FIDUCIARY DUTIES OF DIRECTORS OF 
FINANCIALLY TROUBLED DELAWARE CORPORATIONS

Russell C. Silberglied
North American Regional Vice Chair
Bankruptcy & International Insolvency Group

I. Fiduciary Duties of Directors -- Generally.

A. The primary fiduciary duties of corporate directors of a Delaware corporation are the duties of loyalty, care and good faith. See, e.g., Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 179 (Del. 1986); Emerald Partners v. Berlin, 726 A.2d 1215, 1221 (Del. 1999).


2. Duty of Loyalty - prohibits a corporate director from engaging in self-dealing or usurping corporate opportunities in the performance of his or her duties as a director. See, e.g., Guth v. Loft, Inc., 5 A.2d 503, 510 (Del.

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1 Mr. Silberglied is a Director of Richards, Layton & Finger, P.A. ("RL&F"), the Lex Mundi member firm in Wilmington, Delaware (U.S.A.). The views expressed in this outline are Mr. Silberglied's views and are not necessarily shared by, and should not be attributed to RL&F, its other Directors, or its clients.
(corporate directors' fiduciary duty "requires an undivided and unselfish loyalty to the corporation [and] demands that there shall be no conflict between duty and self-interest"). A material financial interest held by a director which conflicts with or is potentially in conflict with the interests of the company directly implicates this duty.

3. Duty of Good Faith - requires directors to act in what they honestly believe to be the corporation's best interest as opposed to any other interest. See Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1994).


1. The business judgment rule is a judicially created presumption in favor of the non-conflicted (i.e. disinterested) corporate director that "in making a business decision [he/she] ... 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." Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984); accord Revlon, 506 A.2d at 182-84.

2. The Delaware Court of Chancery has held that it is an "elementary precept of corporation law" that "in the absence of facts showing self-dealing or improper motive, a corporate officer or director is not legally responsible to the corporation for losses that may be suffered as a result of a decision that an officer made or that directors authorized in good faith." Gagliardi v. TriFoods Intern., Inc., 683 A.2d 1049, 1051 (Del. Ch. 1996). This is
the case even where the court believes that the board decision, in hindsight, is 'substantively wrong, or... 'stupid'... 'egregious' or 'irrational.'" In re Caremark., 698 A.2d at 967.

3. The business judgment rule can be rebutted by a showing of a breach of the duty of care or loyalty. See, e.g., Cede & Co. v. Technicolor, Inc., 634 A.2d 345 (Del. 1994). Once the business judgment rule is rebutted, the burden shifts to the directors to prove the transaction was entirely fair. See, e.g., Kahn v. Lynch Communication Systems, Inc., 638 A.2d 1110, 1116 (Del. 1994); Cede, 634 A.2d at 361.

II. Fiduciary Duties of Directors of a Solvent Company.

A. It is well settled that the fiduciary obligations of a director of a solvent company are owed to the corporation. See, e.g., Guth, 5 A.2d at 179. Those same fiduciary duties extend to the corporation's shareholders who, as proprietors of the business enterprise are the ultimate beneficiaries of the corporation's growth and increased value. See, e.g., Revlon, 506 A.2d at 179; Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985); Aronson, 473 A.2d at 811.

B. Directors of a solvent Delaware corporation owe no fiduciary obligation to the corporation's creditors. See Simons v. Cogan, 549 A.2d 300, 304 (Del. 1988) ("Before a fiduciary duty arises, an existing property right or equitable interest supporting such a duty must exist.").
1. Delaware courts have routinely rejected efforts to expand the fiduciary obligations of directors of solvent companies to creditors, finding that a creditor's rights are fixed by contract with the corporation. See, e.g., Katz, 508 A.2d at 879; Simons, 549 A.2d at 303.

2. Indeed, favoring a creditor over a shareholder of a solvent Delaware corporation might constitute a breach of the director's fiduciary obligations. See Revlon, 506 A.2d at 182-184.

III. Fiduciary Duties of Directors of a Financially Troubled Company.

A. To Whom Are Fiduciary Duties Owed?

1. When a Delaware corporation finds itself in the "vicinity of insolvency," or insolvent in fact, the class of constituencies to whom directors owe duties expands to include creditors.

   a. While certain non-Delaware courts have held that corporate directors no longer owe a fiduciary duty to shareholders upon insolvency, the Delaware decisions are clear that upon insolvency or the "vicinity of insolvency", directors' fiduciary duties expand to include both creditors and shareholders. See, e.g., Credit Lyonnais Bank Nederland, N.V., Civ. A. No. 12150, 1991 WL 277613 at *34 (Del. Ch. Dec. 30, 1991); Geyer, 621 A.2d at 789; Equity-Linked Investors, L.P. v. Adams, 705 A.2d 1040, 1042 (Del. Ch. 1997) (finding that directors of a company on the "lip" of
insolvency did not breach their fiduciary duties in preferring the interests of common equity over preferred equity which had a liquidation preference).

