

AMERICAN CORPORATE LAW: DIRECTORS' FIDUCIARY DUTIES AND LIABILITY DURING SOLVENCY, INSOLVENCY, AND BANKRUPTCY IN PUBLIC CORPORATIONS

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I. INTRODUCTION

This article examines contemporary differences in the fiduciary duties and liability of corporate directors and officials belonging to non-distressed public corporations, to corporate entities facing insolvency (approaching insolvency), and to those that eventually become insolvent. Delaware General Corporate Law is one of the most advanced and flexible corporation statutes in the United States. The Delaware Court of Chancery has over 200 years of legal precedent as a maker of corporate law.¹ As a result, cases from that state are examined in light of the evolving trend in fiduciary duties of corporate officers and directors.²

In the wake of a declining Wall Street market, exorbitant executive salaries, and lofty severance packages, frequently accompanied by dismal company performance, directors' duties and liability are given a closer look than ever before.³ Other constituents, such as corporate creditors, believe

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¹ EPSTEIN, FREER, ROBERTS & SHEPHERD, *BUSINESS STRUCTURES* 165 (Thompson & West, 2nd ed. 2007).

² The corporate law of the State of Delaware is said to be understood as a kind of de facto federal law, because most U.S. companies are incorporated in Delaware. See Bernard Black et al., *Legal Liability of Directors and Company Officials Part 1: Substantive Grounds for Liability (Report to the Russian Securities Agency)*, 2007 COLUM. BUS. L. REV. 614, 643 (2007).

³ In this vein, some proposed corporate governance reforms have been made with the goal of improving corporate governance, and they include iter alia: i) limiting board discretion

and often assert that directors owe them a fiduciary duty to consider their interest. Hence, with insolvency looming, corporate officers and directors may feel there is little incentive to protect corporate assets for shareholders, because those assets are likely to go to creditors. On the other hand, officers and directors may be tempted to use the creditors' money for their own benefit or to save the company.⁴ Yielding to such temptation may expose directors and officers to personal liability.

However, the true question here is whether there should be a shift in the directors' fiduciary duty and liability beyond the shareholders and corporation as the latter becomes financially distressed. Would a shift like that be justified? Another relevant question is whether this duty should be owed to the creditors of the corporation as it approaches insolvency, (i.e., enters the "zone of insolvency") or when it has finally become insolvent. Furthermore, how does recent case law address directors' fiduciary issues under these different corporate contexts? This paper examines the answers to such questions and proposes some guidelines that may help a distressed company's officers and directors limit their exposure to personal liability.

Traditionally, fiduciary duties involve those of care, loyalty and good faith. The duty of care requires directors to act as reasonable, prudent people under all circumstances. This requires a deliberative decision-making process based on full and credible information. The duty of loyalty, in turn, requires a fiduciary to act in good faith for the benefit of the corporation. Therefore, this duty prohibits self-dealing, misappropriation of corporate assets, conflicts of interest, lack of independence, and disloyal conduct. Lastly, the duty of good faith forbids conduct motivated by intent to impede,

regarding levels and structure of executive compensation (*See* TARP Standard Compensation and Corporate Governance, 74 Fed. Reg. 28394 (June 15, 2009) (31 C.F.R. pt. 30); Excessive Pay Shareholder Approval Act, S. 1006, Cong. 111th (2009); Excessive Pay Capped Deduction Act of 2009, S. 1007, Cong. 111th (2009); Corporate and Financial Institution Compensation Fairness Act of 2009, H. R. 3269, Cong. 111th (2009); ii) increasing shareholder influence in director elections through right of shareholders to access the company's proxy for certain shareholders nominations (SEC Proposing Rel., Facilitating Shareholders Director Nominations, proposed new Rule 14a-11 of the Securities Exchange Act of 1934; iii) providing shareholders with "advisory" vote on aspects of executive compensation (see proposed shareholder Bill of Rights Act, S. 1074, Cong. 111th (2009); Investor Protection Act of 2009, H.R. 3817 Cong. 111th (2009) (draft legislation delivered by the United States Department of the Treasury to the United States Congress on July 10, 2009). *See* The Report of the Task Force of the ABA Section of Business Law Corporate Governance Committee on Delineation of Governance Roles & Responsibilities, note 3 (August 2009).

⁴ Alan D. Lasko & Associates, P.C., *Avoiding Personal Liability when the Corporation is in the "Zone of Insolvency": A Guide for Directors and Officers*, (2004), <http://abiworld.net/newsletter/utc/vol2num3/zone.pdf> (last visited April 4, 2011).

interfere with, or harm the corporation.⁵ This duty invariably impacts the board as well as the interplay between officers and directors.

II. BRIEF OVERVIEW OF THE CORPORATE BOARD OF DIRECTORS & MANAGEMENT

In the traditional model of corporate structure, the board of directors manages the corporation's business. Although boards generally continue to maintain this central legal role, it is widely understood that, under modern corporate practice, it is the corporate executives who hold management functions, not the board members.⁶ Because the term *managing model* is now an inaccurate description (especially over the last 25 years), the term *monitoring model* has been adopted to recognize that management functions are no longer exercised by the board, but by senior executives.⁷ Hence, in classic governance theory, the role of the board is to oversee and limit the executive officers' exercise of power - a role for which the board is accountable to shareholders. This implies that, being the executive officers responsible to the directors and the directors directly responsible to shareholders, the framework rests on the shareholders' ability to effectively monitor and respond to the board's oversight of the corporation.⁸ This intended hierarchy between the boards and management was commonly reversed in the past. The directors' incentive to properly monitor management is undercut by some factors.⁹ Today, the monitoring model of

⁵ Elizabeth B. Burnette & Elizabeth Gomperz, *The New and Emerging Fiduciary Duties of Corporate Directors*, BANK DIRECTOR MAG., 1st quarter, 2009, http://www.bankdirector.com/issues/articles.pl?article_id=12013. The case of *Pereira v. Cogan*, 294 B.R. 449 (S.D.N.Y. 2003) illustrates how these duties may be evaluated. In this case, a corporation's bankruptcy trustee challenged transactions involving a stock redemption, excessive compensations to a company official, insider loans and the payment of non-business expenses. The court found that in the four year period during which the company was in the zone of insolvency, the directors among other things failed to discuss, investigate and approve the loans made to the corporate official; failed to set up procedures by which loans would be approved or to require the pledge of adequate collateral; and failed to investigate or determine whether the loans were fair to the corporation. For failure in the fiduciary duties of good faith, loyalty to the general creditors and due care to protect the general creditors, the directors and officers were held liable for over \$20 million. See Alan D. Lasko & Associates, *supra* note 4.

