Navigating D&O Fiduciary Duties in the Zone of Insolvency
Avoiding and Defending Fiduciary Duty Claims and Maximizing D&O Insurance Coverage

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NAVIGATING D & O FIDUCIARY DUTIES IN THE ZONE OF INSOLVENCY: D&O DUTIES .. FROM FACING BANKRUPTCY TO FILING BANKRUPTCY

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OVERVIEW

- With dynamic markets and hypersensitive capital markets, directors and officers of companies that have appeared relatively healthy may suddenly find themselves facing the slippery slope toward financial restructuring and workout, unable to meet financial covenants and other credit agreement requirements. Financial uncertainty or crisis bring with them issues of fiduciary duties and responsibilities that many may not have seen before.

- Historically, two concepts have dominated restructuring practice and commentary on the duties of directors and officers of a company facing financial distress –
  - the “zone of insolvency” (as discussed herein, the period in which a company’s financial performance is near but not quite at insolvency); and
  - “deepening insolvency” (as discussed herein, the worsening of an insolvent company’s financial condition) – to suggest an expansion of director and officer duties, as a company approaches, or operates in, insolvency, for the benefit of the company’s creditors.

- Since 2006, case law, particularly in the Delaware state courts and Third Circuit bankruptcy courts, appeared to signal a retreat from the expansion of duties suggested by the “zone of insolvency” and “deepening insolvency “models for fiduciary duties and liability, signaling that the prospect for exposure may not be as great as directors and officers regularly had been counseled.
More recent cases out of the Delaware and Third Circuit courts have indicated that creditor and trustee plaintiffs continue to have an arsenal of potent weapons in seeking redress against officers and directors for losses resulting from their company’s failure.

- The zone of insolvency analysis continues to be relevant in light of uncertainties in determining with real-time precision the point when a company becomes insolvent.
- Plaintiffs have sought to navigate around case law discrediting “deepening insolvency” as an independent cause of action by linking their allegations with more traditional breach of fiduciary duty claims.

As companies find themselves entering a restructuring mode, their directors must be careful to monitor and consider the company’s changing economics, to determine the appropriate course of action in a particular set of circumstances and to understand the type of lawsuit that may arise by disgruntled stakeholders.

The universe of parties to whom the directors of a corporation owe duties, and the consequences of potential failings, are not static. Accordingly, directors must keep a watchful eye on the solvency of the corporation and take great care to act in good faith and exercise reasonable business judgment appropriate for the circumstances notwithstanding the exigencies of the moment, for their fiduciary duties may be shifting right before their eyes.
For a company in financial distress, directors should consider three different circumstances in which a company’s financial distress may manifest:

- “Insolvency”:
  - Under Delaware law, a corporation is insolvent if it “has either: 1) a deficiency of assets below liabilities with no reasonable prospect that the business can be successfully continued in the face thereof, or 2) an inability to meet maturing obligations as they fall due in the ordinary course of business.” Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 782 (Del. Ch. 2004).
  - The U.S. Bankruptcy Code defines the term “insolvent”, with reference to an entity other than a partnership or municipality, as a financial condition such that the sum of the entity’s debts is greater than all of the entity’s property, at a fair valuation, exclusive of property transferred, concealed or removed with intent to hinder, delay or defraud the entity’s creditors. 11 U.S.C. § 101(32)(A)
    - ii) “Claim” means (A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or (B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured. 11 U.S.C. § 101(5).

However, courts generally have avoided developing a hard and fast definition for the “zone of insolvency.” see Prod. Res. Group, L.L.C., 863 A.2d at 790-91(Del. Ch. 2004)

“Deepening Insolvency.” The concept of “deepening insolvency” refers to a situation where an already insolvent company becomes more insolvent as a result of actions taken or not taken by the company, or the impact of commercial industry, or economic conditions.

Some courts have concluded or suggested that once a company is insolvent, acts or inaction causing a company to assume greater debt and become more insolvent (or entering “deepening insolvency”) are justification for a derivative suit. See, e.g., Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc., 267 F.3d 340 (3d Cir. 2001).
No bright-line “real-time” methods exist of determining when a company may be approaching insolvency or actually is insolvent, based on an insolvency test that aggregates all of a company’s known and potential liabilities and is based on the fair market value of a company’s assets.

A company’s reasonable prospects for successfully continuing a business cannot be assessed by an objective test.

A company may be unable to pay its most significant debts as they mature, such as loans and public or private bond debt, while it continues to pay its obligations arising in the ordinary course of business to trade vendors and service providers.

The most recent trend in Delaware and Third Circuit case law suggests that directors should be less concerned with whether the company is almost insolvent or may become more insolvent, and more concerned with whether they are taking actions that reflect

- their reasonable business judgment,
- without regard for their personal interests,
- in good faith and
- in the best interests of all stakeholders in the company – shareholders, creditors, employees, suppliers.
BASIC INSOLVENCY CONCEPTS (CONT’D)

- Questions raised and answered by the more recent decisions:
  - What parties may pursue actions against directors when a company is moving towards insolvency, or in the "zone of insolvency"?
    - When a company is solvent but in a financial condition that could be described as the "zone of insolvency," only shareholders may bring derivative suits against directors.
  - May creditors sue directors when an insolvent company becomes more "insolvent" or is in the midst of "deepening insolvency"?
    - "Deepening insolvency" has little current support as a claim and has been invalidated by the influential Delaware Supreme Court.
    - However, "deepening insolvency" may yet be considered by courts in determining traditional claims for breach of fiduciary duties of loyalty or care, or in determining damages resulting from such claims.
  - When a company is insolvent, what sort of suits by creditors – direct or derivative – may directors be exposed to?
    - Creditors may bring derivative suits only against directors of a corporation that is insolvent; but, generally, they may not bring direct suits against individual directors.
  - Do the parent directors owed fiduciary duties to parent’s insolvent wholly-owned subsidiary?
    - While a parent corporation of an insolvent wholly-owned subsidiary must consider the best interests of the subsidiary as a whole, including creditors, the fiduciary duty of the parent’s directors to the subsidiary depends on the corporate structure.
FIDUCIARY DUTIES


The “duty of care” requires directors both to use that amount of care which ordinarily careful and prudent persons would use in similar circumstances, and to consider all material information reasonably available. *In Re Walt Disney Co. Deriv. Litig.*, 907 A.2d 693, 749 (Del. Ch. 2005); See also *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985); Robert Clark, Corporate Law Section 3.4, 123 (Aspen Publishers, Inc. 1986).

There are two contexts in which duty of care liability can arise: (i) where liability may be said to follow from a board decision that results in a loss because that decision was ill advised, or negligent; or (ii) where liability for a loss arises from an unconsidered failure of the board to act in circumstances in which due attention would, arguably, have prevented the loss.

Directors generally will not be held liable for the consequences of their exercise of business judgment -- even for judgments that appear to have been clear mistakes -- unless certain exceptions apply; such exceptions may include fraud, conflict of interest, or gross negligence. *In re Caremark Int’l Inc. v. Deriv. Litig.*, 698 A.2d 959, 967 (Del. Ch. 1996)

Gross negligence is the proper standard for determining whether a business judgment reached by a board of directors was an informed one. *Smith V. Van Gorkom*, 488 A.2d 858, 873 (Del. 1986).

Business judgment rule protections do not apply where a loss results from director inaction. *Disney*, 907 A.2d at 748.

The mere fact that a company takes on business risk and suffers losses does not evidence misconduct, and is not a basis for director liability in and of itself. A Director’s oversight duties under Delaware law are not designed to subject directors to personal liability for failure to predict the future and to properly evaluate business risk. *In re Citigroup Inc. Shareholder Deriv. Litig.*, 964 A.2d 106 (Del. Ch. 2009).
The “duty of loyalty” prohibits the fiduciaries from taking advantage of their beneficiaries by means of fraudulent or unfair transactions. Robert Clark, Section 4.1 at 141. See also Lewis v. Vogelstein, 699 A.2d 327 (Del. Ch. 327); Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

Stone v. Ritter. 911 A.2d 362, 370 (Del. 2006): The Delaware Supreme Court held that a breach of loyalty claim may be premised upon the failure of a fiduciary to act in good faith.