b. Most recently, the Bankruptcy Court for the Southern District of New York, applying Delaware law, reinforced this rule, holding that Delaware law requires that "[directors] managing a corporation 'in the vicinity of insolvency,'... must consider the best interests of the corporation, and not just the interests of either creditors or shareholders alone."  RSL Com Primecall, Inc. v. Beckoff (In re RSL Com Primecall, Inc.), No. 01-11457, 2003 WL 22989669, *8 (Bankr. S.D.N.Y Dec. 11, 2003).

2. The question of whether the corporation is in the "vicinity of insolvency" therefore is of some importance, and is dealt with in Section III(C) below.

a. One rationale for the expansion of corporate directors' fiduciary duties in insolvency situations is the trust fund theory, which provides that the directors of an insolvent company hold the company's assets in trust for the benefit of creditors.  See, e.g., Bovay v. Byllesby & Co., 38 A.2d 808, 813 (Del. 1944); Asmussen v. Quaker City Corp., 156 A. 180, 181 (Del. Ch. 1931); American Nat'l Bank of Austin v. Mortgage America Corp. (In re Mortgage America Corp.), 714 F.2d 1266, 1268-69 (5th Cir. 1983).
c. A second rationale, the "at risk" theory, contemplates that as a corporation approaches insolvency, corporate directors may adopt high-risk strategies to save value for shareholders. Donald S. Bernstein & Amit Sibal, *Current Developments: Fiduciary Duties of Directors and Corporate Governance in the Vicinity of Insolvency*, 819 PLI/Comm. 653, 658 (2001). In doing so, directors may put creditors, who at that point are likely the true residual claimants to and beneficiaries of the corporation, at risk if they were solely charged with maximizing value for stockholders.

See *Credit Lyonnais*, 1991 WL 277613 at *36 n.55.

B. Balancing Competing Interests of the Various Constituencies.

1. Efforts to maximize total enterprise value or the value of the corporation for the creditors (e.g., by maximizing the corporation's ability to pay its debts on time) might, in some instances conflict with maximizing the value of the shareholders' interest in the corporation (e.g., by using current cash flow to make investments for future growth). See *Equity-Linked*, 705 A.2d at 1041. Therefore, directors of a financially troubled company often walk a fine line in striking a balance between the interests of creditors and those of shareholders.

2. When presented with such conflicting interests among constituents, the directors should "choose a course of action that best serves the entire corporate enterprise rather than any single group interested in the

a. For example, the Delaware Court of Chancery has held that directors did not breach their fiduciary duties to stockholders in allowing a creditor to foreclose on the debtor's property, where the creditor agreed voluntarily to pay off the company's unsecured creditors. The court held that the directors "reasonably believed that a bankruptcy filing [which was the option advocated by the stockholders] would produce negative returns for all...constituencies, including its stockholders." Odyssey Partners, L.P. v. Fleming Cos., Inc., 735 A.2d 386, 420 (Del. Ch. 1999).

b. Similarly, at least prior to the inception of an actual bankruptcy or insolvency proceeding, there is no requirement to prefer creditors and/or preferred stockholders over common stockholders solely because the company is financially troubled. See Equity-Linked, 705 A.2d at 1040.

i. In Equity-Linked, Genta Inc., a financially troubled pharmaceutical company, sought alternative capital from
third party lenders at the expense of its preferred stockholders who wanted the company to liquidate so that the preferred stockholders could cut their losses.

ii. In denying the injunctive relief to the preferred stockholders, the court acknowledged that the ordinary requirement to prefer the interests of the common stockholders over those of the preferred stockholders was abrogated when a corporation was in the vicinity of insolvency, because in an insolvency scenario an independent board may consider all constituencies in exercising its good faith judgment. However, the court found that the board's decision to seek alternative capital fell within the auspices of its business judgment, thus essentially finding that the board's decision to favor equity over creditors is permissible for a troubled company. Id. at 705 A.2d at 1040.