⁶ See MELVIN ARON EISENBERG, CORPORATIONS AND OTHER ORGANIZATIONS CASES AND MATERIALS 198 (9th ed. 2005).

⁷ *Id.*

⁸ See Edward Greene & Pierre-Marie Boury, *Post-Sarbanes-Oxley Corporate Governance in Europe and the USA: Americanisation or Convergence?* 1 INT'L J. DISCLOSURE & GOVERNANCE, 26 (2003).

⁹ These factors include: "the compromised status of officers serving in a dual capacity as directors; domination of the board by executive directors, particularly where a majority of

the board has been almost universally accepted and adopted by publicly held corporations in the United States.¹⁰ It is inadequate to say that the success of the monitoring model rests on its economic advantage in providing an additional system to monitor management efficiency (through the CEO and other executives).¹¹ However, looking at the board from either managing or monitoring model perspectives, the board of directors is composed of individuals selected by a company's shareholders¹² and is the ultimate

the board lacked independence; control by management of the supply of information to directors; the lack of sufficiently empowered or vigorous board committees; and subversion of non-executive director's independence through connections with management, such as consulting contracts and other business links." *Id.*

The issue of various constraints on the composition of the board is also an important factor to consider – the typical board generally includes a number of directors who are economically and psychologically tied to the corporation's executives, especially the CEO. Because a number of board seats are usually held by inside directors who are also executives of the corporation, the inside director is somewhat dependent on the CEO for both retention and promotion, and on other executives for day-to-day support. He is therefore unlikely to dissent at a board meeting from a line of action determined by the CEO. *See* EISENBERG, *supra* note 6, at 198. *See also* Florence Shu-Acquaye, *Smith v. Van Gorkom Revisited: Lessons Learned in Light of the Sarbanes-Oxley Act of 2002*, 3 DEPAUL BUS. & COMM. L.J. 19, at 48 (2004). However, with board functioning of monitoring senior executives, for this to be effectively done requires that the board consist of at least a majority of independent directors - independent of the executives. The Sarbanes-Oxley Act of 2002 mandates a certain level of board independence, i.e., have no material relationship to the company and its management, as determined by the board of directors, within certain parameters set forth in the listing rules. Both the Act and NYSE have fostered the notion of more independent board members through a mandatory board composition requirement. *See* Shu-Acquaye, *Id.* at 44. Today, the composition and practices for S & P 500 companies appears to have changed—the percentage of independent directors has grown from 78 % in 1998 to 82 % in 2008; fewer active CEOs and other similarly senior executives now serve on boards, with only 31% of new independent directors also holding position as active CEOs, chairman, president or vice chairman, down from 49% in 1998. *See* Spencer Stuart, *Spencer Stuart Board Index* (2008), http://content.spencerstuart.com/sswebsite/pdf/lib/SSBI_08.pdf.

¹⁰ EISENBERG, *supra* note 6.

¹¹ *Id.*

¹² The state laws and articles of incorporation or bylaws determine the manner by which the directors are elected to the board. A company may have a unitary board or staggered board of directors. In a unitary board system, all directors stand for election each year, whereas with a staggered board the directors are grouped into classes, (typically three classes, for example, the). Model Business Corporations Act (MBCA) provides in section 8.06 the allowance for classification into two or three groups of as equal size as possible), with one class of directors standing for election each year., *see* MODEL BUS. CORP. ACT § 8.06 (2008). *See* Lucien Arye Bebchuk, *Asymmetric Information and the Choice of Corporate Governance Arrangements* 4 (HARV. L. SCH. JOHN M. OLIN CENTER FOR LAW, ECON. AND BUS., Discussion Paper Series No. 398, 2002) *available at* http://lsr.nellco.org/harvard_olin/398. Theoretically, staggered terms ensure that a corporation will always have experienced directors in office; practically, two annual meetings would be required to replace a majority of the board of

decision-making body.¹³ The board selects the senior management team, acts as its advisor and counselor, and ultimately monitors its performance.¹⁴ Thus, the board typically delegates significant authority for day-to-day operations to a professional CEO and officers.¹⁵ The CEO and other executive officers therefore derive their authority from the boards, which are responsible for reasonable oversight and supervision of management.¹⁶ This is why the directors and management are said to have a contract with the corporation. In fact, the corporation is often described as an organization consisting of a nexus of contracts:¹⁷ those between the corporation and its

directors. This invariably means that even a majority shareholder cannot easily change corporate policy by simply electing an entirely new board. See CHARLES O'KELLY & ROBERT B. THOMPSON, *CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS* 149 (4th ed. 1999). However, boards are becoming more responsive to shareholders concerns. For example, a significant majority of S & P 500 companies (66%) recently adopted some form of a majority voting standard for uncontested director elections, thereby putting teeth to shareholders campaigns. See *The Report of the Task Force of the ABA Section of Business Law Corporate Governance Committee on Delineation of Governance Roles & Responsibilities* (August 2009) (hereinafter, the *ABA Section of Business Law CG Task Force*) <http://apps.americanbar.org/buslaw/committees/CL260000pub/materials/20090801/delineation-final.pdf>.

¹³ The directors' management power is exercised collectively and individual directors are not given agency powers to deal with outsiders. See O'KELLY & THOMPSON, *supra* note 12, at 136.

¹⁴ The MBCA, which has been adopted by over thirty states (with some variation in some states), provides in section 8.01 that all corporate powers shall be exercised by or under the authority of the board of directors of the corporation, and the business and affairs of the corporation shall be managed by or under the direction, and subject to the oversight, of the board of directors. DEL. CODE ANN. tit. 8, § 141(a) (2005) imports the same principle as the MBCA. The language of the MBCA emphasizes the board's responsibility to oversee management of the corporation.

¹⁵ However, certain board functions that are central to the focus of board management may not be delegated. This includes but not limited to:

Monitoring corporate performance and assessing whether the corporation is being appropriately managed by senior management team.

Selecting, monitoring, evaluating and compensating, and when necessary replacing the CEO and other key members of senior management.

Developing corporate policy; reviewing and approving financial objectives and major corporate actions.

Overseeing audit, internal controls, risk management and ethics compliance; overseeing financial reporting and related disclosures.