Where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation ... only 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.” Lyondell Chem. Co. v. Ryan, 970 A2d. 235, 240 (Del. 2009)(quoting In re Caremark Int’l Deriv. Litig., 698 A.2d at 971).

Bad faith encompasses not only an intent to harm but also intentional dereliction of duty, falling between subjective bad faith – i.e., fiduciary conduct motivated by an actual intent to do harm – and a lack of due care – i.e., action taken solely by reason of gross negligence without any malevolent intent. As a result, no comprehensive or exclusive definition of “bad faith” has been articulated. In Re Walt Disney Co. Deriv. Litig., 907 A.2d at 64 – 66.

Fiduciaries breach their duty of loyalty by intentionally failing to act in the face of a known duty to act, demonstrating a conscious disregard for their duties, resulting in oversight liability by failing to adequately monitor the execution of a flawed sale strategy conducted by a CRO. In re Bridgeport Holdings, Inc., 388 B.R. 548, 564 (Bankr: D. Del. May 30, 2008, B. J. Walsh), citing Stone, 911 A.2d at 369.

Bad faith is a required element of oversight liability. O”Toole v. McTaggart (In re Trinsum Group, Inc., 466 B.R. 596, 616 (Bankr: S.D.N.Y. 2012)

Individuals who become directors after the company has contracted to engage in a transaction do not breach their duty of loyalty by allowing the company to fulfill its contractual obligations. Responsible Person of Musicland Holding Corp. v. Best Buy Co. (In re Musicland Holding Corp.), 398 B.R. 761 (Bankr: S.D.N.Y. 2008)(citing In re Bridgeport Holdings, Inc., 388 B.R. at 566).
“Revlon” Duties: Under Delaware law, directors’ duties of care and loyalty require that a board deciding to proceed with a change-of-control transaction must perform its fiduciary duties by taking reasonable measures to obtain the best available price in selling the company. Revlon v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 182 (Del. 1986).

Delaware Corporate law permits a Delaware corporation to eliminate or limit, in its certificate of incorporation, the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty of care (with certain exceptions), but not for a breach of the duty of loyalty. 8 Del. C. § 107(b)(7). Lyondell Chem. Co., 970 A2d. at 235.

Where directors have been exculpated from personal liability for breaches of the duty of care, and the board is found to have been independent and not motivated by self-interest or ill will, the sole issue under a Revlon claim is whether the directors breached their duty of loyalty by failing to act in good faith. Lyondell Chem. Co., 970 A2d. at 239-40.
“Lyondell Chem. Co. v. Ryan: In its decision of March 25, 2009, the Delaware Supreme Court re-affirmed the broad protections afforded disinterested directors from personal liability for damages in the face of Revlon claims of breach of fiduciary duties. Where directors have been exculpated by corporate charter provision from personal liability for duty of care claims, plaintiffs claim a non-exculpable breach of good faith must demonstrate that the directors “utterly failed” to attempt to obtain the best sale price. Lyondell Chem. Co., 970 A2d. At 244.

Revlon duties do not arise when a third party puts the company “in play,” but, rather, apply only once the company embarks on a change-of-control transaction on its own initiative or in response to an unsolicited offer.

No single blueprint or set of enumerated requirements exist for satisfying a directors Revlon duties. As a result, directors will be able to tailor their actions to the unique circumstances they face.

An imperfect attempt to comply with a board’s Revlon duties does not equate to a conscious disregards of those duties so as to constitute a breach of the duty of loyalty.
A director who plays no role in the process of deciding whether to approve a challenged transaction cannot be held liable on a claim that the board’s decision to approve the transaction was wrongful. *KDW Restructuring & Liquidation Servs. LLC v. Greenfield*, 874 F. Supp. 2d 213, 221 (S.D.N.Y. 2012) (citing *In re Bridgeport Holdings, Inc.*, 388 B.R. at 566).

Derivative actions are more common than direct causes of action, which may be asserted by creditors only where the company is insolvent.

- If directors breach either of the fiduciary duties of care or loyalty, a derivative suit – for an injury to the corporation – may be brought against the corporation by its shareholders on the corporation’s behalf.

- If the alleged wrong is not to the corporation, but to its shareholder(s), a direct suit (such as a suit to inspect a corporation’s books, to enforce voting rights or to compel the declaration of dividends) may be brought against individual directors.

- Whether a derivative action against directors may be asserted by creditors or shareholders is determined by a corporation’s solvency: “When a corporation is solvent, [shareholders] have standing to bring derivative actions on behalf of the corporation because they are the ultimate beneficiaries of the corporation’s growth and increased value... When a corporation is insolvent, however, its creditors [come before] shareholders as the...principal constituency injured by any fiduciary breaches that diminish the firm’s value.” *North Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 101-02, (Del. 2007) (citations omitted) (emphasis in original).
FIDUCIARY DUTIES (CONT’D)

- Derivative actions are more common than direct causes of action, which may be asserted by creditors only where the company is insolvent. (cont’d)
- “It is well-settled Delaware law that neither creditors nor the Trustee on behalf of the creditors has standing to assert direct claims of damage for breach of fiduciary duty against the insolvent corporation’s directors.” *Newsome v. Gallagher*, 2014 U.S. Dist. LEXIS 71794 (N.D. OK May 27, 2014).
- Some case law suggests creditors may be permitted to assert direct claims against directors only on very rare occasions: if such directors show a “marked degree of animus toward a particular creditor.” *Prod. Res. Group, L.L.C.*, 863 A.2d at 798 (Del. Ch. 2004).
- Since standing to bring a derivative action against an LLC is limited by Delaware law (Del. Code Ann. Tit. 6, § 18-1002) to a member or an assignee, derivative standing has been denied to creditors of an insolvent LLC, resulting in the dismissal of the creditor’s derivative claims for breach of fiduciary duty. *CML V, LLC v. Bax*, 6 A.3d 238 (Del. Ch. 2010).
- A court-appointed receiver in an SEC enforcement action has standing to assert breach of fiduciary duty claims on behalf of the legal entity for which the receiver was appointed. *Cobalt Multifamily Investors I, LLC v. Shapiro*, 2014 U.S. Dist. LEXIS 44933 at 22 (S.D.N.Y. March 28, 2014).

The fiduciary duty owed by parent directors to a wholly-owned subsidiary depends on the corporate structure.


While individual directors of a corporate general partner may be liable for breach of fiduciary duty to the partnership and limited partners, *In re USACafes, L.P., Litigation,* 600 A.2d 43, 48-49 (Del. Ch. 1991), as well as to parents and controlling entities of a corporate general partner. See e.g., *Cargill, Inc. v. JWH Special Circumstance LLC,* 959 A.2d 1096, 1120-21 (Del. Ch. 2008), liability has been limited to situations involving breach of a duty not to use control over the partnership's property to advantage the corporate director at the expense of the partnership. *Bay Center Apartments Owner, LLC v. Emery Bay PKI, LLC,* 2009 Del. Ch. LEXIS 54 (Del. Ch. 2009).

Although the TOUSA bankruptcy court, relying principally on *USACafes,* held that the directors of parent TOUSA owed fiduciary duties to creditors of TOUSA's insolvent subsidiaries, *In re TOUSA,* 437 F.R. 447 (Bankr. S.D. FL 2010), no Delaware court has extended the USACafes holding to the parent directors of a wholly-owned subsidiary, and the most recent court to consider the issue also declined to find a fiduciary duty was owed by parent directors to the wholly-owned subsidiary. *Newsome v. Gallagher,* 2014 U.S. Dist. LEXIS 71794 at 17-18.
FIDUCIARY DUTIES (CONT’D)

➢ While Delaware courts recognize that managing members of a limited liability company owe a fiduciary duty to the company and its members, under Delaware law the parties to the limited liability company operating agreement are expressly permitted to modify the scope of these fiduciary duties – expand, restrict, even eliminate. Therefore, in the LLC context, the LLC’s governing documents must be examined and interpreted to determine any fiduciary relationships and claims. Zimmerman v. Crothall, 62 A.3d 676, 701-02 (Del. Ch. 2013); Ross Holding & Mgmt. Co. v. Advance Realty Group, LLC, 2014 Del. Ch. LEXIS 173 at 47-48 (Del. Ch. 2014).

