

FIDUCIARY DUTIES -- DURING THE CHAPTER 11 CASE

**Catherine Steege
Landon S. Raiford
Jenner & Block LLP
330 N. Wabash Ave.
Chicago, IL 60611
(312) 222-9350
csteege@jenner.com
lraiford@jenner.com**

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I. **Introduction.** Outside of bankruptcy, officers and directors owe duties of care, loyalty and independence to the corporation they serve. In performing these duties outside of a bankruptcy case, officers and directors are typically protected from personal liability in four primary ways: (i) through directors' and officers' insurance, (ii) the ability of the corporation to indemnify the officer and director; (iii) the defense of the business judgment rule; and (iv) the availability of the corporation, which typically will have deeper pockets, as a defendant in any action. Once the corporation files for bankruptcy, however, the automatic stay may eliminate certain of these key financial protections and put others in doubt. *See, e.g., In re Touch America Holdings, Inc.*, 381 B.R. 95 (Bankr. D. Del. 2008) (directors' and officers' claims for indemnification subordinated under 11 U.S.C. § 510(b)); *In re Jasmine, Ltd.*, 258 B.R. 119 (D.N.J. 2000) (court allowed debtor to cancel policy in exchange for return of insurance proceeds). This paper explores the duties of fiduciaries during the chapter 11 case and the protections provided to fiduciaries.

II. **Traditional Fiduciary Duties of the Officer and Director.**

A. **Duty of Loyalty:** Officers and directors owe undivided and unqualified loyalty to the corporation which they serve. *Pepper v. Litton*, 308 U.S. 295 (1939). Thus, they must act in good faith and with the reasonable belief that the action taken is in the best interest of the corporation. They also cannot personally profit at the expense of the corporation or place their personal concerns ahead of that of the corporation. This duty historically arises from the idea that corporate directors and officers may be seen as trustees for the benefit of shareholders or as their agents.

B. Recently, a Delaware court held that “[t]he fiduciary duty of loyalty is not limited to cases involving a financial or other cognizable fiduciary conflict of interest. It also encompasses cases where the fiduciary fails to act in good faith. . . . Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith.” *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006).

- i. Unlike a violation of the duty of care, if a violation of the duty of loyalty is alleged, the burden of proof generally lies with the interested director to show that the transaction in question was fair to the corporation. *See, e.g.*, Brodsky & Adamsk, *The Law of Corporate Officers and Directors* § 3.04 (1984).
- ii. By statute, approval of a transaction by a disinterested board may protect the interested director or officer. *See, e.g.*, Del. Cod. Ann. tit. 8 § 144. “[A] director is considered interested where he or she will receive a personal financial benefit from a transaction that is not equally shared by the stockholders”. *Rales v. Blasband*, 634 A.2d 927, 936 (Del. 1993).

C. **Duty of Care:** Officers and directors of a corporation must exercise the care which ordinarily a careful and prudent person would use in similar circumstances and consider all material information reasonably available to him or her. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984). Delaware law, however, allows the corporation to eliminate personal liability of directors of the corporation for failing to exercise the duty of care, but this does not apply to a breach of the

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duties of loyalty or intentional misconduct. Del. Code. Ann. tit. 8 § 102(b)(7). But "[w]hen 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." *Alidina v. Internet.com Corp.*, No. 17235, 2002 Del. Ch. LEXIS 156, 2002 WL 31584292, at *8 (Del. Ch. Nov. 6, 2002).

- i. **Business Judgment Rule.** The business judgment rule also protects directors and officers from a claim for breach of the duty of due care as it creates a presumption "that in making a business decision the director of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company." *In re Healthco Intern. Inc.*, 208 B.R. 288, 306 (Bankr. D. Mass. 1997). Further, "it is . . . firmly established under Delaware law that directors enjoy a presumption of honesty and good faith with respect to negotiating and approving a transaction involving a sale of assets." 1 R.F. Balotti & J.A. Finkelstein, *The Delaware Law of Corporations and Business Organizations*, § 10.6[A], (3d Ed. 2007).
- ii. To fall under the "business judgment" rule, the officer or director must diligently and reasonably inform themselves of all relevant facts and cannot passively approve important transactions without undertaking any examination of the facts. *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985); *see also Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264, 275 (2d Cir. 1986).