Declaring dividends and approving share repurchase programs. See *The Report of the Task Force of the ABA Section of Business Law Corporate Governance Committee on Delineation of Governance Roles & Responsibilities* (August 2009). *Id.*

¹⁶ See *id.*

¹⁷ Melvin A. Eisenberg, *The Conception that the Corporation is a Nexus of Contracts, and the Dual Nature of The Firm*, 24 J. CORP. L. 819 (1999) (stating that "corporate law is constitutional law; that is, its dominant function is to regulate the manner in which the corporate institution is constituted, to define the relative rights and duties of those

employees, suppliers, contractors, shareholders, and directors. The latter is the most important contract, as it relates to the directors' duties and obligations to the corporation. That is why it is not surprising that fiduciary duties are used to describe the shareholder-manager relationship, but not other relationships, such as the creditor-manager relationship. A shareholder's residual return depends on the discretionary performance of another and should require different protection than the creditor's fixed return with a senior claim to the assets of the enterprise.¹⁸

A director's powers to act on behalf of the corporation are derived from the state of incorporation. Regulation of the corporation by the laws of the state of incorporation is often referred to as the "internal affairs doctrine". This doctrine is also known as a "choice of law rule", since courts look to the laws of the incorporating state to determine the basic rights and duties applicable to a corporation.¹⁹ Consequently, state law, among other things, defines the directors' powers over the corporation;²⁰ in this vein, corporations are said to be the creatures of state law.²¹

III. FIDUCIARY DUTY OF CORPORATE DIRECTORS: TO WHOM IS THIS DUTY OWED?

The concept of fiduciary duty, a principal aspect of classic corporate law, consists in that management owes certain obligations (of care, loyalty, and good faith) to the corporation and its various stockholders. But as Berle and Means so clearly illustrated, there is a persistent tension between

participating in the institution and to delimit the powers of the institution vis-à-vis the external world.") *see generally* MELVIN ARON EISENBERG, *THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS* 16 (1976). *See also* Jenson & Meckling, *Theory of the Firm: Managerial Behaviour, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

¹⁸ *See* Robert Thompson, *The Law's Limits on Contracts in a Corporation*, 15 J. CORP. L. 377 (1990).

¹⁹ *See* O'KELLY & THOMPSON, *supra* note 12, at 140.

²⁰ State law, for example, determines the vote required to elect directors, powers of the shareholders to remove directors prior to the end of their term in office, etc.

²¹ *See* Stephen M. Bainbridge, *A Critique of the NYSE Director Independence Listing Standards*, 30 SEC. REG. L.J. 370 (2002). *See also* *Burks v. Lasker*, 441 U.S. 471 (1979). However, the Sarbanes-Oxley Act of 2002 and the SEC rules of implementation are said to have encroached upon state rights by not only regulating the internal affairs of the corporations, but also by being extensive in scope. For example, the Act assigned particular responsibilities and tasks to corporate officers in areas where previously, matters were generally left to their discretion and that of the board; or by mandating specific forms of corporate organization. Greene & Boury, *supra* note 8, at 23. *See also* Shu-Acquaye, *Corporate Governance Issues; United States and the European Union*, 3 HOUS. J. INT'L L., at 593 (2007) for a discussion on the Sarbanes-Oxley Act.

management's fiduciary obligation and its own self-preservation.²² Directors and officers, as corporate agents of the shareholders, are traditionally expected to act in the best interest of the corporation, often stated as the responsibility of maximizing wealth for the interest of the principal (the shareholders). However, adhering strictly to such responsibility would tend to exclude other constituents -namely employers, creditors, and the corporate community. Hence, the real issue is whether the fiduciary duty is owed only to the shareholders to the exclusion of other important constituents, such as creditors who usually have contractual rights against the company. It is also important to ask how the financial health of the company plays into this fiduciary duty at the various economic stages of the corporation: from solvency to *zone of insolvency* and finally, to insolvency? That is, the extent to which financial distress may affect the director duties of a troubled enterprise. Given the extent of the economic crisis and its impact on corporate governance, it is only natural to look at directors' fiduciary duties and determine if they should be extended beyond the traditional constituents when determining directors' liability. Therefore, the duties of care and good faith should be examined in light of corporate crisis. It has been argued that when a corporation becomes insolvent, creditors as residual risk-bearers replace shareholders. In such instances, the fiduciary duties are consequently owed to creditors of the corporation. Thus, as long as a corporation is financially sound, its creditors have no additional protection beyond legal enforceability of the terms of their contracts with the corporation. As a corporation approaches insolvency, however, the shareholders' interests decline in value and may eventually become worthless. The creditors, in turn, obtain an equitable interest in the corporation's assets as the ultimate source of the recovery of debt owed to them.²³

IV. LIABILITY OF OFFICERS AND DIRECTORS OF SOLVENT CORPORATIONS

A. The Duty of Care and the Business Judgment Rule

Because a company's affairs are generally managed by, or under the direction of, corporate directors, there is a standard they are expected to

²² Management has the discretion to exercise its specialized skills, and with discretion comes opportunities for abuse unless the law intervenes. Jensen and Meckling, who do not agree with Berle and Means hypothesis, hold that management has a strong incentive to contract with shareholders (by stock options, bonuses, etc.) to reduce their chances to depart from shareholder interest. See ADOLF BERLE, JR. & GARDENER MEANS, *The Modern Corporation and Private Property* (1932); Jensen and Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. & ECON. 305 (1976).

²³ Alan D. Lasko & Associates, *supra* note 4.

fulfill as they carry out their responsibilities. These responsibilities consist of two basic functions: a decision-making and oversight.²⁴ The latter generally involves the formulation of corporate policy and strategic corporate goals, while the former concerns periodic attention to corporate systems and controls, policy issues or any matter necessitating a director's inquiry.²⁵

As mentioned above, in carrying out their duties, directors are expected to act in good faith, in the best interest of the corporation, and with the care that a person in a similar position would reasonably deem appropriate.²⁶ Therefore, in managing the affairs of the company, directors owe a duty of care to the company and its stakeholders. In some states, the fiduciary duty of care is defined by judicial doctrine, whereas in others states, the statutory formulations replace or supplement the common law.²⁷ For those states that have adopted the Model Business Corporation Act, Section 8.30 delineates the standards of conduct for directors, by concentrating on the manner in which they perform their duties and the level of performance expected of them in managing the business dealings of the corporation.²⁸

In addition to their continuing duty to supervise and monitor the affairs of the corporation, directors are also responsible for making important business decisions.²⁹ Courts invoke the business judgment rule when assessing the conduct of directors and determining whether to impose liability in a particular case.³⁰ The business judgment rule, as a standard of judicial review, is the common law recognition of the statutory authority that has been vested in the board of directors.³¹

What exactly is the business judgment rule? It is a presumption of regularity that the board decisions are made after an informed and

²⁴ The general threshold standard is that every director must discharge his duties in good faith and in a manner the director reasonably believes to be in the best interest of the corporation. Florence Shu-Acquaye, *The Taxonomy of the Director's Fiduciary Duty of Care: United States & Cameroon*, 22 N.Y.L. SCH. J. INT. & COMP. L. 585, 592 n. 31 (2003).