➢ Under Delaware law, “the relationship of joint adventurers is fiduciary in character and imposes upon all of the participants the utmost good faith, fairness and honesty in dealing with each other with respect to the enterprise.” In re Mobilactive Media, LLC, 2013 De. Ch. LEXIS 26 at 69-81 (Del. Ch. 2013) quoting J. Leo Johnson, Inc. v. Carmer, 38 Del. Ch. 579, 584,156 A.2d 499 (1959).

➢ The joint venture fiduciary duty “forbids one joint adventurer from acquiring solely for himself any profit or secret advantage in connection with the common enterprise.” J. Leo Johnson, Inc. v. Carmer, 38 Del. Ch. at 584.

➢ The doctrine of misappropriation of corporate opportunity: (1) the opportunity is within the corporation’s line of business, (2) the corporation has an interest or expectancy in the opportunity, (3) the corporation is financially able to exploit the opportunity, and (4) by taking the opportunity for his own, the corporate fiduciary is placed in an apposition inimical to his duties to the corporation.

➢ In Mobilactive Media, breach of fiduciary duty claim permitted on same set of facts as those for breach of contract claim where plaintiffs sought remedies not otherwise provided for by contract. Stewart v. BF Bolthouse Holdco, LLC, 2013 Del. Ch. LEXIS 215 at 47-51 (De. Ch. 2013).
THE “ZONE” OF INSOLVENCY

- **Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.:** The concept of the “zone of insolvency” likely started with a footnote to this Delaware Court of Chancery case, which stated:

  such directors will recognize that in managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right (both the efficient and the 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 interested in the corporation) would make if given the opportunity to act. *Credit Lyonnais Bank Nederland, N.V.*, 1991 Del. Ch. LEXIS 215, at *108 n. 55.

- **Prod. Res. Group, L.L.C. v. NCT Group, Inc.:** The Delaware Court of Chancery noted that *Credit Lyonnais Bank Nederland, N.V* footnote 55 “was read more expansively by some, not to create a shield for directors from stockholder claims, but to expose directors to a new set of fiduciary duty claims, this time by creditors.

  To the extent that a firm is in the zone of insolvency, some read this case as authorizing creditors to challenge directors’ business judgments as breaches of a fiduciary duty owed to them.” *Prod. Res. Group, L.L.C.*, 863 A.2d at 789.
THE “ZONE” OF INSOLVENCY (CONT’D)

- North American Catholic Educational Programming Foundation, Inc. v. Gheewalla, 930 A.2d 92 (Del. 2007). The Delaware Supreme Court put to rest the notion that, in Delaware, directors of a not-yet-insolvent company owed a duty both to shareholders and creditors.

- As a matter of law, a corporation’s creditors may not assert direct claims against directors for breach of fiduciary duties when the corporation is either insolvent or in the zone of insolvency.” They may only assert derivative claims.

- When a company is operating in the “zone of insolvency,” directors owe their fiduciary duties to a corporation and its shareholders and not to creditors.

- Thus, under current Delaware law, if a corporation is approaching insolvency, the fiduciary duties of directors do not shift from shareholders to creditors. Directors must continue to make decisions of business judgment based on what is best for the corporation and its shareholders and not necessarily what is best for the creditors.

- Following the reasoning underlying the Gheewalla decision, the District Court for the Southern District of New York, in RSL Communs., PLC v. Bildirici, 649 F. Supp. 2d 184, 201-08 (S.D.N.Y. 2009), held that New York law did not provide for “zone of insolvency” liability of directors.
“DEEPPENING INSOLVENCY”


- Deepening insolvency could harm a corporation in several ways: the incurrence of additional debt could force a company into bankruptcy, thereby creating additional administrative costs; bankruptcy stemming from deepening insolvency could harm a corporation’s ability to conduct business in a profitable manner; it could harm relationships with and credibility with customers, suppliers, employees; and lastly, “prolonging an insolvent corporation’s life through bad debt may simply cause the dissipation of corporate assets.”

- The “harms [stemming from deepening insolvency] can be averted, and the value within an insolvent corporation salvaged, if the corporation is dissolved in a timely manner, rather than kept afloat with spurious debt.”
“DEEPENING INSOLVENCY” (CONT’D)

- *Seitz v. Detweiler, Hersey & Assocs., P.C. (In re CitX Corp.), 448 F.3d 672 (3d Cir. 2006)* The Third Circuit concluded that “deepening insolvency” could be a valid cause of action but “should not be interpreted to create a novel theory of damages for an independent cause of action like malpractice.”

- Deepening insolvency beyond the *Lafferty* holding was determined to be limited, and would not sustain a claim of negligence or support an independent deepening-insolvency cause of action.

- *Lafferty* did not extend the concept of deepening insolvency beyond Pennsylvania.

- In determining a deepening insolvency cause of action, the incurrence of new debt is not sufficient to support the claim if the company suffers no loss on the loan transaction. However, the insolvency could be deepened when the loan proceeds are squandered or assets otherwise are looted, widening the gap between liabilities and assets and impairing the ability to service outstanding debt. *In re Parmalat Secs. Litig, 501 F. Supp. 2d 560, 578 (S.D.N.Y. 2007)*
“DEEPENING INSOLVENCY” (CONT’D)

- Trenwick America Litigation Trust v. Ernst & Young, L.L.P., 906 A.2d 168, 205 (Del. Ch. 2006). The Third Circuit held that Delaware law does not recognize an “independent cause of action for deepening insolvency.”

- The board of even an insolvent company “may pursue, in good faith, strategies to maximize the value of the firm.”

- When an insolvent corporation’s board acts with due diligence and good faith in the pursuit of a “business strategy that it believes will increase the corporation’s value, [even if the strategy] involves the incurrence of additional debt[...][t]hat the strategy results in continued insolvency and an even more insolvent entity does not in itself give rise to a cause of action.”

- In such circumstances, the directors will be protected by the business judgment rule because the “fact of insolvency does not render the concept of ‘deepening insolvency’ a more logical one than the concept of ‘shallowing profitability.”

- The “proper role of insolvency [is] to act as an important contextual fact in the fiduciary duty matrix.”
Deepening insolvency has been challenged outside of the Third Circuit as a valid cause of action.

- *In re SI Restructuring, Inc.*, 532 F.3d 355, 362-64 (5th Cir. June 20, 2008) (agreeing in dicta with the Third Circuit’s *Trenwick* decision, while finding that the trustee’s deepening insolvency theory was not supported by the court’s findings);

- *Fehribach v. Ernst & Young LLP*, 493 F.3d 905, 909 (7th Cir. 2007) (refusing to accept plaintiff’s deepening insolvency theory and stating that “the theory makes no sense when invoked to create a substantive duty of prompt liquidation that would punish corporate management for trying in the exercise of its business judgment to stave off a declaration of bankruptcy, even if there were no indication of fraud, breach of fiduciary duty, or other conventional wrongdoing.”)

Federal and state courts often follow Delaware’s lead on such creditor issues, suggesting that it is likely that deepening insolvency will no longer be a credible alternative for plaintiffs elsewhere.

- *See, e.g., In re I.G. Services, Ltd.*, 2007 Bankr. LEXIS 3329, at *1 (Bankr. W.D.Tex. July 31, 2007) (“The Delaware courts’ decisions have proved to be immensely influential in the national debate over the shape of causes of action that have their genesis in breach of fiduciary duties on the part of officers and directors….It seems fair to say...that both state and federal courts within this jurisdiction are likely to give weight to the court from whence creditor-initiated actions for breach of fiduciary duties have emerged.”) (citation omitted).
“DEEPENING INSOLVENCY” (CONT’D)

➢ *In re Radnor Holdings Corp.*, 353 B.R. 820 (Bankr. D.Del. 2006): Where the creditors’ committee was found to have tried its claims of recharacterization and breach of fiduciary duty as if it were a “deepening insolvency” case, the bankruptcy court held that, in light of *Trenwick*, “simply calling a discredited deepening insolvency cause of action by some other name does not make it a claim that passes muster.”