3. Little if any modern case law has analyzed the issue of whether a board can prefer the interests of one creditor over the interests of another creditor in the same class.

a. So long as applicable law is otherwise followed, there does not appear to be a doctrinal reason that the law should be any different with respect to allegations that the company preferred one claimant
in the same class over another (e.g. two trade creditors) than it is in the reported cases cited above, where the courts allowed the company to prefer one class of claims over another.

b. One older case addresses the issue. In Asmussen, 156 A. at 180, the plaintiff sought the appointment of a receiver to investigate the failure of a dissolved corporation to pay its debt to the plaintiff despite having made payments to other creditors during the corporation's dissolution. The court held that the board was permitted to prefer certain creditors of an insolvent company by liquidating the company, paying those creditors in full, and failing to pay other similarly situated creditors at all. Such a course of action today would be of little effect, because the creditors could cause such payments to be recaptured by filing an involuntary bankruptcy case and a fraudulent conveyance and/or preference lawsuit. Moreover, the Delaware courts have expressly recognized that Asmussen has been overruled at least where the company is engaged in judicial dissolution proceedings under state law. See In re RegO Co., 623 A.2d 92, 108 n. 34 (Del. Ch. 1992).

c. Once a company files for bankruptcy, it becomes more difficult, but arguably not impossible, to persuade a court that, in the directors' business judgment, a transaction supported by equity is favorable to one supported by creditors.
i. While little case law is on point precisely because, due to the absolute priority rule, directors of a bankrupt corporation ordinarily favor creditors, the Delaware Bankruptcy Court recently gave some guidance in stating that "fiduciary duty requires that the controlling shareholder(s) and director(s) of the debtor maximize the value of the assets for payment of unsecured creditors." In re High Strength Steel, Inc., 269 B.R. 560, 569 (Bankr. D. Del. 2001).

ii. However, the Delaware District Court recently stated that, in exercising their fiduciary duties, directors of a debtor should aim to maximize the value of the corporation's "long-term wealth creating capacity." In re Hechinger Invs. Co. of Delaware, 274 B.R. 71, 89 (D.Del. 2002). That standard seems to imply that one of the primary goals of creditors of an insolvent company -- getting paid quickly -- is not paramount.


a. Suppose that a board of a Delaware corporation is confronted with the following scenario: a large interest payment is about to come due on a series of notes. In determining whether or not to make
the payment, management informs the board of directors (the "Board") that the company is in default on its trade debt, in part because liquidity is tight. Moreover, the company is in default on covenants contained in its bank facility and the banks have indicated that they will not agree to waive the defaults if the interest payment on the notes is made. The bank debt previously was unsecured, but the company recently granted security interests to the bank. In 60 days, the preference period with respect to the security interests the company granted to the banks will expire, which will result in the banks becoming over-secured. While refinancing of the bank debt appears unlikely, the company is also seeking a merger partner or other strategic alternative. This process is in its nascent stages. If successful, the strategic alternative could be in the best interests of all parties, but it is speculative to conclude that such an arrangement can be found and consummated quickly.

b. In light of the foregoing, the Board is faced with two immediate questions: whether it should make the interest payment on the notes and whether is should cause the company to file for bankruptcy prior to the running of the bank's preference period.

c. While this scenario might seem fairly typical, there is no written opinion that directly addresses what a board should do under these circumstances. Based on the limited case law precedent set forth
above in Section III, the Board should resolve this issue by taking whatever action maximizes the value for the corporate enterprise as a whole. As long as the Board makes this decision in an informed manner -- i.e., by carefully considering all of the relevant factors in determining whether to file for bankruptcy now or to refrain at least temporarily -- and without regard to any personal interests, the Board's decision should be given deference by a reviewing court.²

d. In assuring that a reviewing court will agree that the Board reached its decision in an informed manner, a Board should take special care to gather and consider the input of management and the company's financial advisors, including the likelihood and timing of the strategic alternatives and refinancing options.

C. Determination of Insolvency and the Vicinity of Insolvency.

1. A key question is at what point the new or expanded fiduciary obligations of corporate directors are triggered. The cases focus on three potential periods: (i) when the company files for bankruptcy; (ii) when the company becomes insolvent, by whatever definition of insolvency is used (as

² See Angelo, Gordon & Co. L.P. vs. Allied Riser Communications Corp., 805 A.2d 221, 229 (Del. Ch. 2002) (holding that the business judgment rule applies in suits by creditors); see also LaSalle National Bank v. Perelman, 82 F. Supp. 2d 279, 293 (D. Del. 2000) (holding that officers and directors are given "broad latitude to balance competing interests in a bankruptcy case in order to make decisions that are in the best interests of the estate") (hereinafter, "Marvel"); Cf. Section D, infra (explaining the application of the business judgment rule in such circumstances).
explained below); and (iii) even before insolvency is reached, when it becomes clear that insolvency is approaching. Because the overwhelming majority of cases agree that the duties attach prior to a bankruptcy filing, this outline focuses on the "vicinity of insolvency" and the insolvency in fact cases.

