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corporate advisor

Directors of Financially Troubled Companies Face Special Duties and Risks

In today's difficult economic environment, many companies, both public and private, are encountering financial or liquidity problems. Directors of financially troubled companies need to be aware of when their fiduciary duties may extend not just to the company and its stockholders, but also to the company's creditors.

In addition, directors and officers of financially troubled companies need to understand that they may become subject to personal liability, either as a result of their own acts or omissions or as a result of the failure of the company to satisfy its obligations.[1]

Fiduciary Duties

Directors owe a duty of care and a duty of loyalty to the corporation on whose board they serve and to the corporation's stockholders.

The duty of care obligates a director to act on an informed basis, in good faith and in a manner he or she reasonably believes to be in the best interests of the corporation. The director must act with such care as a reasonable person would use under similar circumstances.

The duty of loyalty obligates each director to put the interests of the corporation ahead of his or her personal interests. This duty prohibits a director from usurping corporate opportunity for his or her own benefit.

The fiduciary duties owed by directors to stockholders are considered special. Absent unusual circumstances, these duties generally are not extended to other constituencies. For example, absent the special circumstances discussed below, directors do not owe fiduciary duties but only contractual obligations to the creditors of a corporation, primarily because creditors, unlike stockholders, had the opportunity to protect themselves by negotiating specific contractual rights from the corporation.

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When Does a Fiduciary Duty to Creditors Arise?

Insolvency

When a corporation becomes insolvent — either because it is unable to pay its debts as they become due or because its liabilities exceed the fair value of its assets — the directors must generally put the interests of the creditors ahead of the interests of the stockholders. This shift occurs principally because the creditors of an insolvent company, and not the stockholders, bear the risk of further erosion of the residual value of the enterprise.

At the point of insolvency, the interests of the stockholders and creditors (wage earners, tax collectors, secured debt holders and the trade creditors) can be quite different.

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[1] Unless otherwise specified, this article discusses principles of Delaware corporate law, although comparable provisions and principles are contained in the corporation law statutes of most states.

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While stockholders may be inclined to have the corporation use any remaining cash in risky transactions which represent the stockholders' only chance to create value for their stock, from the creditors' perspective the so called "Hail Mary pass" may represent an improper squandering of assets, and thus a breach of the board's duties to creditors. For example, a board's decision to devote all of the company's remaining cash to a highly speculative product development program — in the hope that it will achieve an unexpected breakthrough that increases the corporation's value — might be a breach of the board's duties to creditors.

The Vicinity of Insolvency

Some courts have suggested that the duties of directors may shift away from the stockholders to include other constituencies, including creditors, when a corporation is not insolvent but is operating in the "vicinity" or "brink" of insolvency. Although there is no bright line test of when this occurs, one court has stated that a transaction that brings a corporation to the "brink of insolvency" is one that leaves the corporation with unreasonably small capital, creating "a condition of financial debility short of insolvency . . . but which makes insolvency reasonably foreseeable."

When a corporation is in the vicinity of insolvency, the prudent course is to consider the interests of the corporate enterprise as a whole, taking into account the interests of creditors, employees and customers as well as stockholders.

Directors should not assume that they will automatically receive the benefit of the business judgment rule.

Will Board Decisions Be Protected by the Business Judgment Rule?

If a board's action is challenged in court by stockholders, the directors are generally entitled to the benefits of the "business judgment rule," which establishes a presumption that in making a business decision, the directors acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the corporation. The purpose of the business judgment rule is to prevent judicial second guessing of directors' decisions, except in clear cases of abuse. If the business judgment rule applies, the directors' action or decision will be sustained if it can be attributed to any rational business purpose. On the other hand, the business judgment rule will be held inapplicable, or its presumption that directors acted properly will be overcome, if (1) there is evidence that the directors did not act properly or with due care, or (2) if the directors' decision or action involves a breach of the duty of loyalty.

Some courts have suggested that decisions made by directors of entities that are insolvent or in the vicinity of insolvency should also be afforded the protection of the business judgment rule. However, this issue has not been definitively settled and directors should not assume that they will automatically receive the benefit of the business judgment rule.

In light of this uncertainty, boards should understand that the record of their deliberations and actions will be subject to great scrutiny. It is advisable to keep minutes demonstrating the board's careful consideration of all relevant facts and circumstances and the interests of all relevant constituencies.

Potential Personal Liability

For Breach of Fiduciary Duties

If the board of directors has breached its fiduciary duties, can a director be held personally liable?

Most state corporation law statutes authorize corporations to include in their charters provisions that limit a director's personal liability for negligence, which would generally include a breach of a director's duty of care. For example, Section 102(b)(7) of the Delaware General Corporation Law authorizes Delaware corporations to include provisions eliminating the personal liability of a director to the corporation or its stockholders for monetary damages for a breach of fiduciary duties, with exceptions for wrongful acts such as a breach of the duty of loyalty or acts or omissions which involve intentional misconduct or a knowing violation of law. Similar provisions are contained in the business corporation statutes of Massachusetts, New Jersey, New York and Virginia.

The purpose of these provisions is to protect directors from duty-of-care claims and to limit disincentives to serving as a board member. By their terms, however, these provisions apply only to actions by stockholders or on behalf of the corporation and thus do not protect directors in suits brought by creditors. In addition, these provisions apply only to directors acting in their capacities as directors and do not protect directors from liability for actions taken in any other capacity, such as active management of the company. Directors should not assume that the statutory exculpatory provisions will protect them against claims made by creditors.