²⁵ See THE BUSINESS LAWYER, CORPORATE DIRECTOR'S GUIDEBOOK 1578-84 (2001).

²⁶ MODEL BUS. CORP. ACT. § 8.30 (2008).

²⁷ Under Delaware law, Del. Code Ann. tit. 8 § 141 (a) (2011) available at <http://delcode.delaware.gov/title8/c001/sc04/index.shtml> provides that "the business and affairs of a Delaware corporation are managed by or under its board of directors." Also, the MODEL BUS. CORP. ACT. § 8.30(b) states "that members of the board...shall discharge their duties with the care that a person in a like position would reasonably believe appropriate under similar circumstances." This standard is often characterized as a duty of care. See also MODEL BUS. CORP. ACT. § 8.30.

²⁸ Directors are expected to perform their duties in "good faith" and in a manner reasonably believed to be in the corporation's best interest. MODEL BUS. CORP. ACT. § 8.30.

²⁹ O'KELLY & THOMPSON, *supra* note 12.

³⁰ *Supra* note 26.

³¹ MM Companies v. Liquid Audio Inc., 813 A.2d 1118, 1127 (Del. 2003).

reasonable investigation, in good faith, and with the honest belief that the decisions were made in the best interest of the corporation.³²

Although the business judgment rule is designed to foster the complete exercise of managerial power granted to directors, it is not an unfettered power.³³ Application of the business judgment rule is based on a demonstration that informed directors did in fact make a business judgment regarding the matter being examined.³⁴ A director's obligation to inform himself, in preparation for his decision, derives from the fiduciary capacity in which he serves the company and its stakeholders.³⁵ Therefore, to determine whether the directors' business judgment was informed, one needs to examine if turns on whether they took the necessary steps to inform themselves of all material and relevant issues prior to making the business decision.³⁶ Once this presumption is established, the decision of the board is protected from judicial review of the merits.³⁷ To overcome this presumption, a challenger must present evidence that directors failed in meeting their fiduciary duties and thus deserve to be stripped of the protection provided by the business judgment rule. Courts are generally reluctant to second-guess the board's decisions, as judges do not necessarily possess the corporate expertise and skills of the board.³⁸ Hence, a director or officer of a solvent corporation is therefore entitled to the protection of the business judgment rule unless a duty is breached. The shareholders,

³² Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984). The business judgment rule serves as a shield which protects directors from liability for their decisions. Where it is found that the directors should receive protection of the rule, the courts would not interfere with or second guess the directors' decision. If the directors are found not to be entitled to the protection of the business judgment rule, the courts would then scrutinize the directors' decision to determine whether it was intrinsically fair to the corporation and its shareholders. O'KELLY & THOMPSON, *supra* note 12, at 285.

³³ See generally Smith v. Van Gorkom, 488 A.2d, 858, 871 (Del. 1985); Hanson Trust PLC v. ML SCM Acquisitions Inc., 781 F.2d 264, 275 (2d Cir. 1986).

³⁴ Kaplan v. Centex Corp., 284 A.2d 119, 124 (Del. Ch. 1971).

³⁵ Lutz v. Boas, 171 A.2d 381 (Del. 1961).

³⁶ Aronson, 473 A.2d, at 812.

³⁷ See R. Franklin Balotti & Joseph Hinsey IV, *Director Care, Conduct and Liability*, 56 BUS. LAW 35, 37 (2000).

³⁸ See Caremark Int'l Derivative Litigation, 698 A.2d 959, 967 (Del. Ch. 1996) (*arguing against substantive judicial review of the board*). This reluctance was also expressed in Joy v. North, 692 F.2d 880, 866 (Conn. 1982). There are certain circumstances, however, "which mandate that a court take a more direct and active role in overseeing the decisions made and actions taken by the directors. Under such circumstances, the court subjects the directors' conduct to enhanced scrutiny to ensure that it is reasonable, before the protection of the business judgment rule may be conferred." UNOCAL Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954 (Del. 1985). See WILLIAM KLEIN, RAMSEYER & STEPHEN M. BAINBRIDGE, BUSINESS ASSOCIATIONS 36 (5th ed. Update 2004).

therefore, bear the burden of overcoming the presumption that directors and officers have complied with their fiduciary duties.³⁹

Delaware courts have also crafted other standards of review in different contexts that displace the business judgment rule. See *UNOCAL Corp v. Mesa Petroleum Co.*,⁴⁰ (enhanced scrutiny for defensive measures); *Mac Andrews & Forbes Holdings, Inc. v. Revlon, Inc.*,⁴¹ (duties attendant to a sale of control).

B. Liability of Officers and Directors during Insolvency or while Entering the “Zone of Insolvency”

While the corporate officer and director’s fiduciary obligation is to pursue the best interests of the shareholders in a normal or solvent corporation, case law, primarily from Delaware, establishes different fiduciary duty regimes that may apply when the company is in or approaching insolvency.⁴² Delaware defines insolvency as either “a deficiency of assets below liabilities with no reasonable prospect that the business can be successfully continued in the face thereof” or “an inability to meet recurring obligations as they fall due in the usual course of business.”⁴³ So, when a company is financially healthy, the directors owe fiduciary duties to the corporation and its shareholders. Once a corporation becomes insolvent, courts have traditionally refused to extend fiduciary duties for the benefit of creditors, propounding that creditor rights are limited by the terms

³⁹ See *Omnicare, Inc. v. NCS Healthcare*, 818 A.2d 914, 927 (Del. 2003).

The question then turns on what results when the board is stripped of the protection afforded under the business judgment rule? Once the business judgment rule presumption is pierced, upon a showing that the directors breached their fiduciary duty of care, the burden of proof shifts to the board of directors who must then demonstrate that the decision was intrinsically fair to the company and therefore warranted protection. In other words, the board must meet the two-part “fairness test” delineated in *Weinburger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983). The first prong of the “fairness test” is a demonstration that the transaction was the result of fair dealings by the board of directors. (Fair dealing encompasses questions of when the transaction was timed; how it was initiated; how the negotiated was structured; the manner in which the transaction was disclosed to the directors; and how the approval of the directors and shareholders was obtained. Fair price deals with the economic and financial considerations of the proposed merger, including such relevant factors as the market value of the assets, future earnings prospectus and any other factor that could affect the intrinsic value of the company’s stocks. O’KELLY & THOMPSON, *supra* note 12, at 258. The second element is met, if it is shown that a fair price was obtained.