➢ Under Delaware law, a board is not required to wind down operations simply because a company is insolvent, but rather may conclude to take on additional debt in the hopes of turning operations around.

➢ The making of a loan does not increase insolvency, but, rather, “increases liabilities (the amount of the loan) and assets (the cash provided by the loan) in the same amount.”

➢ “As a matter of law, there is no *per se* breach of fiduciary duty for an insider making a bid to purchase a company or its assets.”
However, courts have recognized the viability of deepening insolvency under the laws of certain other states as a cause of action or a theory of harm. For example:

- In *Thabault v. Chait*, 541 F.2d 512 (3rd Cir. 2008), the Third Circuit, considering New Jersey law, held that whether deepening insolvency constitutes a valid theory of damages for a harm is a matter that is uniquely subject to state law principles, and affirmed a jury’s verdict against an accounting firm based on a professional malpractice claim, where deepening insolvency was used to determine damages.

  Upon an examination of New Jersey law, the Third Circuit found that New Jersey law “provides for a remedy for traditional tort damages that flow from wrongful conduct that results in increased liabilities, decrease in fair asset value and lost profits of a corporation... traditional damages, stemming from actual harm of a defendant’s negligence, do not become invalid merely because they have the effect of increasing a corporation’s insolvency.” *Id.* at 522; see also *Forman v. Salzano (In re Norvergence, Inc.)*, 405 B.R. 709 (D. N.J. 2009) (court would not dismiss a claim for deepening insolvency under New Jersey law).

- In *DeGiacomo v. Tobin & Assocs., P.C. (In re Inofin Inc.)*, 2012 Bankr. LEXIS 5237 at 94 (Bankr. D. Mass. 2012), the court denied motion to dismiss a deepening insolvency cause of action after reviewing case law which found the cause of action to exist in some states but not in others.

  “In the absence of definitive case law from the Supreme Judicial Court of Massachusetts as to the viability of depending insolvency as a separate cause of action or as a measure of damages... The Trustee has stated a plausible theory of damages due to negligence unmoored to damages predicted upon deepening insolvency. Accordingly, the Court shall not carve out deepening insolvency from the Trustee’s potential damage claim resulting from the Defendants’ negligence at this time, subject of course, to the requirement that such damage be foreseeable.”
SIGNIFICANT POST-*TRENWICK* DEVELOPMENTS ON THE BUSINESS JUDGMENT RULE AND FIDUCIARY DUTIES

- *In re Bridgeport Holdings, Inc.* The Debtor sold a substantial portion of its assets one day prior to filing its Chapter 11 petition. The Debtor’s liquidating trust asserted a claim for breach of fiduciary duties based on, among other claims, the board’s abdication of responsibility to the restructuring professional it hired, the board’s failure to supervise the restructuring professional, and the board’s acquiescence in the restructuring professional’s decision to sell the assets in an allegedly rushed and uninformed manner. 388 B.R. at 554-61.

- The cause of action for breach of fiduciary duty accrues when the wrongful act takes place, and the statute of limitations is only tolled for claims of wrongful self-dealing.

- Where a breach of the duty of loyalty and lack of good faith is alleged as well as a breach of duty of care, an exculpatory provision in the company’s articles of incorporation cannot justify a dismissal of the duty of care claims.

- In the sale context, a board’s failure to obtain a valuation of the company’s assets and failure to adequately market those assets constituted breaches of the duty of care, imposing oversight liability on the directors.

- The Business Judgment Rule is rebutted if the plaintiff shows that the directors failed to exercise due care in informing themselves before making their decision.
SIGNIFICANT POST-\textit{TRENWICK} DEVELOPMENTS ON THE BUSINESS JUDGMENT RULE AND FIDUCIARY DUTIES (CONT’D)

\begin{itemize}
  \item \textit{In re Troll Communications, LLC.}, 385 B.R. 110 (Bankr. D. Del. 2008): The Chapter 7 trustee alleged breach of fiduciary duties claims based on the directors’ decision to use proceeds of an equity buy-in to pay debts owed to an equity holder of the company. The trustee also asserted that the directors failed to take reasonable actions to prevent the “ever-deepening insolvency” of the debtor entities.
  \item Where the trustee pled facts sufficient to question the disinterestedness of a majority of the board of directors, the Business Judgment Rule presumption may not be used as a basis to dismiss a breach of loyalty claim.
  \item Where the trustee’s cause of action was not explicitly asserted as a “deepening insolvency” cause of action but was, in substance, a claim of deepening insolvency, the claim was dismissed as both a cause of action and a theory of damages.
\end{itemize}
SIGNIFICANT POST-*TRENWICK* DEVELOPMENTS ON THE BUSINESS JUDGMENT RULE AND FIDUCIARY DUTIES (CONT’D)

- *Miller v. McCown De Leeuw & Co., Inc., (In re The Brown Schools)*, 386 B.R. 37 (Bankr. D. Del. 2008): The Chapter 7 trustee asserted against debtor’s former majority equity holder and its affiliates (as well as former directors of the debtor and the former law firm representing the debtor) claims for breach of fiduciary duty, aiding and abetting breach of fiduciary duty, corporate waste and civil conspiracy, as well as a cause of action for deepening insolvency.

- While *Trenwick* mandated the dismissal of the claim for deepening insolvency, it did not require dismissal of the other causes of action.

- If defendant was on both sides of the transaction, the burden of proof is on the defendant to prove that the transaction was entirely fair.

- While duty of care violations may resemble causes of action for deepening insolvency, because the alleged injury in both is the result of the board of directors’ poor business decision, claims for breach of the fiduciary duty of loyalty in the form of self-dealing are not deepening insolvency claims in disguise.

- The *CitX* decision only held that deepening insolvency was not a viable theory of damages for the particular malpractice claim before the Third Circuit in that case, and was not a broad invalidation of deepening insolvency as a valid theory of damages for all independent causes of action. Accordingly, deepening insolvency was found to be a valid theory of damages for the trustee’s breach of fiduciary duty claim.
SIGNIFICANT POST-*TRENWICK* DEVELOPMENTS ON THE BUSINESS JUDGMENT RULE AND FIDUCIARY DUTIES (CONT’D)

- *Hamilton Partners, L.P. v. Highland Capital Mgmt., L.P.*, 2014 De. Ch. LEXIS 72 (Ch. Del. January 30, 2014, Noble, Vice Chancellor): A stockholder class action challenged the merger between a Nevada corporation, a successor-by-merger to a Delaware corporation, and an affiliate of one of the company’s stockholder, which was the final step in a complicated, going-private transaction between the Delaware corporation and the stockholder (following a debt repurchase by the Delaware corporation, a reincorporation by merger of the Delaware corporation into the new Nevada corporation, a self-tender offer by the Nevada corporation, a debt refinancing by the Nevada corporation and director resignations from the Nevada corporation):

  - Plaintiff asserted breach of fiduciary duty claims against the stockholder and breach of fiduciary duty and aiding and abetting claims against one of the directors of the Delaware and Nevada corporation. The Court denied the stockholder’s motion to dismiss but granted the director’s motion to dismiss.

  - In determining whether Delaware or Nevada law applied, Court applied the “internal affairs doctrine,” under which claims implicating a corporation’s internal affairs are governed by the corporate law of the state of incorporation at the time of the actions constituting the alleged breach. In this case, Delaware law applied to matters pertaining to the restructuring agreement, because the stockholder and the director at that time were in such capacities regarding a Delaware company. Nevada law applied to actions post-merger and not prescribed by the restructuring agreement.
SIGNIFICANT POST-*TRENWICK* DEVELOPMENTS ON
THE BUSINESS JUDGMENT RULE AND FIDUCIARY DUTIES
(CONT’D)

*Hamilton Partners, L.P. v. Highland Capital Mgmt., L.P. (cont’d):*

- A minority stockholder challenge of the fairness of a merger between a corporation and its controlling stockholder implicated the “entire fairness” standard of review, the most rigorous standard of review, where the burden of proof is on the controlling stockholder to establish that the transaction was a product of fair dealing and at a fair price. The burden of proof shifts if the controlling stockholder establishes that a well functioning special committee of the board approved the transaction.