D. **Revlon Duties:** *Revlon Inc. v. McAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986) held that in the context of a sale of a company, the duty of the director is to maximize short-term stockholder value when sale of control of the company or the break-up of company becomes inevitable. The role of the directors in a sale context is an active one, similar to “an auctioneer responsible for selling the company to the highest bidder.” *Id.* at 184. Following *Revlon*, the Delaware Supreme Court held that “*Revlon* does not demand that every change in control of a Delaware corporation be preceded by a heated bidding contest.” *Barkan v. Amsted Indus. Inc.*, 567 A.2d 1279, 1286 (Del. 1989)

III. The Fiduciary Duties Of The Trustee During Reorganization

A. **The Duties of the Trustee.** A starting point for understanding the fiduciary duties of directors and officers of a debtor in possession during the chapter 11 case is to understand the role of the trustee. With a few limited exceptions, 11 U.S.C. § 1107 grants the DIP the rights, powers and duties of a trustee. 11 U.S.C. § 1106, which incorporates key provisions of § 704, sets forth the statutory duties of the trustee. In addition to these statutory duties, the case law also imposes fiduciary obligations upon a trustee to act for the beneficiaries of the “trust” and includes the traditional duties of care, loyalty and impartiality. *Hall v. Perry*, 703 F.2d 1339, 1357 (9th Cir. 1983); Restatement (Second) of Trusts § 170, 174. In addition, trustees must treat all beneficiaries fairly and equally with impartiality. *Id.* § 183. State law provisions which allow for approval of actions taken where there is a conflict of interest or for the application of the business judgment rule

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and limitations on liability for a breach of the duty of care do not apply to the trustee.

B. Trustee Immunity. Trustees enjoy a quasi-judicial immunity from suit for actions taken on behalf of the estate and “are generally immune from suit for actions arising out of the operation of the estate.” *In re Marcos Gurnee Partnership*, 182 B.R. 211, 216 (Bankr. N.D. Ill. 1995). The exceptions to this rule are actions taken outside of the trustee’s authority (*id.* at 217) and actions taken in breach of the trustee’s fiduciary duties. *Id.* at 219. Whether a trustee faces personal liability for actions taken that are merely negligent as opposed to willful and deliberate is an unsettled question. *Id.*

C. The rule of *Barton v. Barbour*, 104 U.S. 126 (1881) requires that actions against a receiver must be brought either in the court that had appointed the receiver or, only with that court’s permission, in another court in order to ensure that the administration of the estate’s assets not be impaired. Congress has engrafted an exception to that rule through 28 U.S.C. § 959 (a) which provides that trustees (and DIPs) may be sued in their official capacity without leave of the court appointing them with respect to their acts or transactions in carrying on business.

IV. The Fiduciary Duties of the DIP. “Debtors in possession and those who control them owe fiduciary duties to the bankruptcy estate. The fiduciary obligations consist of two duties: the duty of care and the duty of loyalty.” *In re Brook Valley VII, Joint Venture*, 496 F.3d 892, 900 (8th Cir. 2007).

A. Duty of Loyalty. The duty of loyalty of the DIP is the same as the duty of loyalty of a trustee. The DIP must not self-deal, cannot act with a conflict of interest and

must not take actions which are improper. (*Id.*; *In re Coram Healthcare Corp.*, 271 B.R. 228, 235 (Bankr. D. Del. 2001); *But see In re Schipper*, 933 F.2d 513 (7th Cir. 1991) (suggesting that the duties of a trustee are higher than those of the DIP in the sale context; affirming a lower court decision not to find a breach of fiduciary duty where the DIP failed to disclose an earlier offer for the property that was sold as part of the Section 363 sale).