⁴⁰ *UNOCAL*, 493 A.2d 946.

⁴¹ *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

⁴² *Rutherford Campbell, Jr. & Frost Brown, Managers Fiduciary Duties in Financially Distressed Corporations: Chaos in Delaware (and elsewhere)*, 32 IOWA J. CORP. L. 491, 500 (2007).

⁴³ *Id.*

of their contracts with the corporation.⁴⁴ Consequently, directors need not take creditors' interest into account in their decision-making process.⁴⁵

However, when a corporation becomes insolvent, creditors replace shareholders as the residual risk-bearers and the fiduciary duties owed to shareholders consequently shift to the creditors. That is, the creditors can assert a derivative claim on behalf of the corporation against the directors based on fiduciary duties. However, insolvency does not transform derivative claims into direct claims, but it provides creditors with standing to assert those claims belonging to the corporation itself.⁴⁶ There is an apparent distinction between being insolvent and approaching insolvency, the latter also known as *entering the zone of insolvency*.⁴⁷ In the case of corporations approaching insolvency, some courts hold that fiduciary duties are owed to both shareholders and creditors.⁴⁸ The Delaware Supreme Court rejects this

⁴⁴ Laura Lin, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Director's Duty to Creditors*, 46 VAND. L. REV. 1485, at 1510 (1993). The American Bar Foundation Commentaries on Indentures 2 (A.B.F., 1971), comments that the rights of a debt securities holder are largely a matter of contract law. There is no governing body of statutory or common law that protects the holder of unsecured debt securities against harmful acts by the debtor except in the most extreme situations. Short of bankruptcy, the debt security holder can do nothing to protect himself against actions of the borrowers which jeopardize its ability to pay the debtor unless he takes a mortgage or collateral or establishes his rights through contractual provisions set forth in the debt agreement or indenture. Id.

⁴⁵ *Id.*

⁴⁶ See *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, CA (quoting *Production Resources Group LLC v. NCT Group, Inc.*, 863 A2d 772, 776 (Del. Ch. 2004)).

⁴⁷ This is the period when the corporation is in financial distress, but may or may not be actually insolvent. There is no bright line rule for examining the exact point at which a corporation enters into the zone. Courts have followed several approaches including: being based on the period before insolvency in fact (also called balance sheet insolvency, occurs when a corporation's liabilities exceeds its assets); equitable insolvency, which is an inability to pay debts as they come due. See *Avoiding Personal Liability when the Corporation is in the "Zone of Insolvency": A Guide for Directors and Officers*, a publication from Alan D. Lasko & Associates, *supra* note 4.

⁴⁸ Bankruptcy, Restructuring and Commercial Law Advisory: Fiduciary Duties and Insolvency: Limiting Personal Liability in Tough Economic Times (2009), <http://www.jdsupra.com/post/documentViewer.aspx?fid=40e90886-fd37-4482-9d59-eba3f781012c>.

In the earlier Delaware case of *Credit Lyonnais Bank Nederland N.V. v. Pathe Commc'ns Corp.*, Civ. A. No. 12150, 1991 WL 277613 (Del. Ch. 1991), Chancellor Allan stated that when a corporation is operating in the vicinity of insolvency, the board of directors is not merely the agent of the residual risk bearers but owes its duty to the "corporate enterprise." He further stated that the board's obligation in such circumstances is "to the community of interest that sustained the corporation...to maximize the corporation's long term wealth creating capacity." Although the discussion of the court focused on two constituencies, shareholders and creditors, there are other corporate constituencies that might be included

notion by holding that officers and directors do not necessarily owe fiduciary duties to creditors of a company in the zone of insolvency. Those creditors cannot bring breach of fiduciary duty actions to recover individually, but may bring derivative claims on behalf of the corporations for such a breach.⁴⁹ Likewise, in the 2006 case of *Trenwick American Litigation Trust v. Ernst & Young L.L.P.*⁵⁰, the Delaware Court of Chancery explicitly rejected *deepening insolvency* as a cause of action against directors of an insolvent corporation. That is, creditors cannot hold directors liable for prolonging the lifespan of an insolvent corporation and worsening its financial state.⁵¹ Consequently, *Trenwick* departs from prior federal district and appellate court decisions recognizing the *deepening insolvency* theory.⁵² Vice Chancellor Strine, in rejecting this theory, reaffirmed that while directors of an insolvent corporation owe fiduciary duties to creditors, the directors' decision are still protected by the business judgment rule. However, if directors have breached their fiduciary duties in a way that worsens a corporation's insolvency, then that result may lead to additional damages. Nevertheless, the cause of action remains the same (breach of fiduciary duties) and the act of worsening a corporation's insolvency does not constitute a separate cause of action.⁵³ Hence, so long as directors adhere to their fiduciary obligations, they can continue to operate and pursue business strategies when a company is insolvent without fear of liability to creditors under a standard of review other than the business judgment rule.⁵⁴

in the "community of interest", including employees and community, and is therefore not very clear. Rutheford Campbell, Jr. & Christopher Frost, *supra* note 42, at 504. Chancellor Strine's dictum in *Production Resources* exacerbated the ambiguity in *Credit Lyonnais*, as he views *Credit Lyonnais* as merely creating a "shield" for corporate managers. This is a shield that allows managers operating in the vicinity of insolvency more discretion to make decisions that benefit creditors at the expense of shareholders. That is, the duty of corporate managers in the vicinity of insolvency continues to be an obligation to act in the best interest of shareholders, subject, however, to an expanded right (but not an obligation) to transfer wealth from shareholders to creditors. *Id.*

⁴⁹ *Id.*

⁵⁰ Court of Chancery of Delaware, New Castle, 906 A. 2d 168, 99 (2006).

⁵¹ The litigation trust attempted to hold the defendant directors liable for "deepening insolvency." The decision also held that, absent insolvency, a parent company's directors do not owe any particular duties to the wholly-owned subsidiaries. The wholly-owned subsidiary's directors' only duty is to serve the parent company unless the parent's directive would cause the subsidiary to violate its legal obligations. *See* 20 Richard Reinthaker, J. Rravis Laster, and Steven Hass, *An End to "Deepening Insolvency" as a Theory of Director Liability, Insights: THE CORPORATE & SECURITIES LAW ADVISOR*, no. 9 (Sept. 2006).