2. "Vicinity of Insolvency" or "Zone of Insolvency".

a. The generally accepted view of Delaware law is that the expansion of a director's fiduciary duties occurs when a corporation is in the "vicinity of insolvency." See Credit Lyonnais, 1991 WL 277613 at *34 ("At least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, buts owes its duty to the corporate enterprise."). See also Brandt v. Hicks, Muse & Co., Inc. (In re Healthco Int'l, Inc.), 208 B.R. 288, 300 (D. Mass. 1997) ("When a transaction renders a corporation insolvent, or brings it to the brink of insolvency, the rights of creditors become paramount.").

b. The court in Credit Lyonnais noted that when operating a solvent company

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3 See, e.g., Geyer, 621 A.2d at 789; Pereira v. Cogan, No. 00 CIV. 619 (RWS), 2001 WL 243537 at *8 (S.D.N.Y. March 8, 2001) (applying Delaware law); In re Kingston Square Assocs., 214 B.R. 713, 735 (Bankr. S.D.N.Y. 1997) ("it is universally agreed that when a corporation approaches insolvency or actually becomes insolvent, directors' fiduciary duties expand to include general creditors"); In re Ben Franklin Retail Stores, Inc., 225 B.R. 646 (Bankr. N.D. Ill. 1998), aff'd in relevant part, No. 97C7934, 97C6043, 2000 WL 28266 (N.D. Ill. Jan. 12, 2000).
in the vicinity of insolvency, circumstances may arise when the right (both the efficient and fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors or the employees, or any single group interest in the corporation) would make if given the opportunity to act. See Credit Lyonnais, 1991 WL 277613 at *34 n.55.

The Court concluded that "[a]t least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise." Id. at *34.

c. The term "vicinity of insolvency" or "zone of insolvency" has rarely been defined precisely.

i. See, e.g., In re NCS Healthcare, Inc. Shareholders Litig., 825 A.2d 240, 256 (Del. Ch. 2002), rev'd on other grounds, 822 A.2d 397 (Del. 2002) (finding that the company had entered the zone of insolvency or become insolvent at some undefined moment in time after its obligations became overwhelming).

ii. Recently, however, the United States District Court for the Southern District of New York, interpreting Delaware law, articulated a test for determining the boundaries of the zone of insolvency. Pereira v. Cogan 294 B.R. 449, 520-521 (S.D.N.Y. 2003). In Pereira, the court used a modified version of the cash flow and capital adequacy methods of
determining insolvency. (See Section III(C)(3), infra).

Thus, the court held that a company is in the zone of insolvency when "it cannot generate and/or obtain enough cash to pay for its projected obligations and fund its business requirements for working capital and capital expenditures with a reasonable cushion to cover the variability of its business needs over time." Id.

3. Insolvency in Fact.

a. Other courts have agreed that a director's fiduciary duties to creditors arise prior to the institution of bankruptcy proceedings, commencing, at the latest, upon the company becoming insolvent in fact. See Geyer, 621 A.2d at 787-790; Clarkson Co. Ltd. v. Shaheen, 660 F.2d 506, 512 (2nd Cir. 1981). These courts were not called upon to determine whether such fiduciary duties to creditors arose even before the company became insolvent in fact.

b. In Geyer, the court determined that "it is efficient and fair to cause the insolvency exception to arise at the moment of insolvency in fact rather than waiting for the institution of statutory proceedings." Geyer, 621 A.2d at 789.

c. Courts that have held that fiduciary duties to creditors attach upon (at the latest) insolvency in fact, rather than the bright-line test of a bankruptcy filing, have grappled with when "insolvency in fact"
occurs. There are several federal and state statutory definitions of the term insolvency, ranging in analyses from the balance-sheet test to equitable insolvency.

i. The Bankruptcy Code defines insolvency as a "financial condition such that the sum of such entity's debts is greater than all of such entity's property, at fair valuation..." 11 U.S.C. § 101(32)(A).

ii. In Odyssey Partners, 735 A.2d at 417, the court used a corporation's inability to pay debts as they became due in the ordinary course as a measure of insolvency. See also Geyer, 621 A.2d at 789 (utilizing the dictionary definition of insolvency: "[an] entity is insolvent when it is unable to pay its debts as they fall due in the usual course of business."); Francotyp-Postalia AG & Co. v On Target Tech., Inc., No. 16330, 1998 WL 928382 at *5 (Del. Ch. Dec. 24, 1998) (following the Odyssey Partners test as the "only reasonable application" of an insolvency test, because "[i]t is all too common, especially in the world of start-up companies...to operate with liabilities in excess of...assets...").