- i. **Specific Cases.** Examples of disloyal behavior in the chapter 11 context include: (1) DIP's CEO was also a consultant to one of the debtor's largest noteholders receiving \$1 million per year under the consulting agreement (*Corum*, 271 B.R. at 235-36); (2) refusal to pursue preference or other avoidance actions against third parties holding guarantees from an officer or director of the DIP (*In re Tel-Net Hawaii, Inc.*, 105 B.R. 594, 595 (Bankr. D. Hawaii 1989); *In re Caruso Cheese, Inc.*, 107 B.R. 808, 820 (Bankr. N.D.N.Y. 1989); (3) acquisition of estate assets (*In re Allied Gaming Management, Inc.*, 209 B.R. 201, 203 (Bankr. W.D. La. 1997) ("there is an absolute bar on fiduciaries acquiring estate property"); (4) partners in debtor partnership caused debtor to consent to stay relief and then, pursuant to their undisclosed interest in the secured lender, bid in debt at the foreclosure sale to obtain title to estate property (*Brook Valley*, 496 F.3d at 901).
- ii. **State Law Concepts.** Many state statutes allow corporations to enter into transactions with directors or officers if there is disclosure and the board

approves. Do these statutes apply in the chapter 11 context or is the DIP like a trustee barred absolutely from self-dealing?

B. **Duty of Care.** This duty is often recognized as being the same duty of care as that exercised by the trustee. *See, e.g., Ford Motor Credit Co. v. Weaver*, 680 F.2d 451, 461 (6th Cir. 1982); *Lustig v. Sweden Broadcasting Co.*, 77 B.R. 404 (Bankr. W.D.N.Y. 1987). The DIP's judgments are classified, like those of a trustee, as being either discretionary or non-discretionary, with greater liability attaching to those judgments that are non-discretionary. *Ford Motor Credit*, 680 F.2d at 461-63 (if DIP negligently lost property of the estate, DIP violated fiduciary duties because preservation of the estate's property is a primary obligation of the DIP). The DIP's duty of care is to protect and maximize the return to the estate's assets, not to waste assets by continuing to operate or incurring additional debt if there is no reasonable chance for reorganization, to furnish information about the estate and its administration as requested by a party in interest and in exercising reasonable diligence and care in formulating a reorganization plan. *See Comment: Trust Me, I'm a Lawyer: Restoring Faith in Fiduciaries by Dumping "Due Diligence" and Tolling the Statute of Limitations for Postpetition Breach of Fiduciary Duty in Chapter 11*, 22 Bank. Dev. L. J. 637, 641 (Spring 2006).

i. **Applicability of the Business Judgment Rule.** In other contexts within the chapter 11 case, courts scrutinize the reasonableness of the decision being made, not merely whether the officer or director rationally believed it to be in the best interests of the corporation, suggesting that the

business judgment rule is heightened in the chapter 11 case. *See, e.g., In re Aqua Assocs.*, 123 B.R. 192, 198 (Bankr. E.D. Pa. 1991).

V. The Future of Fiduciary Duties for a Director or Officer During Chapter 11?

A. Should the DIP be held to the same standards as the trustee or the pre-bankrupt directors and officers?

- i. Holding directors and officers to the standard of a trustee allows the current management of the business to stay in place (thereby avoiding disruption of the debtor's business) and also creates the proper incentives for the current management to avoid those practices that may have lead to a chapter 11 filing in the first place.
- ii. The Code already treats a DIP (and by extension the DIP's officers and directors) and the trustee similarly throughout the Code. Applying the same fiduciary duties actually comports with an underlying principal of the Code.
- iii. If the DIP is held to these standards, logically the DIP would enjoy the quasi-judicial immunity a trustee enjoys from lawsuits seeking to impose personal liability upon the trustee for his or her actions.

B. Rejection by the Courts:

- i. The Seventh Circuit has expressly held that the fiduciary duties of a DIP are not the same as those imposed on a trustee and instead are aligned with those of an officer and director outside of bankruptcy proceedings. *In re Schipper*, 933 F.2d 513 (7th Cir. 1991).

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- ii. Likewise, the district court for the Southern District of New York has also refused to impose a trustee standard on the directors and officers of a debtor. *See In re Integrated Resources, Inc.*, 147 B.R. (S.D.N.Y. 1992).

