SPOTLIGHT ON CORPORATE GOVERNANCE: YOUR DUTIES AS A DIRECTOR

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The topic of director fiduciary duties is one of the most fundamental and important ones in corporate restructuring law. Boards of directors need to consider their fiduciary duties as well as measures that can be taken to mitigate risks and potential liability.

Fiduciary duties are typically owed to the company for the benefit of its owners.

While each state has its own interpretation of fiduciary duties, the general rule is that a corporation owes fiduciary duties to the corporation itself and its owners. Importantly, that rule shifts when a company is insolvent. During insolvency, the board owes its duties to the corporation and its creditor constituency.

It is important to note that Delaware law no longer holds that fiduciary duties shift from the equity holders to creditors when a company is approaching the infamous "zone of insolvency," and fiduciary duties continue to be owed to the enterprise as a whole.

There is no single definition of insolvency.

Courts apply a number of tests to determine when a company is insolvent. Such determinations include reviewing whether: (i) the value of a company's liabilities exceeds the value of its assets (the "balance sheet test"), or (ii) a company's cash flow is no longer sufficient to satisfy obligations as they become due in the ordinary course of business (the "equitable insolvency test"). Moreover, insolvency can occur gradually or all at once, including due to a liquidity shortfall triggered by the loss of a key customer or financing relationship. In the current environment, if a company knows (or should know) that it will not be able to meet its obligations, it may indeed have reached the point of insolvency.

In practice, it is challenging to determine when insolvency occurs, especially for early-stage companies that lack recurring sources of revenue. Forecasting cash flows and outflows is key, and a company should be conservative in its cash planning. It may be necessary for companies to seek emergency funding from their current investors or outside sources. A board should seek the advice of its advisors to help determine how

much runway a company has and whether additional capital is available to stave off insolvency.

Fiduciary duties include the twin duties of care and duty of loyalty.

The actions of directors, and the fiduciary duties that underlie them, are governed by the law of the state in which a company is organized or formed. These duties typically include the duty of care and the duty of loyalty, and they require a board to act in good faith and in the best interests of the corporation and its stakeholders.

Directors' and fiduciary duties include the following:

Duty of Care – The duty of care requires fiduciaries to exercise the care which ordinarily careful and prudent men would use in similar circumstances.

Duty of Loyalty – The duty of loyalty obligates a fiduciary to act in "good faith" and refrain from putting his or her interests ahead of those of the corporation. In short, the duty of loyalty is intended to ensure a director (or officer) does not act in its own self-interest, but rather in the best interest of the company.

The duty of care requires a board to stay informed and make decisions with requisite care.

To meet the duty of care, a board should examine all relevant information about the business that is reasonably available and, in making decisions, consider all relevant information and reasonable alternatives. This may even permit a board to approve transactions that carry real execution risk, so long as the decisions are well-informed and the risks of success are properly weighed against the likelihood of failure. As the Delaware Chancery Court noted back in 2006 in the Trenwick decision, "the mere fact that a business in the red gets redder when a business decision goes wrong and a business in the black gets paler does not explain why the law should recognize an independent cause of action based on the decline in enterprise value . . ."

In practice, and especially when insolvency is a consideration, a board should consult with its advisors to ensure that it is taking the necessary actions to protect the business. In discharging the duty of care, directors may reasonably rely on the advice of advisors whom the directors reasonably believe are acting in their respective areas of professional expertise.

During a liquidity shortfall, it is particularly important that directors and officers preserve cash to pay employee wages and benefits as well as employment-related taxes; otherwise, directors and officers may face personal liability if they continue to allow employees to work beyond the point in time at which they know the corporation does not have sufficient funds to pay wages, benefits, and related tax liabilities.

The duty of loyalty requires a board to balance the interests of various constituencies.

Directors must act in good faith and in a manner they reasonably believe to be in the best interests of the business enterprise. It is of particular importance for employees of venture capital funds who sit on boards of portfolio companies to recuse themselves from decisions that may create the appearance of a conflict between the interests of the corporation and the interests of the fund. For example, if a venture capital fund is seeking to provide the company with "rescue financing," board members associated with the fund or sponsor should not be part of the decision-making process and the company should consider all reasonably accessible potential sources of capital before agreeing to funding from existing sources.

If a board member is involved in a fiduciary dispute, and that decision is later challenged, courts may look to the "entire fairness" of the transaction. That is, courts will take a closer look at whether the transaction was the product of both fair dealing and fair pricing. It is of great importance that a board obtain proper counsel before entering into a transaction that could later be challenged as self-dealing.

The actions of a board and management team are generally - but not always - protected.

If you are a reasonably informed and involved director during a corporate restructuring — whether appointed pre-restructuring or specifically in a restructuring context — the law generally has your back. It was common in years past for restructuring lawyers to tell the board of directors of a distressed corporation that they had entered the "zone of insolvency," a confusing place where normal fiduciary duties to the corporation changed and the risk of director liability increased. Taking risks that might increase creditor losses was discouraged, even when the pay-off of a successful rescue strategy was substantial. In other words, for a director, the zone of insolvency was a place where his or her ordinary expertise was no longer relevant and the prudent director was the one who walked quietly down the path of least resistance. Corporate law today protects legitimate corporate risk-taking by distressed corporations and their directors.

In most circumstances, assuming the above-mentioned rules are followed, a board's decision-making will be protected. However, if a board's decision-making is

subsequently challenged, a court will typically avoid second-guessing decisions by deferring to the "business judgment" exercised by directors.

But, certain actions will remove this protection from a board's determinations. Obvious pitfalls include engaging in self-dealing or insider transactions, committing fraud, and failing to fulfill certain corporate responsibilities. In addition, directors may be liable for the unlawful payment of dividends or unlawful stock repurchases when the corporation is undercapitalized. A board should discuss these pitfalls with its advisors before taking any such actions.

Practical measures for limiting director liability in the face of a liquidity crisis.

While there is no way to completely insulate a board and its directors from a breach of fiduciary duty lawsuit, boards may protect themselves by considering the following actions in consultation with their advisors:

- Maintain appropriate D&O insurance.
- Ensure that corporate books and records reflect a sufficiently deliberative process.
- Thoroughly review actions that may potentially prefer one constituency over another.
- Document the scope of fundraising efforts and alternatives to financings (such as a merger, asset sale, or reduction of operations).
- Exercise due care in approving transactions that may arguably leave a corporation inadequately capitalized, even if the corporation is solvent at the time.
- Disclose any potential conflicts of interest and scrutinize all insider transactions.
- If the decision is made to wind-down the company, create a realistic budget that allows for an orderly wind-down process in order to maximize value for stakeholders.
- It may be sensible to consider (and budget for) purchasing a longer tail on D&O insurance to ensure adequate coverage for challenges that might arise as to the actions - or inactions - of the board.

The board record should be clear that directors were adequately briefed about their fiduciary duties under applicable corporate law and were afforded sufficient time to ask questions of counsel. In many circumstances, the board's own involvement and view of the reasonableness of a particular corporation action will be critical evidence in support of a defense to a *post hoc* challenge as to the propriety of its actions.