For Non-Payment of Wages and Trust Fund Taxes

The payment of wages and withholding taxes are corporate obligations, but under many state statutes certain officers may be held personally responsible if the corporation fails to pay them. For example, in Massachusetts, the failure to pay employee wages (including commissions, overtime and accrued vacation) can result in civil and criminal liability of the officers or agents managing the corporation. A director acting in a managerial capacity may also be held individually responsible for unpaid wages. Most states have similar statutes. Personal liability for unpaid wages may also be imposed under federal law.

In addition, in most states the failure to pay "trust fund" taxes (that is, sales or withholding taxes collected from others and held in trust for the state or federal government) becomes the personal liability of the officer who was responsible for paying the trust funds to the government. Although the responsible officer is usually a member of management, it is not uncommon for the IRS or a state taxing authority to sue all directors and officers in these situations. Accordingly, it is prudent to ensure that there is always a sufficient reserve to pay wages and trust fund taxes.

Indemnification and D&O Insurance

Many corporate charters include provisions requiring the corporation to indemnify its directors and officers. In general, these provisions provide indemnification against liabilities and expenses arising out of legal proceedings brought against directors or officers in their capacity as such if they acted in good faith and in a manner reasonably believed to be in, or not opposed to, the best interests of the corporation. These provisions provide more protection than the limitation of liability provisions described above because they generally cover officers as well as directors and cover suits (often including advancement of defense expenses) brought by parties other than the corporation or its stockholders.

Most states also authorize corporations to purchase and maintain insurance on behalf of officers and directors against liabilities incurred by them for actions taken in their official capacity or otherwise arising from their service to the corporation. D&O insurance generally also provides "indemnification coverage" for the corporation's indemnification payments to officers and directors and may also cover directors and officers against claims that are not indemnified. Many policies now also include "entity coverage," which provides coverage to the corporation in the event it is sued. In the ordinary case, the policies advance expenses of defending claims when the entity, because of insolvency, is unable to do so.

Actual policy language varies significantly from company to company, but most policies contain exclusions from coverage under certain circumstances, such as self-dealing. In addition, most policies do not protect against wage or tax claims and, with the exception of director and officer only policies, often do not provide coverage

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for suits brought by one insured against another insured - the so called “insured versus insured” exclusion, which generally is intended to prevent the corporation from suing its own officers and directors in order to recoup losses from their business mistakes.

Once a corporation is insolvent or in bankruptcy, the issues associated with its insurance coverage become more complex. For example, if a corporation in bankruptcy has entity coverage or indemnification coverage it is possible that the proceeds of the D&O policy will be considered an asset of the debtor corporation with policy proceeds unavailable to officers and directors for their legal expenses and litigation costs. In addition, if a policy contains an insured versus insured exclusion without an exception for claims brought by a debtor in possession or a bankruptcy trustee, the exclusion may bar their claims (or at least delay significantly the availability of insurance funds for defense expenses or indemnification).

In light of the numerous issues that can arise with respect to insurance coverage, it is important that the company’s D&O policy be set up from the beginning to try to provide the desired result in the event of later financial difficulties.

Should I Resign?

Directors of financially troubled companies often consider resigning in hopes of mitigating their personal liability. For a number of reasons, however, resigning may do little or nothing to decrease a director’s liability and may even increase it.

If there is already liability for past actions, resignation will not wipe the slate clean.

Moreover, with appropriate attention and professional advice, remaining on the board may help the director avoid incurring new liabilities. When a corporation faces financial or liquidity problems many decisions requiring extensive discussion and analysis will need to be made, including whether to sell some or all of the corporation’s assets, responding to lawsuits and creditor claims and satisfying employee and tax claims. If something goes awry, it will be easier to blame directors who have resigned and are not there to defend themselves. Similarly, if decisions must be made with respect to D&O insurance, it may be better to participate in the decision-making process. In one case, the judge permitted indemnification reimbursement for ongoing litigation defense expenses for those directors and officers who were still in office, but not for those who had resigned.

The question of whether to continue to serve on the board of a financially troubled company can be even more challenging for a director with multiple roles which create real or perceived conflicts of interest. For example, the director may be affiliated with an entity that is both a creditor and a stockholder of the financially troubled company. In such a situation, the director must be careful to fulfill all applicable duties in each capacity.

Whether resigning is advisable is a highly fact-specific issue that must be analyzed on a case-by-case basis. As a starting point, however, directors should not assume that resignation will necessarily reduce their liability. ■

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Issues List:
Serving as a VC Director of a Financially Troubled Company

1. *When a company nears insolvency, directors owe fiduciary duties to creditors, not just stockholders*

- Conflicts may arise because stockholders are willing to risk remaining cash, while creditors want to preserve assets.
- Normal limitations on personal liability for director negligence probably do not apply to claims by creditors.
- The board of directors may not get the benefit of the business judgment rule.

2. *If an inside dilutive financing round is contemplated:*

- Be aware that inside rounds can give rise to potential conflicts and duty of loyalty claims.
- Use special committee of independent directors if no outside pricing possible.
- Comply with Delaware Section 144 – disclose all conflicts/interests.
- Consider giving all preferred holders a chance to participate pro rata.

3. *Resignation may not be the best course of action*

- Won't limit liability for what has already happened.
- Loss of ability to control what happens next could make situation worse.

4. *Take actions that will limit further personal liability*

- Create a good record of how the board satisfied its duty of care (i.e., considered all relevant constituencies, engaged counsel, meet frequently).
- Don't act as management. Director's role is oversight. Active management increases liability risk.
- Make sure all wages and trust fund taxes are fully paid.
- Don't make your VC fund a "guarantor" – avoid making assurances to third parties to get them to deal with the company.
- Understand the implications of different alternatives for liquidation (Chapter 11 vs Chapter 7 vs non-bankruptcy approaches).
- Examine D & O coverage as early in the process as possible. (Are wage and tax claims covered? Will insured vs insured exclusion interfere with payments to directors?)

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