**The Fiduciary Duties of the Creditor's Committee
in Chapter 11 Proceedings**

**Alan K. Mills
Barnes & Thornburg LLP
Indianapolis, Indiana**

The Fiduciary Duties of the Creditor's Committee in Chapter 11 Proceedings

I. Introduction

The following discussion focuses on the fiduciary duties of the creditors' committee in Chapter 11 proceedings and the potential challenges a committee may encounter in abiding by its fiduciary duties. Creditor Committees are bound by a strict duty of fidelity, loyalty, and impartial service to all unsecured creditors. Unfortunately, this may be easier in theory than in practice.

II. The Purpose of a Creditors Committee

Creditors committees are tasked with representing the interests of unsecured creditors in Chapter 11 proceedings. Their duties include examining the debtor's assets, investigating the debtor's business affairs, reviewing any liens on and monitoring the disposition of the debtor's assets, assessing the debtor's existing and foreseeable liabilities, and assisting in the formulation of a plan of reorganization. This list is not exhaustive. A committee's responsibilities may broaden as the Chapter 11 proceeding progress. In the interest of maximizing the potential returns for the unsecured creditors, it is not uncommon for creditors' committees to act proactively by suing third-parties on behalf of the debtor's estate. A creditors' committee will employ all means necessary to benefit the entire class of unsecured creditors with the clear purpose of optimizing the financial outcome for its constituents. Ultimately, a creditors' committee will decide what outcome of the Chapter 11 proceedings best suits the unsecured creditors, be it liquidation, reorganization, or another alternative.

It is clear from the language of Title 11 of the United States Code (the "Bankruptcy Code") that Congress intended creditors' committees to play a significant

role in Chapter 11 proceedings. Section 1102(a)(1) provides that “as soon as practicable after the order for relief under chapter 11 of this title, the United States Trustee shall appoint a committee of creditors holding unsecured claims and may appoint additional committees of creditors or of equity security holders as the United States Trustee deems appropriate.”¹

The drafters of the Bankruptcy Code understood the benefit of providing a platform for unsecured creditors in the Chapter 11 process. Unsecured creditors tend to have familiarity with and expertise in the debtor’s respective industry, which may be essential to the formation of a plan of reorganization. In addition, unsecured creditors have a lot, if not the most, to lose when a debtor becomes insolvent. With respect to fairness, it makes intuitive sense that unsecured creditors should be afforded an effective conduit to advance their cause and protect their interests.

Section 1103 of the Bankruptcy Code specifies the powers and the duties of a creditors’ committee.² The committee, with court approval, may employ attorneys and

¹ **§ 1102 Creditors’ and equity security holders’ committees**

(a)(1) Except as provided in paragraph (3), as soon as practicable after the order for relief under chapter 11 of this title, the United States Trustee shall appoint a committee of creditors holding unsecured claims and may appoint additional committees of creditors or of equity security holders as the United States Trustee deems appropriate.

² **§ 1103 Powers and duties of committees**

- (a)** At a scheduled meeting of a committee appointed under section 1102 of this title, at which a majority of the members of such committee are present, and with the court's approval, such committee may select and authorize the employment by such committee of one or more attorneys, accountants, or other agents, to represent or perform services for such committee.
- (b)** An attorney or accountant employed to represent a committee appointed under section 1102 of this title may not, while employed by such committee, represent any other entity having an adverse interest in connection with the case. Representation of one or more creditors of the same class as represented by the committee shall not per se constitute the representation of an adverse interest.
- (c)** A committee appointed under section 1102 of this title may - (1) consult with the trustee or debtor in possession concerning the administration of the case; (2) investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business, and any other matter relevant to the case or to the formulation of a plan; (3) participate in the formulation of a plan, advise those represented by such committee of such committee's determinations as to any plan formulated, and collect and file with the court acceptances or rejections of a plan; (4) request the appointment of a trustee or examiner

accountants to assist in all of its affairs. The committee may consult with the Trustee or debtor-in-possession (“DIP”) concerning the administration of Chapter 11 proceedings. The committee may participate in the formulation of a plan and request the appointment of a Trustee in the event the DIP is not performing its duties effectively. The Bankruptcy Code allows the committee to perform any service that is in the interest of unsecured creditors.