⁵² *See* Official Comm. of Unsec. Creditors v. R.F. Lafferty, 267 F.3d 340 (3d Cir. 2001) (recognizing deepening insolvency under Pennsylvania law); *OHC Liquidation Trust v. Credit Suisse First Boston*, 340 B.R. 510 (Bankr. D. Del. 2006).

⁵³ *Id.*

⁵⁴ *Id.*

The Delaware Supreme court in a 2007 decision, *North American Catholic Educational Programming Foundation, Inc., v. Gheewalla*,⁵⁵ C.A., affirming the Court of Chancery's decision on this intriguing issue, ruled that creditors of an insolvent corporation, or of a solvent corporation operating in the "zone of insolvency",⁵⁶ may not assert direct claims against the corporation's directors for breach of fiduciary duty. This closed the last narrow window that the Court of Chancery had left open in stating: "we hold that the creditors of a Delaware corporation that is either insolvent or in the zone of insolvency have no right, as a matter of law, to assert direct claims for breach of fiduciary duty against the corporate directors."⁵⁷ The Delaware Supreme Court therefore saw no basis for enlarging the scope of the duties owed by Clearwire's directors. The court observed that, while the protection of shareholders' interests is entirely dependent on directors acting as fiduciaries, creditors' interests are protected by, among other things, contractual agreements, general commercial law, and bankruptcy law.⁵⁸ The court viewed the extension of a director's fiduciary duty to the creditors in the wake of the corporation's financial distress as not only unnecessary, but counter-productive, and reaffirmed the Chancery Court's position that: "an otherwise solvent corporation operating in the zone of insolvency is one in most need of effective and proactive leadership—as well as the ability to negotiate in good faith with its creditors—goals which would likely be significantly undermined by the prospect of individual liability arising from the pursuit of direct claims by creditors."⁵⁹ In other words, when a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change. Directors must continue to fulfill their fiduciary duties to the corporation and its shareholders by exercising their business

⁵⁵ North American Catholic Educational Programming Foundation (NACEPF) was part of an alliance formed to hold FCC-approved spectrum licenses for microwave signal transmissions. The defendants were certain of the directors of Clearwire Holdings, Inc., a Delaware corporation (Clearwire), who were appointed by Goldman Sachs & Co., Clearwire's major investor. Clearwire breached an agreement to acquire the spectrum licenses held by NACEPF and its alliance members. Following Clearwire's failure, NACEPF sued the defendant directors, alleging that they breached fiduciary duties owed directly to NACEPF as a creditor of a corporation that was either insolvent or operating in the "zone of insolvency". See Thompson Hine, *Directors of Insolvent Corporation in Delaware Owe No Direct Fiduciary Duties to Creditors*, June 21, 2007 available at <http://www.thompsonhine.com/publications/3publication1130.html>.

⁵⁶ The Delaware Supreme Court did not find it necessary in view of its ultimate disposition of the case to provide a precise definition of what constitutes the "zone of insolvency".

⁵⁷ Thompson Hine, *supra* note 55.

⁵⁸ *Id.*

⁵⁹ *Id.*

judgment in the best interest of the corporation, for the benefit of its shareholders.⁶⁰

C. Duty of Corporate Officers and Directors during Bankruptcy

As a firm's financial situation worsens, individual creditor's natural incentive is to withdraw their capital, which inevitably leads to an inefficient liquidation of the corporate assets if unchecked.⁶¹ Hence, when the corporation files for bankruptcy under Chapter 11 of the United States Bankruptcy Code, there is a change in the fiduciary duties of corporate directors and officers. Chapter 11 substitutes a governance regime with one that includes creditor representation, negotiation and default rules regarding the allocation of value in reorganization plans, and judicial oversight over important decisions.⁶² Basically, Chapter 11 stays individual debt collection actions in favor of the continued operation of the business in a manner that allows for collective negotiations over the future of the firm. Creditors may not exercise non-bankruptcy contractual remedies, such as declaring a breach of managerial fiduciary obligations, and then withdraw capital. Rather, the Chapter 11 process substitutes a system of managerial duties to the "estate"⁶³ - specific voting rights, creditor representation, judicial supervision, and judicial approval of specific managerial decisions.⁶⁴ In other words, the directors and officers are still required to fulfill the fiduciary responsibilities of a trustee to act in the interests of both creditors and shareholders, often articulated by bankruptcy courts as the duty to maximize the value of the estate,⁶⁵ rather than to benefit a particular group of claimants.⁶⁶ In the same vein, the Bankruptcy Code neither require nor permits the bankruptcy judge to consider the effect of managerial decisions

⁶⁰ *Id.*

⁶¹ Campbell & Frost, *supra* note 42, at 508.

⁶² *Id.*

⁶³ Under the Bankruptcy Code, the term *estate* refers to all of the pre-bankruptcy corporation's property and interests in property. 11 U.S.C. § 541(a) (1988).

⁶⁴ Campbell & Frost, *supra* note 42, at 512.

⁶⁵ Again, this means that the duty to maximize the estate equates to the duty to maximize the value of the corporation's assets for the benefit of the shareholders and creditors without regard to the distributional outcome.

⁶⁶ *Id.* Managers' duties in Chapter 11 proceedings and how the opposing interests of creditors and shareholders must be delicately balanced is evidenced in Matter of Cent. Ice Cream Co., 836 F.2d 1068 (7th Cir. 1987) where shareholders of the debtor appealed an order of the bankruptcy court approving litigation between the debtor and a third-party. The creditors favored the settlement because it was enough to pay their claims in full. The district court affirmed the order and sanctioned two shareholders for challenging the settlement. In its order approving the settlement, the bankruptcy court made clear that it was guided by the best interests of the creditors.

on other constituents, such as employees or other non-investor constituencies.⁶⁷ Therefore, a primary source of funds for the bankruptcy estate consists of recovery from directors and officers, whose breach of fiduciary duties may have contributed to the company's insolvency.⁶⁸

Clearly, the filing of a corporate bankruptcy under Chapter 11 heralds a substantial change in the governance of the corporation. As previously mentioned, there is an inevitable change in the fiduciary duties of directors and officers of the corporation. This shift is compounded by the conflicts of interest between shareholders and creditors from the inception of a loan, heightened as the financial condition of the company deteriorates and its debt equity ratio increases.⁶⁹