- The court ruled that a just-less-than-majority (e.g., 48%) stockholder may be considered a controlling stockholder by virtue of also being a significant creditor that exercises sufficient control over the corporation’s business affairs, notwithstanding well-established Delaware law that a corporation’s creditor—even on that owns a majority of the corporation’s debt—does not owe fiduciary duties to stockholders.

- When a stockholder challenges a board decision as a breach of fiduciary duty, the Court examines the director’s conduct through a doctrinal standard of review which gives deference to the good faith business decisions of informed, disinterested and independent directors under the business judgment rule, where a breach of fiduciary duty can only be sustained if the directors’ decision was irrational—the plaintiff must allege disloyal conduct.

- The stockholder needs to rebut the presumptive business judgment standard for at least half of the directors who approved the action or decision at issue, even if the stockholder brings the action against less than all the directors.

- A director may lack independence and be beholden to another’s domination or control if the decision-making process is effectively “sterilized” by a party’s influence rather than the merits of the business decision.

- A director must disclose any material interest that a reasonable director would find important in evaluating the merits of the actions or decision in question.
SIGNIFICANT POST- _TRENWICK_ DEVELOPMENTS ON THE BUSINESS JUDGMENT RULE AND FIDUCIARY DUTIES (CONT’D)

- **Quadrant Structured Prods. CO. LTD v. Vertin,** 115 A. 3d 535, 2015 De. Ch LEXIS 129 (Del. Ch. May 4, 2015): Court considered creditor-derivative suit on claims that board of directors, by pursuing investment strategies involving riskier credit default swaps, acted for the benefit of the company’s shareholder (which was also a junior creditor) and contrary to the interests of the company’s more senior creditors while the company was insolvent, resulting in the directors’ breach of their fiduciary duties to the senior creditors. Subsequent the commencement of the lawsuit, the directors approved actions resulting in the company’s return to solvency.

- Court declined to require plaintiff to prove company was “irretrievable insolvent” with no reasonable prospect of returning to solvency to sustain standing to bring creditor-derivative claims, and there is no “continuous insolvency” requirement for creditor standing. As a result, plaintiff did not lose standing to sue if corporation that was insolvent at the time the complaint was filed subsequently becomes solvent.

- In determining solvency of company, Court determined that a traditional balance sheet test is not a bright-line GAAP analysis, but, instead, requires a “reasonable market value” analysis that takes into account the realities of the business world in which corporations incur significant debt when seizing business opportunities that may have “prospect value” which may be viewed as assets for purposes of the balance sheet test.
SIGNIFICANT POST-TRENWICK DEVELOPMENTS ON THE BUSINESS JUDGMENT RULE AND FIDUCIARY DUTIES (CONT’D)

- *Leal v. Meeks (In re Cornerstone Therapeutics Inc., S'holder Litig.),* A 3d 1173, 2015 LEXIS 231 (Del. May 14, 2015): Delaware Supreme Court reversed Chancery Court that, in the context of an interested transaction, had applied an automatic inference of disloyalty on disinterested, independent directors protected by an exculpatory charter provision (adopted in accordance with Del. Code Ann. Tit. 8 § 102(b)(7)), for motion to dismiss purposes, permitting the exculpated claims to survive.

- Delaware Supreme Court clarified that the determination of whether directors would be exculpated could be made prior to a fully-developed factual record and a determination as to whether the transaction was entirely fair, as long as no particularized pleadings have been made that, if true, would give rise to an inference of a breach of the duty of loyalty.

- “[A]pplying the entire fairness standard against interested parties *does not* relieve plaintiffs seeking damages of the obligation to plead non-exculpated claims against each of the defendant directors.

- Pleading standard requiring plaintiffs to sufficiently plead non-exculpated claims against exculpated independent directors (for example, claims for breach of duty of loyalty) applies regardless of whether standard of review of the underlying transaction is *Revlon, Unocal,* entire fairness or the business judgment rule.
Because the test for insolvency lies in a fairly gray area absent the requisite intensive review of a company’s financial position, directors should be mindful of creditors and all other stakeholders of the company when they think a company is approaching insolvency but may not yet be insolvent.

Once a company reaches the point of insolvency, however measured, directors’ fiduciary duties transfer from the corporation’s shareholders to its creditors: “The directors continue to have the task of attempting to maximize the economic value of the firm. That much of their job does not change. But the fact of insolvency does necessarily affect the constituency on whose behalf the directors are pursuing that end. By definition, the fact of insolvency places the creditors in the shoes normally occupied by the shareholders – that of residual risk-bearers.”

Because creditors are placed in the shoes of shareholders once the firm is insolvent, in theory, they may assert any of the same claims that previously belonged to shareholders, but such suits are generally limited to derivative suits.

Creditors may not be able to assert direct claims against a corporation’s directors at all, but if they are, such claims could only arise in very narrow and unique circumstances if such directors “display such a marked degree of animus towards a particular creditor with a proven entitlement to payment that they expose themselves to a direct fiduciary duty claim by that creditor.”
The question of whether a company is insolvent may be litigated within the context of a derivative suit, and the test for insolvency is more complicated than liabilities exceeding assets. Also, there must also be “no reasonable prospect that the business can be successfully continued.”

Even though directors may not simultaneously owe duties to creditors and shareholders, both groups, in theory, could bring simultaneous suits (although not both successfully).

The period when a corporation approaches insolvency or right after it enters insolvency is dangerous because it is a time when creditors and shareholders may take different positions on whether the corporation is solvent, and both groups may bring suits.

Although only one suit, at most, could stand, in order to avoid needless litigation, directors should take heed of potential duties to both groups.

Once a company does reach the point of insolvency, directors may not be fearful of making good faith decisions for the company which result in the company accumulating greater corporate debt, or other decisions which may turn out to deepen the company’s insolvency.

Nonetheless, directors must continue to be mindful that they continue to exert the degree of “skill, diligence, and care” that their constituents reasonably may demand.
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Navigating D&O Fiduciary Duties
Avoiding and Defending Fiduciary Duty Claims in Distressed Situations

Samuel S. Cavior, Esq.
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When Can D&Os Be Sued, and By Whom?

To whom fiduciary duties are owed vs. Standing to assert breaches

• Fiduciary duties of D&Os are owed to their corporation.
• Residual beneficiaries have *derivative* standing, on behalf of the corporation, to assert breaches.
  □ Solvent circumstances
  □ Insolvent circumstances
  □ Zone of insolvency
• Creditors never have standing to assert *direct* fiduciary claims.
• Creditors always have standing to assert direct *non-fiduciary* claims.
Types of Fiduciary Duty Claims

Failure to monitor

• Typically involves failure to monitor compliance with law

• Failed attempt to apply theory to business risk
  □ *In re Citigroup Inc. S’holder Deriv. Litig.*, 964 A.2d 106 (Del. Ch. 2009) (alleged failure to monitor exposure to subprime mortgage market)
  □ In principle, it may be possible for a plaintiff to assert bad faith conduct with respect to board oversight with the necessary degree of particularity.
Types of Fiduciary Duty Claims

Improper transaction approval
• Typical transactions include—
  - Mergers & acquisitions
  - Asset sales
  - Declaring & paying dividends
  - Obtaining financing
  - Providing guarantees or collateral, for affiliates

Deepening insolvency (?)
Standards for Review of D&O Conduct

“[A]lthough the fiduciary duties of the directors are unremitting, ‘the exact course of conduct that must be charted to properly discharge that responsibility will change in the specific context of the action the director is taking with regard to either the corporation or its shareholders.’