III. Fiduciary Duties of Creditor Committees

Creditors’ Committees are to be advocates for *all* unsecured creditors. They are obligated to protect the financial interests of their constituents while simultaneously protecting their rights as a class. Ideally, committees provide balance in Chapter 11 proceedings and counter the influences of secured creditors or self-interested debtors. Great emphasis is placed on the notion that creditors’ committees must provide a voice for all unsecured creditors. Committee members should never act out of self-interest, nor the interests of a particular creditor or subgroup of unsecured creditors. Members must set aside their individual agendas while working in their respective capacities as committee members. This does not prohibit them from acting on their own behalf outside of committee activities. Yet, a committee member should never use its committee position to further its own agenda.

Such an obligation requires the creditors’ committee to act in good faith, honestly, and reasonably. A committee has a strict duty of fidelity, undivided loyalty, and impartial service.³ The committee’s duty of undivided loyalty requires its members to

under section 1104 of this title; and (5) perform such other services as are in the interest of those represented.

³ See *Life Serv. Systems*, 279 B.R. 504, at 513 (Bankr. W.D. Pa., 2002).

put aside their subjective motivations and sacrifice for the good of the constituents as a whole. Unbridled honesty is encompassed in the notion of loyalty. A committee must fully disclose any existing or potential conflicts of interest that may arise in committee affairs. For example, if a committee's counsel has a professional relationship with a committee member or a constituent outside of the committee, such information must be disclosed to the committee and the committee's constituents.

There must be an acknowledged duty of care as well. The committee is required to be reasonably informed and particularly considerate when acting on behalf of its constituents. Before a committee makes a decision, it must be reasonably informed of all material information and remain up-to-date with respect to the Chapter 11 proceedings. If a committee is not sufficiently informed, it risks jeopardizing the financial returns of the unsecured creditors as a whole.

IV. Challenges to a Committee's Capacity as a Fiduciary

A. Adequate Representation

Many of the issues that arise with respect to the exercise of a committee's fiduciary duties stem from whether the committee is adequately representing its constituents. As noted above, the creditors committee must at all times act for the benefit of all unsecured creditor—never one creditor or class of unsecured creditors. Yet, this does not mean that a committee must be a replica of the class of unsecured creditors. Instead, the committee is only required to adequately represent the constituency by providing a meaningful and effective medium by which all unsecured creditors may voice their subjective concerns.

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The creditors' committee must represent the interests of a minority class of unsecured creditors as well as a majority class. The committee must be diligent in safeguarding the rights of dissenting constituents. This can be difficult for a committee to manage, especially in light of how committees are typically formed. Pursuant to Section 1102(b)(1), the Trustee is to select the seven (7) creditors with the largest claims.⁴ Given how much may be at stake for the largest unsecured creditors, it would be convenient for a committee to ignore the interests of the lesser invested creditors. Yet, the committee must avoid the temptation of acting solely for the sake of the largest creditors. If it appears that the committee is failing to assert the interests of a particular subclass of unsecured creditors, the Trustee has the authority to appoint additional committees.⁵ Unfortunately, this is can be extremely expensive and should be avoided. In *In re McLean Industries, Inc.*, the Court addressed the issue of when it may be necessary to establish additional committees for the purpose of affording more effective representation. The court stated:

Creditors committees often contain creditors having a variety of viewpoints. Some members may favor liquidations; others may favor continuation of the business in order to preserve jobs or the viability of an important customer Such conflicts are not unusual in reorganization In the usual case, they might not require a separate committee unless they impair the ability of the unsecured creditors committee to reach a consensus.⁶

Considering the importance of balancing the competing interests that inherently pervade a creditors' committee, it is important that upon formation of the committee, effective mechanisms for conflict resolution are established. It is not uncommon for

⁴ **§1102(b)(1)** A committee of creditors appointed under subsection (a) of this section shall ordinarily consist of the persons, willing to serve, that hold the seven largest claims against the debtor of the kinds represented on such committee, or of the members of a committee organized by creditors before the commencement of the case under this chapter, if such committee was fairly chosen and is representative of the different kinds of claims to be represented.