iii. In Marvel, the Delaware District Court appears to have applied both the Odyssey Partners test, in holding that the
company was not insolvent on the relevant date because no debts were currently due, and a test based on fair market valuation, holding that evidence demonstrated that the value of the company's assets exceeded the fair market value of its liabilities. Marvel, 82 F. Supp. 2d at 291. Similarly, under the Uniform Fraudulent Transfer Act, a company is insolvent "if the sum of the Debtor's debts is greater than all of the debtors assets at a fair valuation," and presumes that a company "generally not paying [its] debts as the become due" is insolvent. U.F.T.A. § 648 2(a), (b).

iv. Most recently, the Delaware Court of Chancery reaffirmed the validity of the balance-sheet test for determining insolvency in Allied Riser. The Allied Riser court held that a company was insolvent because its liabilities were greater than its assets. Allied Riser, 805 A.2d at 224.


1. The United States District Court for the District of Delaware has confirmed that a "debtor has a duty to use reasonable care in making decisions but once those decisions are made, the debtor is protected by the business judgment rule." Marvel, 82 F.Supp. 2d at 292 (citations omitted). Thus, the business decisions of the directors of an insolvent corporation (whether or not it has filed for bankruptcy) are given the same degree of
judicial deference as business decisions of the directors of solvent companies. See Allied Signal, 805 A.2d 221 at 229; Equity-Linked, 705 A.2d at 1041 (deferring to business judgment of non-bankrupt company on the lip of insolvency).

2. While the application of the business judgment rule assures that courts will not second guess business decisions of a disinterested board of directors who act in an informed manner and in good faith, creditors can prove liability in the same manner as can shareholders of a Delaware corporation who seek to rebut the business judgment rule. See supra section I.

3. In making business decisions, directors of an insolvent or nearly insolvent company must be particularly mindful of the person or entity to which they owe fiduciary duties, because they might lose the protections of the business judgment rule and be held liable for a breach of those duties if they are not cognizant of the various constituencies to which they owe fiduciary duties. In other words, a director is charged with the duty of informing himself or herself as the financial status of the corporation in order that such director may properly determine to whom he or she owes the duties or care, good faith and loyalty, and failure to inform oneself might be found to be a breach of the duty of care or loyalty. See, e.g., Burroughs v. Fields, 546 F.2d 215, 217 (7th Cir. 1976) (finding fraud where, when the company was on the brink of insolvency and a duty was owed to creditors, a director paid a commission to himself, "at a time
when he knew or should have known the condition of the corporation...");
U.S. v. Spitzer, 261 F.Supp. 754, 755 (S.D.N.Y. 1966) (any director, officer or shareholder who controls the affairs of the corporation is assumed to be aware of all outstanding claims against the debtor and can be held liable for failure to inform himself or herself of such claims or acting in disregard or such information).

E. Exculpation

1. Many Delaware corporations have a provision in their certificates of incorporation which provides exculpation to directors found liable for a breach of the duty of care to stockholders. This is an important protection for a board which is permissible under 8 Del. C. § 102(b)(7).

2. Because the fiduciary duties owed to creditors by the directors of an insolvent corporations are similar to the fiduciary duties owed to stockholders of a company, one could argue that a director should be exculpated from liability to a creditor for a breach of the duty of care if a company has an exculpation provision.

a. This issue has never been decided by the Delaware courts. See Geyer, 621 A.2d at 671 (raising the issue but not deciding it because the issue was not before the court).

b. The only courts which have considered the issue have held that such a provision is inapplicable to creditor claims. See Ben
Franklin, 225 B.R. at 651; Pereira v. Cogan, 2001 WL 243537, *10 (S.D.N.Y. March 8, 2001). These courts reasoned that the statutory underpinning for 102(b)(7) exculpatory provisions refers to "stockholders" rather than "creditors" and that "shareholders' investments in corporations are subject to the rights and limitations of the certificate of [i]ncorporation. Creditors' 'investments' are not; they are subject to specific contracts." See Ben Franklin, 225 B.R. at 652.

IV. Conclusion

Directors of solvent companies owe fiduciary duties of loyalty, care and good faith to the corporation and its shareholders. Provided that such duties are appropriately discharged and the directors are not conflicted, directors are generally shielded from personal liability for errant business decisions by the "business judgment rule." The category of persons to whom directors' duties are owed will expand as a corporation's financial prospects decline. As a corporation becomes insolvent, or if it is in the "vicinity of insolvency," its directors will owe fiduciary duties to the corporation's creditors, as well as its shareholders. Accordingly, the directors of a company in financial distress must be aware of their emerging fiduciary duties to the corporation's creditors.