V. STATUTORY EXCULPATORY PROVISIONS AND DIRECTOR'S FIDUCIARY DUTY.

It has become commonplace for directors to be held personally liable for actions taken by directors and officers even when such actions involve neither dishonesty nor self-dealing. The question then, is whether it is efficient to expose directors to draconian potential liability for breaching the duty of care? Would the shareholders' interest be served, given that directors may become overly cautious in carrying out their duties or refuse to serve on boards?⁷⁰ Consequently, many corporate charters now contain exculpatory provisions, protecting directors from personal liability for breaches of the fiduciary duty of care. Hence, the traditional bulwark against personal exposure has led to the directors' and officers' liability insurance, the so-called "D & O" insurance,⁷¹ which may provide a means for corporations to

⁶⁷ See Christopher W. Frost, *Bankruptcy Redistributive Policies and the Limits of the Judicial Process*, 74 N.C. L. REV. 75 (1995). This may be understood in the context that non-shareholder constituencies are generally expected either to price the risk that management actions may not necessarily be in their best interests or mitigate or eliminate such risks through contract provisions. *Id.*

⁶⁸ Dennis Klein and Mira Edelman, *Litigating against Directors and Officers of Bankruptcy Dot-Com Entities: A Potential Asset for Debtor's Estate*, 27 DEL. J. CORP. L. 804 (2002). Another possible area of recovering losses is because of director or officer mismanagement. Director & Officer (D & O) Coverage under the Corporate Insurance Policy, *id.*, at 809. See discussion below.

⁶⁹ See MICHAEL JENSEN AND CLIFFORD SMITH, JR., STOCKHOLDERS, *Managers and Creditor Interests: Application of Agency Theory*, in Edward Altman and Marti Subrahmayar., eds., RECENT ADVANCES IN CORPORATE FINANCE, at 112-15 (Irwin 1985).

⁷⁰ O'KELLY & THOMPSON, *supra* note 12, at 324.

⁷¹ Mathew Bender & Company, Inc., Delaware Corporation Law and Practice § 16.01 (2008). There are 3 basic types of coverage found in a typical D & O insurance policy: A direct coverage of officers and directors (also known as "Side A" coverage); coverage of indemnification payments that the corporation is permitted or required to make to directors and officers (also known as "Side B" coverage); and entity coverage, which covers the corporation's own losses arising from a claim. See Richard M Cieri and Michael Riela,

limit the substantive exposure of directors to liability, as well as strengthening the ability to indemnify directors and officers for litigation expenses.⁷² Beginning with Delaware in 1986 (after the Delaware Supreme Court decision in *Smith v. Van Gorkem*⁷³, finding the directors liable for the breach of their fiduciary duty of care), over 40 states have enacted legislation allowing corporations to limit or eliminate directors' liability for breaches of fiduciary duty. Delaware Corporate Law, Section 102 (b) (7)⁷⁴ deals with the substantive limitation on personal corporate liability, while Section 145, as amended, deals with indemnification of director and officer liability.⁷⁵

An exculpatory provision such as Section 102 (b) (7) is in the nature of an affirmative defense, and therefore, the burden of the defendants (directors) is to demonstrate that they are entitled to the protections of the relevant charter provisions. On the other hand, Section 2.02 (b) (4) of the Model Business Corporation Act provides similar protection by eliminating or limiting the liability of a director to the corporation for money damages for any action or omission, except in cases of "liability for: a) the amount of

Protecting Directors and Officers of Corporation that are Insolvent or in the Zone of Insolvency, 2 DEPAUL BUS. & COMM. L.J. 295 (2004) (citing Nan Roberts Eitel, *Now You Have It, Now You Don't: Director's and Officers' Insurance after a Corporate Bankruptcy*, 46 LOY L. REV. 585, 585-86 (2000)).

⁷² *Id.* It is being said that a properly structured and implemented D & O insurance and corporate indemnification program serves the same purpose as the business judgment rule, although more broadly, given that these directors and officers are insulated not only from duty of care and in some cases, loyalty litigation, but also from securities fraud litigation, as well as, Securities and Exchange Commission (SEC) and Department of Justice (DOJ) investigations. See Timothy W. Burns, *Complete Guide to D & O Insurance*, (2007), available at <https://www.Directorship.com/complete-guide-to-d-and-o>. In fact, the following four activities are considered those that pose the greatest threat of liability to officers and directors: 1) Securities Fraud class-action law suits, 2) derivative actions for breaches of director's or officer's duty of care or loyalty to the corporation, 3) SEC investigations and 4) DOJ investigations and indictments. *Id.*

⁷³ *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

⁷⁴ Again, this provision authorizes Delaware corporations, by a provision in the certificate of incorporation to exculpate their directors from monetary damage liability for breach of duty of care. The statute carves out several exceptions including "acts or omissions not in good faith...." JEFFREY BAUMAN, CORPORATIONS & OTHER BUSINESS ASSOCIATION STATISTICS, RULES AND FORMS 415 - 442 (2009).

⁷⁵ *Id.* Section 145 summarily put, permits a corporation to indemnify (inter alia) any person who is or was a director, officer, employee or agent of the corporation against expenses (including attorneys' fees), judgments, fines and amounts paid in settlement of specified actions, suits or proceedings, where among other things: (i) that person is, was or is threatened to be made a party to that action, suit or proceeding and (ii) that person "acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interest of the corporation...." ROBERT HAMILTON, JONATHAN MACEY, CASES AND MATERIALS ON CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED LIABILITY COMPANIES 776 (Thompson West Ed. 2007).

financial benefit received by a director to which he is not entitled; b) an intentional infliction of harm on the corporation or the shareholders; c) a violation of section 8.33 or d) an intentional violation of criminal law.”⁷⁶

The real question is whether such exculpatory provisions should be extended to directors for a breach of fiduciary duty to creditors? That is, even if such a breach has been found, could it be covered by officer and director's insurance? Generally, a breach of duty to creditors may or may not be covered by *O & D* insurance depending on the policy language. However, while directors may be personally liable to creditors for a failure to meet their duty of care, that duty, as discussed above, is not enforceable by creditors. The obligations to creditors are deemed contractual and the responsibility of corporate directors is thereby measured by the terms of the contract, trust indenture, or charter provision. A claim for breach of this duty is considered a breach to the entire class of creditors and therefore should be prosecuted by either a Chapter 7 Trustee, a Debtor-in-Possession (DIP) under Chapter 11, or Creditors' Committee.⁷⁷ Accordingly, many courts have recognized this fiduciary duty under a trust-fund doctrine, in which the directors are considered trustees of the corporate assets held for the benefit of the insolvent corporation's creditors.⁷⁸

VI. ADVICE AND RECOMMENDATIONS ON HOW TO MINIMIZE DIRECTORS' PERSONAL LIABILITY

How directors or candidate directors/officers may minimize potential personal liability on the boards they serve or manage is a real challenge for contemporary corporations. Excerpts of some recommendations/checklists obtained from various articles are summarized below.

