

# Directors & Officers in these Uncertain Times:

*Fiduciary Duties,  
Zone of Insolvency  
& Business Judgments*

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Please allow me to  
introduce myself?



## Topics:

- Review the basics
- Key Cases/Concepts
- Zone of Insolvency
- Legislative Action
- Suggestions
- Question & answer





Why  
does it  
matter?

The trend in D&O liability is a bit alarming. Both the frequency and severity of claims are on the rise. ... Since the economic downturn in the fourth quarter of 2008, the frequency of claims has skyrocketed as the stock market (measured by the S&P 500 and the Dow Jones) has declined.

- The National Director's Institute

“As the fallout from the credit crisis dramatically demonstrates, D&O Insurance is no longer an unnecessary luxury designed to provide Directors and Officers with an extra level of comfort—to be tucked away and never called upon. It is now a business necessity.”

- The American Health Lawyer Association

“A Barclay’s equity analyst predicts that Chubb Corp. may face as much as \$2 billion in directors and officers policy losses because of a surge in lawsuits brought on by the U.S. economic crisis.”

-Insurance News

“Directors failed in their fiduciary duty ... Ignorance is no excuse.”

- *Backdated Options May Snare Some Directors,*

**USA Today**

The Basics -

What duties and to whom?



# Owed to the corporation.

- Del. Code Ann. Tit. 8, sec. 141(a)
- See, e.g., *Revlon v. MacAndrews & Forbes Holdings Inc.*, 506 A.2d 173, 179 (Del. 1986).

# Duty of Care

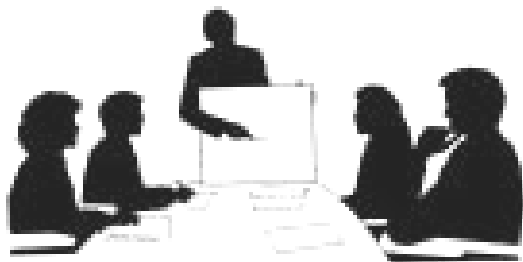
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Requires that directors discharge their duties in good faith and with the care that an ordinarily prudent person in a like position would exercise under similar circumstances and in a manner the director reasonably believes to be in the best interests of the corporation.

# Duty of Care

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- Primary emphasis: process by which directors arrive at a decision.
- Directors must consider all information reasonable available to them.
- May rely on experts and others knowledgeable in the matter if the directors believe that reliance is warranted.



# Duty of Care

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“[O]nly a sustained or systematic failure of the board to exercise oversight - such as an utter failure to attempt to assure a reasonable information and reporting system [exists] - will establish the lack of good faith that is a necessary condition to liability. Such a test of liability - lack of good faith as evidenced by sustained or systematic failure to exercise reasonable oversight - is quite high.”

*In re Caremark International, Inc. Derivative Litigation*, 698 A. 2d 959 (del. Ch. 1996)

# Business Judgment Rule

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A presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company

# Business Judgment Rule

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- Any rational business purpose
- No second guessing



# Duty of Loyalty

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- Requires directors to act in the best interests of the corporation and its shareholders.
- Refrain from self-dealing, usurpation of corporate opportunity and any acts that would permit them to receive an improper personal benefit or injure their constituencies.

# Duty Of Good Faith

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- The scope of the duty of good faith is unclear.
- A failure to act in the face of a known duty to act.
- Cannot act in a manner unrelated to a pursuit of a corporation's best interests.
- Cannot maintain a sustained or systematic failure to provide oversight .

# Personal Liability (Delaware)

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- Only liable for failure to meet duty of care if the director is “grossly negligent” or “reckless indifference.”
- Almost all corporate charters eliminate personal liability for breach of fiduciary duty except for: (i) breach of the duty of loyalty or (ii) acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law.

# Exculpation Clauses

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- Section 102(b)(7)
- Certificate of incorporation can include a “provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty.”
- Exceptions include: (i) “any breach of the director's duty of loyalty,” (ii) “acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law,” (iii) unlawful distributions, and (iv) “any transaction from which the director derived an improper personal benefit.”

# Not-for-profits

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- Duty of Care
- Duty of Loyalty
- Duty of Obedience
- Not-for-profit Director protections – gross negligence
- Enforcement by attorneys general

# Key Cases



# The *Caremark* Decision

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- Enlarged directors' duty of due care to include the duty to properly oversee company operations.
- Post *Caremark*, "oversight liability" claims are based not on a director's affirmative wrongful act but rather on a director's failure to act
- Since *Caremark*, plaintiffs have creatively and aggressively alleged *Caremark* "oversight liability" claims against corporate directors.

# Revlon

- In sale context, the "board must perform its fiduciary duties in the service of a specific objective: maximizing the sale price of the enterprise."