Standards for Review of D&O Conduct

Failure to monitor

• “[D]irector liability based on the duty of oversight ‘is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment.’” In re Citigroup, 964 A.2d at 123 (quoting In re Caremark, 698 A.2d at 967)

• “[A] showing of bad faith is a necessary condition to director oversight liability.” In re Citigroup, 964 A.2d at 123 (emphasis in original)

• “Only 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.” In re Caremark, 698 A.2d at 971

• Bad faith may be found where a director “intentionally acts with a purpose other than that of advancing the best interests of the corporation,...acts with the intent to violate applicable positive law, or...intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.” In re Walt Disney Co. Deriv. Litig., 906 A.2d 27, 67 (Del. 2006)
Standards for Review of D&O Conduct

Improper transactions – Business Judgment Rule

• Protects disinterested and independent directors from liability if they acted in good faith and followed a reasonable decision-making process, unless the decision is wholly irrational or the directors otherwise breached the duty of care or duty of loyalty.

• More specifically, the rule creates a rebuttable presumption that—
  □ a decision was made by directors, who
  □ were disinterested and independent,
  □ acted in subjective good faith, and
  □ employed a reasonable decision-making process.

• As long as those presumptions are not successfully rebutted, the directors’ decision will be reviewed not for reasonableness but for rationality—i.e., courts will not second-guess the wisdom of the business decision unless the decision cannot be attributed to any rational business purpose.
Standards for Review of D&O Conduct

Improper transactions – Business Judgment Rule (cont’d)

- To rebut the presumption, a complaining party must plead sufficient facts from which a court could reasonably infer that the board either breached its duty of care or breached its duty of loyalty.
  - Not necessary for all directors to be disinterested and independent. Absent a controlling stockholder, so long as the majority of the directors are not conflicted and a majority of the vote approves the transaction, the remaining directors’ conflicts (if fully disclosed) should not prevent review under the business judgment rule.
  - A reasonable decision-making process reflects a good faith attempt to gather, analyze and weigh the merits of all reasonably available material information about the subject matter being considered by the board, including alternatives.
Standards for Review of D&O Conduct

Improper transactions – Entire Fairness

- If the presumption of the business judgment rule fails or is rebutted, then the burden shifts—the directors must affirmatively prove the entire fairness of the transaction.

- Entire fairness means objectively fair, addressing two components:
  - Fair dealing - focuses on the actual conduct of corporate fiduciaries in the initiation, structure, and negotiation of a transaction.
  - Fair price.
Standards for Review of D&O Conduct

Improper transactions – Revlon Duties

• For certain significant corporate actions (e.g., sale of a business, change of control, merger, response to a bidder’s offer, break-up, etc.)
  □ Before applying any business judgment rule presumptions, courts employ an intermediate level of scrutiny between the business judgment rule and the entire fairness standard.

• Once in “sale” mode, so-called “Revlon duties” require directors to try to secure the highest value reasonably attainable for the benefit of the stockholders
  □ Each step in the sale process must be aimed at maximizing short term value for stockholders.
  □ Sale process itself must be fair – may favor a particular bidder only if the board believes it will facilitate the best transaction for stockholders.
Selected Issues & Cases

• *In re Caremark Int’l Inc. Deriv. Litig.*, 698 A.2d 959 (Del. Ch. 1996)
  - Director liability for failure to monitor is predicated on utter failure to implement any reporting or information system or controls, or else conscious failure to use reporting or information system or controls to monitor or oversee operations.
  - Duty of care includes an obligation to implement some compliance measures.

• *Stone v. Ritter*, 911 A.2d 362 (Del. 2006)
  - Failure to act in the face of a known duty to act is a breach of the duty of loyalty, where it demonstrates conscious disregard of responsibilities to be discharged in good faith.

  - Directors breached duty of loyalty by abdicating decision-making authority to restructuring professional and failing to monitor execution of sale strategy.
Selected Issues & Cases

  
  - Denying motions to dismiss fiduciary duty claims against directors of parent and directors of wholly-owned subsidiaries.
  - If a wholly-owned subsidiary is insolvent—
    - its directors cannot act to benefit the parent company without considering creditors’ interests, any more than directors may neglect the interests of minority shareholders.
    - its parent’s directors cannot control the subsidiary in a way that benefits the parent to the detriment of the residual beneficiaries of the subsidiary.

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Selected Issues & Cases

• *In re Puda Coal, Inc. Stockholders Litig.*, Case No. 6476-CS (Del. Ch. Feb. 6, 2013) (bench ruling)
  □ Denying motion to dismiss a failure to monitor claim against independent U.S. directors who for two years had failed to discover that the entire asset base of the China-based company had been sold out from under them.
  □ “Independent directors who step into these situations involving essentially the fiduciary duty of oversight have a duty not to be dummy directors. I’m not mixing up care in the sense of negligence with loyalty here, in the sense of your duty of loyalty. I’m talking about the loyalty issue of understanding that if the assets are in Russia, if they’re in Nigeria, if they’re in the Middle East, if they’re in China, that you’re not going to be able to sit in your home in the U.S. and do a conference call four times a year and discharge your duty of loyalty. That won’t cut it.”
Selected Issues & Cases

  - Non-independent board of an insolvent company pursued a risky business strategy in which the primary beneficiary of any upside would be the controlling parent, while the downside would fall entirely on creditors.
  - Creditors argued that the directors owed a duty of loyalty to them, as the primary residual claimants, which required the board to meet the entire fairness standard.
  - “The fault in this reasoning lies not in the theory, but in its application to business decisions that generally affect the value of the entity as a whole and which do not confer specific benefits on the directors themselves or, in dual-fiduciary situations, on the competing beneficiaries of fiduciary duties.... [W]hen directors make the decisions that appear rationally designed to increase the value of the firm as a whole, Delaware courts do not speculate about whether those decisions might benefit some residual claimants more than others.”
  - Court distinguished transactions to transfer value from the insolvent corporation to its controlling parent, which would be evaluated under the entire fairness standard, and for which creditors could assert a derivative fiduciary claim.
Deepening Insolvency

• Claim is for mismanagement, using a hindsight test.
• Typically, defendants conceal the corporation’s true financial condition in raising debt capital, leading to greater losses for creditors in a later liquidation.
• The theory is that D&Os breached a fiduciary duty owed to creditors by prolonging the life of the corporation, either fraudulently or negligently, at creditors’ expense.

• *Trenwick Am. Litig. Trust v. Ernst & Young, LLP*, 906 A.2d 168 (Del. Ch. 2006)
  □ Delaware state courts have categorically rejected the existence of a cause of action for deepening insolvency.
  □ As long as a board acts with due diligence and in good faith, “directors are protected by the business judgment rule” even if the chosen strategy results in a deepening insolvency.
  □ Delaware law does not require the board to shut down an insolvent corporation and manage towards a near-term dissolution for the benefit of creditors.
Deepening Insolvency

- *Trenwick* (cont’d)
  - “Even when the company is insolvent, the board may pursue, in good faith, strategies to maximize the value of the firm.”
  - “Even when a firm is insolvent, its directors may, in the appropriate exercise of their business judgment, take action that might if it does not pan out result in the firm being painted in a deeper hue of red.”
  - “If a plaintiff cannot state a claim that the directors of an insolvent corporation acted disloyally or without due care in implementing a business strategy, it may not cure that deficiency simply by alleging that the corporation became more insolvent as a result of the failed strategy.”
  - Chancery Court decision was affirmed *en banc* by the Delaware Supreme Court, which also cited it in *Gheewalla*.

- *Seitz v. Detweiler, Hershey & Assoc. (In re CitX Corp)*, 448 F.3d 672 (3d Cir. 2006)
  - Deepening insolvency is not a valid theory of damages for an independent cause of action.
Deepening Insolvency

- *Official Comm. of Unsecured Creditors v. Baldwin (In re Lemington Home for the Aged)*
  
  - 659 F.3d 282 (3d Cir. 2011): While acknowledging that recent Delaware case law has called into question the viability of deepening insolvency as a cause of action, the Third Circuit noted that it was bound by its prior ruling in *Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340 (3d Cir. 2001), which only an *en banc* ruling can overturn.
  
