Director Fiduciary Duties in an Insolvency Context

With businesses focused on the impact of the novel coronavirus (COVID-19) pandemic on current and future liquidity, balance sheet and cash flow concerns, and an expected decline in the level and profitability of business activity in these difficult and uncertain times, in many cases attention has turned to the issue of the duties and responsibilities of directors to creditors when a corporation is financially troubled and is either approaching insolvency (the so-called “zone of insolvency”) or becomes insolvent.

When a corporation is solvent, directors’ fiduciary duties are to shareholders only. It is well-established under Delaware law that, when a corporation is solvent, directors’ duties run to the corporation and the corporation should be managed for the benefit of its shareholders. While there has been some discussion within the corporate community in recent years about boards also taking into consideration the interests of other stakeholders, fiduciary duties are not owed to creditors of a solvent corporation. Instead, creditors of a solvent corporation are protected through other means, such as contracts, fraud and fraudulent conveyance laws, implied covenants of good faith and fair dealing, bankruptcy law, general commercial law and creditors’ rights.

When a corporation approaches insolvency, directors’ fiduciary duties remain to the shareholders. In the seminal Gheewalla decision (North American Catholic Educational Programming v. Gheewalla (Del. Supr. 2007)), the Delaware Supreme Court was emphatic that directors’ fiduciary duties do not shift from the shareholders to the creditors when a corporation is operating in the “vicinity” or the “zone” of insolvency. “[D]irectors owe their fiduciary obligations to the corporation and its shareholders…. When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners.” The Delaware Supreme Court observed that “[t]o 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.”

Actual insolvency (whether based on the balance sheet or cash flow) does alter directors’ obligations. When a corporation becomes insolvent, the board’s fiduciary duties are to all of the corporation’s residual claimants. Once a company is insolvent, the residual claimants include both the creditors and the shareholders. Thus, directors must continue to make decisions based on what they believe will be in the best interests of the corporation but with the consideration directed to the interests of creditors as well as shareholders. Gheewalla held that, whether a corporation is solvent or insolvent, a creditor does not have the right to directly assert a breach of fiduciary duty cause of action against directors (because the directors have no fiduciary duty to the creditors themselves), but that, once a corporation is insolvent, a creditor obtains standing to assert derivative claims on behalf of the corporation for directors’ breaches of fiduciary duties to the residual claimants (because the directors’ fiduciary duties
are to the corporation and all of its residual claimants, which, post-solvency, includes the creditors). The board owes no particular fiduciary duties to the creditors, however. (Indeed, Gheewalla held that “[d]irectors of insolvent corporations must retain the freedom to engage in vigorous, good faith negotiations with individual creditors for the benefit of the corporation.”) Stated differently, directors need not shut down an insolvent firm and marshal its assets for distribution to creditors—but they can do so if as a matter of business judgment, taking into account all of the residual claimants’ interests, they believe that it is the best course for the corporation to take.

**The Gheewalla doctrine.** In Gheewalla, the Delaware Supreme Court affirmed the Court of Chancery’s dismissal of a creditor’s claim that the directors of the company breached their fiduciary duties by, among other things, allowing the diminution of the company’s assets while the company was insolvent or in the zone of insolvency. Decisions since Gheewalla have reinforced its holding. For example, in *Nelson v. Emerson* (Del. Ch. 2008), the Court of Chancery held that a company’s directors did not breach their fiduciary duties by filing for bankruptcy, even if doing so frustrated the corporation’s creditors from collecting on their secured claims. The court stated that the directors of a Delaware corporation do not breach their fiduciary duties by, in good faith, making a “non-frivolous” filing for bankruptcy “[t]o seek to benefit the equity holders by…protect[ing] the[jr] interests…..” Similarly, in *Quadrant v. Vertin* (Del. Ch. 2015), the Court of Chancery held that a corporation’s directors (who were not independent of the controlling shareholder) did not breach their fiduciary duties by pursuing a risky investment strategy that, if successful, would have maximized value for the corporation as a whole, in a context where the corporation’s creditors bore the full risk of failure of the strategy.