From *Howard Rice, Nemerovski Canady, Falk & Rabkin*,⁷⁹ directors can minimize personal liability by acting diligently and on an informed basis, including:

- Following proper board processes and ensuring that adequate systems exist for receiving corporate information;
- Remedying all regulatory and accounting deficiencies quickly and thoroughly;

⁷⁶ MODEL BUS. CORP. ACT ANN.

⁷⁷ Alan D. Lasko & Associates, P.C., *supra* note 4.

⁷⁸ See Dennis Klein & Mira Edelman, *Litigating against Directors and Officers of Bankrupt Dot-Com Entities: A Potential Asset for the Debtors' Estate*, 27 DEL. J. CORP. L. 803, 804 (2002). See *Upton v. Tribilcock*, 91 U.S. 45, 47-48 (1875); *Automatic Canteen Co. of AM. v. Wharton*, 358 F.2d 587, 590 (2d Cir. 1966).

⁷⁹ Howard Rice Alert, *Director Liability in the Wake of the Worldcom and Enron Settlements*, Feb. 25, 2005, http://www.iln.com/articles/pub_169.pdf.

- Practicing good corporate governance, including vigilance over compliance with the Sarbanes-Oxley Act (SOX) of 2002 as well as NYSE or NASDAQ corporate governance rules, paying special attention to executive compensation issues and related party transactions;
- Directors should ensure they have adequate indemnification agreements with the corporations, including sufficient D & O insurance coverage;⁸⁰
- Potential directors should engage in enhanced diligence prior to accepting a board seat and should only associate with corporations and management teams that maintain the highest ethical standards.

A check-list for avoiding personal liability to creditors for their actions when the corporation is or may be in the zone of insolvency, includes:⁸¹

- If the corporation is encountering significant fluctuations in asset values, be apprised of its net worth based upon realistic market values, rather than inflated cost or outdated goodwill;
- If decisions would pose a substantial risk to corporate assets, it may be prudent to consult with and/or obtain the consent of major creditors before implementing decisions;
- Seek expert legal and financial advice about the likely effects for major stockholders and creditors when considering a financially significant transaction;
- Consider alternative courses of action before approving any transactions, such as a financial restructuring, that may have the effect of placing the corporation in the zone of insolvency;
- Consider retaining financial advisors to evaluate whether contemplated transactions are fair to the creditors of the corporation;
- Maintain neutrality with respect to preserving corporate value for the community of the corporation's interests

⁸⁰ Directors and officers should not rely on indemnification claims against the corporation after it enters bankruptcy proceedings, because such claims may be disallowed by the bankruptcy court—this means the directors and officers would receive nothing on account of their claims.

⁸¹ Excerpted from Alan D. Lasko & Associates, P.C., *supra* note 4. See also Richard M. Cieri & Michael Reila, *Protecting Directors and Officers of Corporation that are Insolvent or in the Zone or Vicinity of Insolvency: Important Considerations, Practical Solutions*, 2 DEPAUL BUS. & COM. L.J., at 295 (2004).

when it is in the zone of insolvency; avoid preferring one constituency (stockholders, creditors, officers) over another; likewise, avoid any action that prefers one creditor over another;

- Assure that decisions are defensible on the basis of good faith judgment—generally, it is prudent to avoid dividends or stock redemption while in the zone of insolvency;
- Be prepared to demonstrate, based on reports and outside advisors, reflected in the records of the board's deliberations, that any awards of executive compensations were reasonable and necessary;
- Be very cautious when engaging in insider transactions; and
- Beware of Fraudulent Transfer and Preference Liability Statutes.

VII. CONCLUSION

This paper has shown that directors and officers generally enjoy the broad protection of the business judgment rule presumption that they have fulfilled their fiduciary duties in the absence of self-dealing, fraud, or bad faith. We have also seen that even where the directors are found liable for a breach of their fiduciary duties, many state laws allow for corporations to include exculpation provisions in the certificate of incorporation. These provisions indicate that, in the absence of self-dealing and bad faith, the directors should not be held monetarily liable for their actions. With some exceptions, a corporation may indemnify its directors and officers against most liabilities. The fiduciary duties of directors and officers shift when the corporation is solvent, to when it is in the zone of insolvency, to when it becomes insolvent. In fact, the most likely type of claims against former directors and officers of an insolvent corporation is often a claim by the bankruptcy trustee for breach of fiduciary duties leading to the corporation's insolvency. Some courts have held that directors and officers of an insolvent company have a fiduciary duty to the creditors to protect the assets of the company. For example, in *Geyer v. Ingersoll Publications Company*,⁸² the Delaware Court of Chancery expressly affixed the label "fiduciary obligation" to the duty owed by directors to a creditor of a putatively insolvent corporation, thus presaging the potential expansion of creditors' remedies against corporate directors.⁸³ The plaintiff in this case resold his shares to

⁸² *Belcher v. T. Rowe Price Foundation*, 621 A. 2d 873 (Del. Ch. 1992).

⁸³ David A. Drexler et al., *Delaware Corporation Law and Practice – The Proper Exercise of Directors' Responsibilities* MB Lexis Nexis, (2008).

the defendant corporation for a promissory note upon which the corporation defaulted. The creditor sued the board chairman/controlling stockholder, alleging that he had engaged in a series of transactions which resulted in a shift of corporate assets to the stockholder, rendering the corporation unable to pay its debt to the plaintiff. The court held that, because the corporate defendant was allegedly insolvent, the complainant validly alleged a breach of fiduciary duty owed by the director directly to the plaintiff creditor.⁸⁴ Consequently, directors and officers of a corporation must be conversant with the shifting fiduciary duties and their continuing obligations to comply with the law in the new paradigm. Although this shifting duty may vary from one jurisdiction to another, the fundamental issue is the same: Was the fiduciary duty of the directors and officers breached, and if so, who was hurt by the breach? Was it the shareholders, the corporation, or other constituents including creditors? Who can bring action for breach of such duty and who recovers damages for that breach, if found? Depending on the jurisdiction or interpretation of how and when there is a shift in the fiduciary duty, the answer to these questions may vary. However, understanding these duties in a shifting paradigm becomes undoubtedly essential for the directors and officers, who can minimize personal liability by acting diligently and on a fully informed basis.

⁸⁴ *Id.*