  - Case 13-2707 (3d Cir. Feb. 23, 2015): Jordan, J., concurring in denying a petition for rehearing *en banc*, while noting—
    
    ▪ “much has changed in the acceptance of deepening insolvency,” which has been “widely repudiated,” and
    
    ▪ “there is reason to believe that our prediction in *Lafferty* [that the Pennsylvania Supreme Court would support deepening insolvency]...has been undermined and ought to be reconsidered.”
Deepening Insolvency

• As a measure of damages?
  □ Even if not an independent cause of action, deepening insolvency may still be used as measure of damages in connection with fiduciary breach claims.
  □ *Silverman v. KPMG, LLP (In re Allou Distribs., Inc.)*, 395 B.R. 246, 264-65 (E.D.N.Y. 2008) (“Courts in this Circuit have considered deepening insolvency as a basis for damages that may result from the commission of a separate tort.”).
Minimizing Risk of Fiduciary Duty Claims

Avoiding failure-to-monitor claims

• Act in subjective good faith
• Understand the business and industry
  □ Stay informed and current
  □ Obtain and review financial reports, analyst reports and articles
  □ Pay attention to “red flags”
• Implement appropriate monitoring and reporting systems
• Stay involved and engaged
  □ Challenge information, test reporting systems
  □ Cannot “abdicate” responsibilities to a professional advisor/CRO
  □ Cannot just “sit in your home in the U.S. and do a conference call four times a year”

• Create a record of steps taken in performing duty of loyalty
Minimizing Risk of Fiduciary Duty Claims

Avoiding transaction-based claims

• Preserve the presumptions of the Business Judgment Rule
  □ Establish and implement a reasonable decision-making process
  □ Be informed of all material information reasonably available, including with respect to alternative transactions
    ▪ Retain (and adequately supervise) qualified independent advisors, including with respect to valuation and marketing of assets
    ▪ Collect and review relevant information in advance of meetings
    ▪ Ensure sufficient time is provided to review and digest the information
  □ Truly consider the transaction, as well as any alternative transactions, on the basis of all reasonably available material information
    ▪ Ideally, attend meetings in person
    ▪ Ask questions, and obtain a thorough understanding of materials
    ▪ Deliberate
Minimizing Risk of Fiduciary Duty Claims

Avoiding transaction-based claims

• Preserve the presumptions of the Business Judgment Rule (cont’d)
  □ Actually take a decision, based on a good faith belief that it is in the best interest of the corporate enterprise as a whole (and determine solvency, if in question)
  □ Ensure that the decision-making process is not influenced by any self-interest of officers, directors or other parties
    ▪ Disclose all potential conflicts
    ▪ Be aware of potential parent/subsidiary conflicts
    ▪ Abstention from deliberations and voting by conflicted directors
    ▪ Retain independent directors and appoint special committees

• Create a record of steps taken in performing duties of care and loyalty
Exculpation

- State laws allow for corporate charters to limit or eliminate personal financial liability of D&O for breach of certain fiduciary duties.
  - Delaware GCL § 102(b)(7)
  - Model Business Corporation Act § 2.02(b)(4)
- This exculpation applies only to breaches of the duty of care, and not—
  - Breach of duty of loyalty [DGCL § 102(b)(7)(i)]; intentional infliction of harm to the corporation [MBCA § 2.02(b)(4)(B)]
  - Acts or omissions not in good faith [DGCL § 102(b)(7)(ii)]; intentional violation of criminal law [MBCA § 2.02(b)(4)(D)]
  - Willful or negligent conduct in paying dividends [DGCL §102 (b)(7)(iii)]; unlawful distributions [MBCA § 2.02(b)(4)(C)]
  - Transactions where director obtains improper personal benefit [DGCL § 102(b)(7)(iv)]; amount of financial benefit received by director to which director is not entitled [MBCA § 2.02(b)(4)(A)]
Exculpation

When breaches of the duty of care are entwined with breaches of the duty of loyalty, the exculpation provision will not automatically protect directors from personal financial liability for duty of care breaches. For example—

- if failure to monitor is viewed as breach of duty of loyalty
- *Alidina v. Internet.com Corp.*, 2002 WL 31584292 (Del. Ch. Nov. 6, 2002) (“When a duty of care breach is not the exclusive claim, a court may not dismiss [the duty of care claim] based upon an exculpatory provision.”)

Also, although exculpatory provisions can release directors from liability for breaches of the duty of care, it does not eliminate the requirement that directors *act* with due care.

- Directors must continue to exercise due care if their decisions are to be afforded the protections of the business judgment rule.
- Breach of the duty of care is still applicable in remedial contexts other than personal damages, such as actions seeking injunctive relief or rescission.
Indemnification

- Companies can agree to indemnify D&Os, subject to certain conditions.
- Delaware GCL § 145 authorizes corporations to indemnify directors, officers, and agents, as long as the person—
  - acted in good faith; and
  - reasonably believed that the challenged conduct was in (or was not opposed to) the best interests of the corporation; or
  - with respect to a criminal proceeding, had no reasonable cause to believe the conduct was unlawful.
Bankruptcy Issues

- Corporate governance rules still apply after a company files for bankruptcy.
- Filing under Bankruptcy Code does not require insolvency.

Standing

- *Gheewalla* makes clear that creditors have standing to assert *derivative* claims against directors on behalf of an insolvent corporation, for breach of fiduciary duties.
- But once a company files for bankruptcy, any derivative claims that could be asserted on behalf of the company become property of the bankruptcy estate, and may be asserted only by the trustee or debtor-in-possession.
  - *In re The 1031 Tax Group, LLC*, 397 B.R. 670, 680-81 (Bankr. S.D.N.Y. 2008) (fiduciary duty and negligence claims are derivative and belong to the trustee)
Bankruptcy Issues

• Standing (cont’d)
  □ Creditors (or the Committee) can obtain standing to assert the estate’s claims under certain circumstances:
    ▪ A colorable claim for relief exists, prosecution of the action is likely to benefit the reorganization, the debtor has unjustifiably refused a demand to bring suit, and with leave of court. See, e.g., Unsecured Creditors Comm. of STN Enters., Inc. v. Noyes (In re STN Enters., Inc.), 779 F.2d 901 (2d Cir. 1985); In re Perkins, 902 F.2d 1254 (7th Cir. 1990)
    ▪ Note, however, the fact that creditors obtained standing in bankruptcy to prosecute derivative claims does not automatically divest the trustee or debtor in possession from settling those claims.
  □ Often, under the debtor’s plan of reorganization, the corporation’s derivative claims are transferred to a litigation trust for the benefit of creditors.
Bankruptcy Issues

- Automatic stay
  - Stay provided by section 362 of the Bankruptcy Code covers only the debtor.
    - would not prevent action against D&Os (e.g., on non-fiduciary direct claims)
    - (it may be safer to seek relief from the automatic stay)
  - Under section 105, the court may use equitable powers to extend the stay to D&Os.
    - Must show that suit against D&Os is really a suit against the debtor or its assets, or that the litigation would harm the reorganization effort by unduly distracting essential D&Os from participating.

- Indemnification claims
  - General unsecured claims, often receiving small distribution
  - Subject to disallowance or subordination
Bankruptcy Issues

- Releases
  - Plan of reorganization can provide for release of claims against D&Os, by (a) the debtor company, and (b) its creditors.
  - Debtor company may release claims against D&Os in a proper exercise of business judgment. *In re Spansion, Inc.*, 426 B.R. 179 (Bankr. D. Del. 2010)
  - Third party releases of claims against D&Os:
    - Non-consensual: controversial, and not allowed in some Circuits.
      - Prohibited in the Fifth, Ninth and Tenth Circuits.
        - *In re Zale Corp.*, 62 F.3d 746 (5th Cir. 1995)
        - *In re Lowenschuss*, 67 F.3d 1394 (9th Cir. 1995)
        - *In re Western Real Estate Fund*, 922 F. 2d 592 (10th Cir. 1990)
      - Even where allowed, may be difficult to obtain.
        - *In re Metromedia Fiber Network Inc.*, 416 F.3d 136, 143 (2d Cir. 2005) (appropriate only in “truly unusual circumstances”)
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D&O Insurance Issues in the Context of Bankruptcy

*Strategies and Pitfalls on the Road to Maximizing Coverage*

Alexander D. Hardiman, Esq.