# Lyondell -

- A board has no *Revlon* duty to seek the best price just because a bidder puts the company "in play"
- There is no blueprint of legally required steps that a board must follow to satisfy its *Revlon* duties as each change of control transaction has unique circumstances
- The test for determining whether directors have breached their duty of loyalty by failing to act in good faith while fulfilling *Revlon* duties is whether the directors utterly failed to attempt to obtain the best sale price

# Disney

- Fiduciary duties determined by director not whole board
- Best practices are great, nut not required

# Gantler v. Stephens

- Fiduciary duty obligation applies to officers



## Zone of Insolvency

## What is the Zone?

- Amorphous
- Expands situation where directors owe creditors a fiduciary duty beyond those where corporation is actually insolvent, to situations where the corporation was operating in the zone of insolvency.

# Insolvency Tests

- Actual insolvency
- Balance Sheet Test
- Equitable Insolvency
- The Z Score

## *Credit Lyonnaise*

“[i]n managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right course to follow for the corporation may diverge from the choice that stockholders would make.”

## *Production Resources*

“The reason for this bears repeating – the fact of insolvency does not change the primary object of the director’s duties, which is the firm itself. The firm’s insolvency simply makes the creditors the principal constituency injured by any fiduciary breaches that diminish the firm’s value and logically give them standing to pursue these claims to rectify that injury.”

*North American Catholic Educational  
Programming Foundation, Inc. (NACEPF) v.  
Gheewalla*

- Creditors of a Delaware Corporation that is either insolvent or in the zone of insolvency have no right to assert **direct** claims for breach of fiduciary duty against corporation's directors.

*Bridgeport Holdings, Inc. Liquidating Trust v. Boyer*

- Claim for breach of fiduciary duty because of failure to seek alternative buyers.

*In re Bear Stearns Litigation, 870 N.Y.S.2d 709 (N.Y. Sup. 2008).*

- Sale to J.P.Morgan “unfair” and “inadequate”
- The Court noted that the company “attempted to salvage some \$1.5 billion in shareholder value and averted a bankruptcy that may have returned nothing to the Bear Stearns’ shareholders, while wreaking havoc on the financial markets. The court should not, and will not, second guess their decisions.”

# Deepening Insolvency

- The “*fraudulent* prolongation of a corporation’s life beyond insolvency,’ resulting in damage to the corporation caused by increased debt.”
- “[A]n injury to the Debtors’ corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life.” *Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., Inc.*, 267 F.3d 340, 347 (3d Cir. 2001)

# Deepening Insolvency

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- The exact “birth date” of the deepening insolvency theory has been traced to the decision in *Investors Funding Corp. of New York Sec. Litig. v. Dansker*, 523 F.Supp. 533 (S.D.N.Y. 1980).
- “Alternatively, to the extent that the cited cases suggest that a corporation may not sue to recover damages resulting from the fraudulent prolongation of its life past insolvency, we decline to speculate that the Illinois courts would accept this restriction on the Director’s freedom of action. For each of these cases rests upon a seriously flawed assumption, i.e., that the fraudulent prolongation of a corporation’s life beyond insolvency is automatically to be considered a benefit to the corporation’s interests.” *See Schacht v. Brown*, 711 F.2d 1343 (7th Cir. 1983).

# Deepening Insolvency

“The concept of deepening insolvency has been discussed at length in federal jurisprudence; perhaps because the term has the kind of stentorious academic ring that tends to dull the mind to the concept’s ultimate emptiness.”

-Vice-Chancellor Leo E. Strine,

*Trenwick America Litigation Trust v. Ernst & Young, LLP, et al,*  
(Del.Ch. 2006)

# Filing Bankruptcy

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- Board still in control
- Trust fund approach
- Approvals and disclosures necessary
- Exculpations and releases

## *Fogel v. U.S. Energy Systems, Inc. et al.,*

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The Delaware Chancery Court held that the automatic stay did not apply to the scheduling or holding of a shareholder meeting of the debtor. The Chancery Court issued an order directing U.S. Energy to schedule a shareholder meeting at the request of a shareholder.

## Impact of *U.S. Energy*

- The Chancery Court may be the proper forum to address corporate governance issues as they may be impacted by the automatic stay;
- The filing of the chapter 11 case does not, on its own, divest shareholders of their right to "exercise their rights of corporate democracy," and
- Absent some clear showing of abuse, which need likely rise to such a level as to "seriously threaten the rehabilitation of the debtor," shareholders meeting rights will not be disturbed.

# Legislation



- American Recovery and Reinvestment Act of 2009 ("ARRA")
- Shareholder Bill of Rights Act of 2009



# Suggestions

# Advice for Directors

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- Be part of the process
- Focus on performance and strategy
- Understand the business and stay current with developments
- Review public filings
- Have management explain costs and benefits of actions taken
- Management should explain any negative reports

# Advice for Directors

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- Be prepared
- Review materials before meetings
- Take extra care with compensation

# Advice to the Board (Sale)

- Getting the highest value is the objective
- Use a deliberative process
- Meet frequently
- Hire investment bankers and other professionals
- Consider alternatives and actively seek offers
- Rely on current information

# Advice to the Board (Sale)

- Document your efforts
- Review indemnification agreements/D&O Insurance
- Appoint a special transaction committee
- Don't be afraid to consider bankruptcy

# Questions?

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