § 317(d); Cal. Lab. Code § 2802 (mandating indemnification of employees for expenses incurred in the discharge of lawful duties).

[24] Del. Gen. Corp. Law §§ 145(a) and (b); Cal. Corp. Code § 317(b).

[25] Del. Gen. Corp. Law § 102(b)(7); Cal. Corp. Code § 204.

[26] Del. Gen. Corp. Law § 145(g); Cal. Corp. Code 317(i).

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