Strafford Publications Teleconference
August 19, 2015
Disclaimer

- The views expressed by the participants in this program are not those of the participants’ employers, their clients, or any other organization. The opinions expressed do not constitute legal advice, or risk management advice. The views discussed are for educational purposes only, and provided only for use during this session.
Overview

- Who does D&O Coverage Belong to?
  - Debtor Entity
  - D&Os
  - Both
- Accessing Coverage and the Bankruptcy Stay
  - Section 302(c) Stay and Policy Proceeds
- Key D&O Policy Provisions to Maximize Coverage
D&O Insurance is the Last Line of Defense

First line of defense

Statutory Protection

Corporate By-laws

Corporate Indemnification Agreements

Last line of defense

Traditional D&O Insurance
ABCs of D&O Coverage

• Side “A”
  - Direct coverage for D&Os to the extent that the entity is not permitted to indemnify or cannot indemnify due to insolvency

• Side “B”
  - Coverage for the entity for reimbursement of amounts paid to indemnify D&Os

• Side “C”
  - Direct coverage for the entity, but for public companies generally limited to securities claims
“D & O policies are obtained for the protection of individual directors and officers . . . Unlike an ordinary liability insurance policy, in which a corporate purchaser obtains primary protection from lawsuits, a corporation does not enjoy direct coverage under a D & O policy. It is insured indirectly for its indemnification obligations. In essence and at its core, a D & O policy remains a safeguard of officer and director interests and not a vehicle for corporate protection.”

*In re First Cent. Fin. Corp.*, 238 B.R. 9, 16 (Bankr. E.D.N.Y. 1999)
Where’s My D&O Policy!?

- D&O policies generally considered property of the bankruptcy estate
  - Minoco Group of Cos., Ltd. v. First State Underwriters Agency of New England Reinsurance Corp., 799 F.2d 517, 519 (9th Cir.1986) (declaring a D & O policy property of the estate thereby disallowing insurance company's attempt to cancel the policy)
  - In re Allied Digital Technologies Corp., 306 B.R. 505, 509 (Bankr.D.Del.2004) (“In fact an overwhelming majority of courts have concluded that liability insurance policies fall within § 541(a)(1)'s definition of estate property.”)
Where Are My D&O Policy Proceeds!?

Courts Disagree Whether “Proceeds” of D&O Policy are Property of Estate

- **In re Downey Fin. Corp., 428 B.R. 595, 603 (Bankr.D.Del.2010)** (“the courts are in disagreement over whether the proceeds of a liability insurance policy are property of the estate.”)
- **In re CyberMedica, Inc., 280 B.R. 12, 16 (Bankr.D.Mass.2002)** (“Whether the proceeds of a D & O liability insurance policy is (sic) property of the estate must be analyzed in light of the facts of each case.”)
- **In re Medex Reg'l Labs., LLC, 314 B.R. 716, 720 (Bankr.E.D.Tenn.2004)** (same)
Where Are My D&O Policy Proceeds!?

“Proceeds” Analysis Factors:
- Does debtor entity have a “direct interest” in proceeds?
- Have the D&Os made claims for indemnification against the debtor entity?
- Does the D&O Policy provide Side “C” entity coverage
Where Are My D&O Policy Proceeds!?

Proceeds Not Property of Estate Despite Side “B” coverage:

- **La. World Exposition, Inc. v. Fed. Ins. Co., (In re La. World Exposition, Inc.),** 832 F.2d 1391, 1399 (5th Cir.1987) (holding that the debtor has no ownership interest in proceeds of an insurance policy where the obligation of the insurance company is only to the directors and officers)

- **In re Daisy Sys. Sec. Litig.,** 132 B.R. 752, 755 (N.D.Cal.1991) (finding that when a D & O insurance policy only provides direct coverage to the directors and officers the proceeds are not property of the estate).
Where Are My D&O Policy Proceeds!? 

- Proceeds May Be Property of Estate Because of Side “B” Coverage:
  - *In re Leslie Fay Cos., Inc.*, 207 B.R. 764, 785 (Bankr. S.D.N.Y. 1997) (“Here, the debtors have an interest in those proceeds because of the possibility that the class action might deplete the policy and theoretically force claims for indemnification to fall upon the estate.”).
Where Are My D&O Policy Proceeds!?

• Proceeds Are Property of the Estate Because of Side “C” Coverage:
  - In re Sacred Heart Hosp. of Norristown, 182 B.R. 413, 420 (Bankr. E.D. Pa. 1995)(“Proceeds available for the Debtor’s liability exposure are not segregated from the proceeds available to the directors and officers. Thus, the Debtor is indeed an insured and has a sufficient interest in the Proceeds as a whole to bring them into the estate.”).
  - In re Vitek, Inc., 51 F.3d 530 (5th Cir. 1995);
Where Are My D&O Policy Proceeds!?  

- **Proceeds Not Property of the Estate Despite Side “C” Coverage:**
Two “Proceeds” Case Studies


• In re MF Global Holdings Ltd., 515 BR 193 (Bankr. S.D.N.Y. 2014)
Maximizing D&O Protection

- Priority of Payments Provision
- Non-Rescindable Side “A” Coverage & Severability
- Presumptive Indemnification Clauses
- Insured v. Insured Exclusion
- Change in Control Provisions & Tail Coverage
- Side “A” Only Policies
- Excess Coverage & Exhaustion
Maximizing D&O Protection

- Priority of Payments Provision
  - Side “A” payments have priority over Side “B” or Side “C” payments
  - Assists or may be determinative in overcoming policy “proceeds” issue
  - Limits uncertainty over D&O defense cost funding
Maximizing D&O Protection

- Non Rescindable Side “A” Coverage:
  - Attempts by insurer to void or rescind coverage based on fraud or misrepresentation
  - Non Rescindable Side “A” Endorsement bars rescission
  - Severability provisions also limit the imputation of knowledge between insureds for rescission / voiding of coverage
Maximizing D&O Protection

- Presumptive Indemnification Clauses:
  - Indemnification of D&O by entity is “presumed” (i.e. if entity is required or permitted to indemnify) then retention applicable to Side “B” applies
  - Include provision stating that presumptive indemnification is inapplicable in the event of “financial insolvency or “financial impairment”
Maximizing D&O Protection

- Insured v. Insured Exclusion (I. v. I)
  - Excludes coverage for claims of entity against D&Os and vice-versa
  - Most I v. I exclusions contain carve out for bankruptcy related claims but often concern coverage for claims by receiver, liquidator, chap 7 trustee
  - Ensure that carve-out is provided claims by DIPs, chap 11 trustee, creditors etc.
Maximizing D&O Protection

- Change in Control Provisions & Tail Coverage:
  - Change in management control as a result of 50%+ change of control on board of directors or sale of all or substantially all of assets
  - Change in control as a result of pre-packs, asset sales, reorganizations
  - Coverage terminates for claims arising out of post-change of control wrongful acts
  - Tail Coverage provides additional time to report claims arising out of pre-policy termination wrongful acts
Maximizing D&O Protection

• Side “A” Only Policies:
  - Side “A” Excess: Triggered when all underlying Side “A” coverage has been exhausted
  - Side “A” Excess “DIC”: Triggered when all underlying coverage has been exhausted and “drops down” when underlying insurer refuses to pay or is insolvent
  - Side “A” “IDL” – Side “A” coverage for independent directors
Maximizing D&O Protection

• Excess Coverage & Exhaustion:
  ▪ Underlying coverage must be exhausted before excess is triggered
  ▪ Ensure that excess policies provide for exhaustion of the underlying limits by the policyholder to avoid forfeiture of coverage arguments by excess insurers in the event of settlements with underlying insurers
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