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# Fiduciary Duties in Times of Financial Distress

In the face of the COVID-19 pandemic, many companies will confront unexpected and acute financial challenges, including liquidity shortages, potential debt defaults, and precipitous revenue declines. Although the cause of today's financial distress is unprecedented, directors may continue to rely on familiar, well-established legal principles for guidance on their duties in these difficult circumstances. Those principles teach that financial distress—including the prospect of insolvency—does *not*:

- weaken the protections of the business judgment rule;
- prevent directors from seeking to preserve and maximize long-term value; or
- increase the risk of liability for well-informed, non-conflicted decisions.

As directors deal with the emergent challenges of the current crisis, we expect these principles, and the protections offered to directors, to be reaffirmed and amplified.

The Delaware Supreme Court addressed the role of directors of distressed companies in its 2007 decision in *NACEPF* v. *Gheewalla*. There, the Court held that directors do not owe fiduciary duties to particular creditors, regardless of a corporation's financial condition. Rather, even in times of distress, a director's duty is to preserve and maximize the value of the corporation "for the benefit of *all* those having an interest in it." Consistent with that logic, the Court held that creditors may not bring fiduciary claims against directors absent actual insolvency. And, even in the case of actual insolvency, creditors cannot bring direct claims against board members; instead, as the "residual beneficiaries" of the corporation's value, they can seek to bring only derivative claims—on behalf of the corporation—to remedy harms to the corporation itself, such as self-dealing payments.

Notably, *Gheewalla* put to rest the notion that there is a "zone of insolvency"—or a condition short of insolvency—in which directors are vulnerable to creditor fiduciary claims. To the contrary, the Court explained that the so-called "zone of insolvency" has no legal significance for Delaware directors. And while *insolvency* may be significant insofar as it opens the door to creditor derivative claims, it does not alter or weaken the protections afforded by Delaware law in defending such claims. As explained by the Court of Chancery in a decision largely adopted by *Gheewalla*, directors of an insolvent firm can still rely on standard charter provisions insulating them from duty-of-care claims. Moreover, the business judgment rule

assures that directors, even in distressed situations, have "the ability to make a range of good faith, prudent judgments about the risks they should undertake on behalf of troubled firms." Financial distress, in sum, is undoubtedly relevant to a board's decision-making, but it "does not suddenly turn directors into mere collection agents" rather than stewards of the firm.

In recent years, the Delaware courts have reaffirmed the deference owed to the decisions of non-conflicted directors in distressed situations. The Court of Chancery has made clear that creditor fiduciary remedies are "not easily invoked" and that, even where available, creditor derivative claims are "subject by default to the business judgment rule" and are "only a vehicle for restoring to the firm self-dealing payments and other disloyal wealth transfers." Directors, accordingly, will not be "held liable for continuing to operate an insolvent entity in the good faith belief that they may achieve profitability" or, as part of a corporate strategy, for making payments to certain non-insider creditors but not others. Likewise, decisions to initiate a debt restructuring or to file for bankruptcy are also entitled to deference.

Application of these principles will of course depend on particular circumstances. In addition, where value is being distributed to shareholders, as in the case of dividends or share buybacks, appropriate focus should be given to the firm's ability to meet its financial obligations and comply with statutory or other legal obligations. And because the decisions made in times of financial distress may well be evaluated after-the-fact, including in the context of a bankruptcy, it is important that the record reflect due consideration and thorough process by the board, including where appropriate evaluation of downside cases.

But we foresee no variation from the basic principle that directors presiding over corporations in financial distress are empowered to manage for the survival and long-term benefit of the business. To the contrary, given the evident need for corporations to protect multiple stakeholders (including employees) in the current crisis, established Delaware law will support judicial deference to directors who responsibly and, on an informed and unconflicted basis, make difficult choices in an effort to preserve and maximize long-term corporate value.

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