In *Quadrant*, the Court of Chancery also clarified the following: (i) 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”; (ii) as a matter of business judgment, directors can favor certain creditors (if non-insiders) over others of similar priority without breaching their fiduciary duties; (iii) when directors make decisions that “increase or decrease the value of the firm as a whole and affect providers of capital differently only due to their relative priority in the capital stock, directors do not face a conflict of interest simply because they own common stock or owe duties to large common stockholders”; and (iv) for creditors to bring derivative claims, there is no requirement that the corporation be “irretrievably insolvent” (rather, the traditional balance-sheet, cash-flow and/or capital tests for insolvency apply), nor that the corporation be “continuously insolvent” throughout the litigation process (rather, the creditor has standing as a plaintiff so long as the corporation was insolvent at the time the complaint was filed and the plaintiff remains a creditor of the corporation). To bring a post-insolvency derivative suit, creditors would have to satisfy the usual standards for such an action, including either bringing demand that the board itself initiate the action or demonstrating in a complaint why a demand would be “futile” (*In re info USA, Inc. S’holders Litig.* (Del. Ch. 2007)).

Based on Gheewalla and Quadrant, it appears that a creditor seeking redress based on a fiduciary derivative claim is likely to succeed only under unusual circumstances. Even if a board adopts a plan to maximize the value of the equity which potentially benefits only the equity holders—with no benefit to and all of the risk on the creditors—the tone and language in these decisions suggests (although these were not the facts in these cases) that creditors’ derivative claims of fiduciary breach would fail. Arguably, the decisions suggest that creditors’ derivative fiduciary claims likely would not succeed unless the directors were so uncareful or so disloyal in formulating the plan, or the plan was so patently flawed, that the plan would not pass muster under business judgment deference.

**A corporation’s solvency status may not always be clear.** There is no bright-line test for when a corporation becomes insolvent. To determine insolvency, courts generally rely on: (i) the balance sheet test—i.e., whether the value of the corporation’s assets exceed its liabilities; (ii) the cash flow test—i.e., whether the corporation has enough cash flow to meet its financial obligations as they become due;
and/or (iii) the unreasonably small capital test—i.e., whether the corporation has enough capital to acquire or maintain financing for future operations. Importantly, the point at which a company became insolvent generally will be determined definitively only after the fact in litigation, with the benefit of hindsight.

**Conclusion.** When a corporation is solvent, it has fiduciary duties to act in the best interests of the shareholders. When a corporation approaches insolvency (the “zone of insolvency”), its fiduciary duties do not change. When a corporation becomes insolvent, however, the duties and responsibilities of directors to the corporation include all residual stakeholder-claimants. Creditors become residual claimants of the corporation once the corporation becomes insolvent; therefore, directors must at that point take into account the creditors’ interests along with the interests of the other residual claimants (including the shareholders). Thus, post-insolvency, creditors have a right to bring *derivative* claims, on behalf of the corporation itself, for directors’ allegedly not acting in the best interests of the corporation and all the residual claimants—but still have no right to bring *direct* claims, on their own behalf, for directors’ allegedly not acting in the best interests of the creditors.

Directors of a company that is or is likely to become financially troubled, should monitor carefully when the company may become insolvent—and, when making decisions, should consider whether the corporation could, in hindsight, be viewed as having been insolvent at that time (in which case, the directors should have taken into account the creditors’ interests as well as the shareholders’ interests). The associated risks are amplified by the fact that, as noted, a post-insolvency derivative claim brought by creditors can continue to be prosecuted even if the corporation’s fiscal health later improves and it is no longer insolvent.

It should be kept in mind that there is some uncertainty as to whether (and if so how and to what extent) the COVID-19 pandemic—which, arguably, is a truly singular event with an extreme global impact—may affect the court’s approach with respect to creditors’ rights (or otherwise). There also is a potential that, in light of the pandemic, legislation could be adopted that affects creditors’ rights. Given how rapidly events are developing with respect to the pandemic, we expect that there will soon be additional developments that will inform the analysis—and current conclusions may have to be updated based on these further developments.

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