more sophisticated committees to form operating procedures and by-laws. Operating procedures and by-laws may be employed to set ground rules for conflict resolution or the establishment of sub-committees. One of the initial tasks of the creditors' committee should be to come to a general consensus as to their priorities and to form a game plan. The goal is a cohesive committee with clear objectives. Typically, a committee will elect a chair to centralize leadership and aid in the minimization of discord. The committee chair must insure that no one creditor's interests supersede others and that under represented unsecured creditors have a sufficient platform to voice their concerns. Such mechanisms aid in reducing the temptation to promote one member's interests or a class of members' interests over others.

B. Privilege and Confidentiality

Section 1102(b)(3) mandates that official committees “provide access to information for creditors who hold claims of the kind represented by that committee[.]”⁷ The drafters of the Bankruptcy Code were aware that access to information is essential for the fair and reasonable execution of the Chapter 11 process. Unfortunately, the sharing of information, especially information that is financial or proprietary in nature, may raise issues of confidentiality or privilege.

Creditors' committees are typically represented by counsel. As with all attorney-client relationships, information exchanged between the committee and its counsel is privileged. In addition, it is not inconceivable that an unsecured creditor outside of the committee may request information about the debtor that may be confidential or

⁵ 11 U.S.C. § 1102(a)(1) (2006).

⁶ *In re McLean Indus., Inc.* 70 B.R. 852, 861 (Bankr. S.D.N.Y. 1987).

⁷ **§1102(b)(3)** A committee appointed under subsection (a) shall (A) provided access to information for creditors who (i) hold claims of the kind represented by that committee; and (ii) are not appointed to the committee; (B) solicit and receive comments from the creditors described in subparagraph (A); and (C) be

proprietary in nature. For example, in *In re Frontier Airlines Holding, Inc.*, the creditors' committee determined that to disseminate the debtor's confidential information to parties who were not bound by confidentiality agreements would damage the debtor's competitive advantage and, therefore, affect the potential return to unsecured creditors.⁸ The committee filed a joint motion requesting that the Court confirm that the committee was not authorized or required to provide access to confidential and privileged information. The Court granted the order and the committee was allowed to withhold information that the debtor deemed to be confidential.

In re Refco, Inc. et al. also addressed the issue of confidential and privileged information with respect to Section 1102(b)(3) obligations.⁹ In *Refco*, the Court opined that the obligations under Section 1102(b)(3) and the risks of disseminating confidential or privileged information must be balanced. The bankruptcy judge must consider the committee's rationale for not disclosing certain information in light of the intended purpose of Section 1102(b)(3). Generally, a committee is not required to disclose information that could reasonable be considered confidential or may waive the attorney-client privilege. Furthermore, a committee is not required to divulge information that the release of which would constitute a violation of an agreement, contract, or law.

C. Competing Fiduciary Duties

Competing fiduciary duties can be a potential challenge for creditor committees. Committee membership is relatively easy to obtain. As a result, it is plausible that

subject to a court order that compels any additional report or disclosure to be made to the creditors described in subparagraph (A).

⁸ See *In re Frontier Airlines Holding, Inc.*, Case No. 08-11298 (Bankr. S.D.N.Y. June 3, 2008) (confirming that the creditors' committee is not authorized or required to provide access to confidential information of the debtors or required to provide access to privileged information).

members of a creditors' committee may discover that they have conflicting fiduciary duties. For example, it is not uncommon for an indenture trustee to serve on a creditors' committee. An indenture trustee owes a fiduciary duty to bondholders. As a committee member, an indenture trustee will also owe a duty of loyalty to *all* unsecured creditors, not just the bond holders it may be contractually obligated to protect.

In *Woods v. City National Bank & Trust Co.*, the Supreme Court addressed the potential conflict of interest an indenture trustee may encounter when serving on a creditors' committee, with respect to compensation for services in particular.¹⁰ The Court stated:

Where a claimant, who represented members of the investing public, was serving more than one master or was subject to conflicting interests, he should be denied compensation. It is no answer to say that fraud or unfairness were not shown to have resulted Protective committees, as well as indenture trustees, are fiduciaries A fiduciary who represents security holders in a reorganization may not perfect his claim to compensation by insisting that, although he had conflicting interests, he served his several masters equally well or that his primary loyalty was not weakened by the pull of his secondary one.¹¹

The Court's opinion reflects the potential pitfalls of the appointment of committee members that may have divergent or conflicting fiduciary duties. The variety of competing duties goes beyond the scope of this discussion. Yet, it is worth mentioning given how frequently conflicting duties affect the ability of creditor committees to function effectively. As a result, it is not uncommon that a committee's membership may frequently change at the discretion of the committee or the bankruptcy court.

V. Conclusion

⁹ See *In re Refco*, 336 B.R. 187 (Bankr. S.D.N.Y. 2006).

¹⁰ *Woods v. City National Bank & Trust Co.*, 312 U.S. 262 (1941).

¹¹ *Id.* at 268-69.

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A creditors' committee is obligated to protect the interests of all unsecured creditors in Chapter 11 proceedings. A committee owes its constituents a strict duty of fidelity, undivided loyalty, and impartial service. As a fiduciary, the committee must be particularly vigilant that it is adequately representing its constituency. In some cases, the committee may be required to protect unsecured creditors from themselves. For example, a committee may have to prohibit confidential, privileged, or proprietary information from being disseminated to unsecured creditors in order to insure the viability of the debtor. Another risk a creditors' committee may face is the myriad of potential conflicts of interest. In the best case scenarios, the committee has established operating procedures or by-laws allowing its members to effectively deal with a conflict. If not, the committee may have to rely on the Trustee or the bankruptcy judge to insure that the committee can efficiently execute its duties.

Skadden

Corporate Governance Considerations

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Corporate Governance Generally

- **The fiduciary duties of directors and officers of companies facing insolvency or near-insolvency is a developing area of law. This presentation, while focused on applicable Delaware law, will identify general corporate governance concepts as a backdrop for discussion.**

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- **The corporate governance practices of troubled companies are placed under increased scrutiny; creditors and stakeholders often allege the following types of problematic corporate governance:**
 - Insufficient board review of strategic options
 - Boards that are uninformed about their company’s businesses and competition
 - Excessive management control over Board actions
 - **In any restructuring scenario, it is thus critical to review and understand the following:**
 - Fundamental rules of corporate governance
 - How these basic rules change in a distressed situation
 - How to implement or continue corporate governance best practices

Fiduciary Duties When Solvent

- **Generally, the directors and officers of a solvent corporation owe fiduciary duties exclusively to the shareholders of the corporation**
 - *Duty of Loyalty*: directors and officers are expected to act without any conflict of interest derived from a material personal financial interest in the matter under consideration
 - Duty of Good Faith: included in the duty of loyalty and requires directors and officers to act in a manner that they honestly believe to be in the best interests of the corporation and its shareholders, without regard to personal or private motives, even if non-financial in nature
 - *Duty of Care*: directors and officers are also expected to act on an informed basis in good faith and in a deliberative manner
 - Increases with the magnitude of the decision being made, measured by gross negligence standard

Fiduciary Duties When Solvent

- **In exercising their duties, directors and officers may rely in good faith on expert advice of outside expert advisors reasonably believed to be qualified**
- **Directors and officers who breach such duties can be held personally liable to the corporation and its shareholders**
- **However, directors and officers who are disinterested and act on an informed basis, in good faith, and in the honest belief that the action was in the best interests of the company, are protected from liability**
 - The business judgment rule is the rebuttable presumption that directors and officers of a corporation have so acted

Fiduciary Duties When Solvent

- **In cases involving wholly-owned subsidiaries, Delaware courts have generally held that directors must manage the subsidiary for the benefit of its only owner, the parent.**
- **Where a subsidiary is not wholly-owned, Delaware courts have generally held that directors owe fiduciary duties to the parent as well as minority shareholders**

Fiduciary Duties When Insolvent

- The fiduciary duties of officers and directors as a corporation approaches insolvency is a developing area of law
- Some courts have held that the general duties owed by directors expand to include an obligation to maximize the value of the enterprise for the “entire community of interests” when the corporation becomes insolvent.
 - Based upon interpretation of language from the 1991 Credit Lyonnais case:
 - “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. . . . [a]t least when the corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise.”
- **Accordingly, these courts generally have sometimes held that directors are trustees or “quasi-trustees” for an insolvent corporation’s creditors**

Fiduciary Duties When Insolvent

- **A company may be operating in the zone of insolvency when it is not yet technically insolvent, but is nevertheless experiencing financing difficulties**
- **Two tests for determining insolvency:**
 - **Bankruptcy Test**: A debtor is insolvent when the sum of its debts exceeds the fair value of its property
 - **“Equitable Insolvency” Test**: A debtor is insolvent if it lacks sufficient property to pay debts as they mature
- **Determining when a corporation is in the zone of insolvency is difficult, but it may be telling that the question is being asked**

Fiduciary Duties When Insolvent

- Until recently, the duties of directors and officers of a Delaware corporation within the zone of insolvency were subject to differing interpretations, but recent case law has clarified the scope and nature of these duties
- First, in Production Resources Group, L.L.C. v. NCT Group, Inc., the Delaware Court of Chancery explained that in Credit Lyonnais it made clear that a board and management of a company in the zone of insolvency are shielded from breach of fiduciary duty claims by *shareholders* who believe that the board and management improperly made decisions with other constituencies in mind
 - The board and management are therefore protected from accusations that they acted too conservatively, rather than making risky decisions designed to maximize shareholder returns
 - Credit Lyonnais was meant as a shield for board members and management, not a sword for creditor groups

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Fiduciary Duties When Insolvent

- **Secondly, under *Gheewalla v. North American Catholic Educational Foundation*:**
 - When a corporation is solvent, directors and officers owe fiduciary duties owed to the corporation and its shareholders. Shareholders can sue derivatively on the corporation's behalf for breach of fiduciary duty.
 - When a corporation is in the zone of insolvency, the same fiduciary duties apply and shareholders retain standing for derivative actions. Officers and directors may take into consideration the impact of their decisions on creditors.
 - When a corporation is insolvent, the primary fiduciary duties owed are still to the corporation. Creditors are still not owed fiduciary duties per se. However, as the residual owners of the company, they can have standing to sue for breach of fiduciary duty on behalf of the corporation (as opposed to a direct cause of action).
- **The *Gheewalla* holding is based upon the Delaware Supreme Court's recognition that directors of insolvent corporations "must retain the freedom to engage in vigorous, good faith negotiations with individual creditors for the benefit of the corporation."**

Fiduciary Duties When Insolvent

- **Although the directors of a wholly-owned and *solvent* subsidiary may manage the subsidiary solely for the benefit of the parent, in the zone of insolvency, directors and officers must exercise care and loyalty to maximize value for the benefit of creditors**
- One court held: “It would be absurd to hold that the doctrine that directors owe special duties after insolvency is inapplicable when the insolvent company is a subsidiary of another corporation. . . . There is no basis for the principal propounded by a few of the Defendants that the directors of an insolvent subsidiary can, with impunity, permit it to be plundered for the benefit of its parent corporation.” In re Magnesium Corp. of America, 2009 WL 116519, *30 (Bankr. S.D.N.Y. Jan. 19, 2009), citing In re Scott Acquisition Corp., 344 B.R. 283, 289 (Bankr. D. Del. 2006).

Fiduciary Duties When Insolvent

- **In recent years, some courts have recognized the cause of action of “Deepening Insolvency”**
 - i.e., directors and officers prolonging a troubled corporation’s life (e.g., by agreeing to additional financing) may be liable to the corporation (and hence creditors and other stakeholders) for any resulting losses.
- **“Deepening Insolvency” is dead as a cause of action in Delaware following recent court decisions. Delaware courts do not want to eliminate the taking of sensible business risks.**
- **Recently, other courts have followed Delaware’s lead, but there are some jurisdictions that still recognize deepening insolvency as an independent cause of action or as a theory of damages in breach of fiduciary duty claims.**