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DIRECTORS' FIDUCIARY DUTIES IN A PANDEMIC

The COVID-19 pandemic brought nearly every area of the law to the forefront. The obligations of directors to corporate stakeholders are not "immune." Corporate directors should very carefully consider how the pandemic's impact on their company will affect their fiduciary duties to the corporation.

As a general rule, members of a company's board of directors owe the shareholders of a corporation fiduciary duties of ***care*** and ***loyalty.***

The Duty of Care.

The duty of care requires that the actions and conduct of directors and officers be informed and considered and that decisions must be made with "requisite care." Directors must (a) inform themselves of all material information reasonably available; (b) carefully consider that information and all reasonable alternatives; and (c) act with requisite care in discharging their duties.

The Duty of Loyalty.

The duty of loyalty requires that directors act in good faith and in a manner they reasonably believe to be in the best interests of the company. They must act in the shareholders' best interests irrespective of their own personal interests.

The Business Judgment Rule.

If a company's directors and officers satisfy these duties of care and loyalty, they will be protected by the business judgment rule. The rule creates a presumption that the actions undertaken by these individuals, so long as performed consistently with their fiduciary duties of care and loyalty, were in the best interests of shareholders and are given latitude by courts. In other words, decisions made by directors will not be condemned by courts using "20/20 hindsight" so long as they abided by their fiduciary duties.

Insolvency Shifts the Duty.

When the business is solvent, the fiduciary duties described above are owed to the company's shareholders and the company, itself. That changes as the business approaches insolvency.

Insolvency can be defined by either of two tests:

The Balance Sheet Test.

1. The sum of its debts (including unmatured and contingent debts) exceeds the aggregate value of its assets at fair market value and

2. There is no reasonable prospect that the business can be successfully continued in the face of that insolvency.

The Cash Flow Test.

The company is insolvent if it is unable to pay its legitimate debts as they come due.

Whether a company satisfies either of these tests is often difficult to determine and directors will not typically be able to determine precisely when the company has become insolvent. Accordingly, directors should exercise care with respect to their fiduciary duties if it appears their company is approaching insolvency, often referred to as the "zone of insolvency."

While directors continue to owe the company fiduciary duties when it becomes insolvent, they also owe creditors those same fiduciary duties or at least are subject to the derivative claims of creditors for having failed to properly acquit those duties. While the business judgment rule still applies to insulate wrong choices if made within the duties of care and loyalty, creditors are far more likely to put that rule to the test than shareholders are.

Directors can exercise their fiduciary duties to the stakeholders (creditors) of an insolvent entity by doing all of the things they ordinarily would do, but also, by carefully considering the effects on the health and continued existence of the enterprise first and foremost. Directors of insolvent businesses often get into trouble by making unreasonable gambles in a last-ditch attempt to rescue the company. Essentially, courts will be more likely to second guess decisions akin to pushing all of one's chips into the center of the table to fill an inside straight. If that poker strategy works, all is well. But the chances of success are poor and ***more importantly***, the additional damage done to the company's finances by a high risk bet ultimately makes creditors worse off than had the directors done nothing and opens them up to greater liability.

Examples of this kind of "bet the farm" decisions that can generate director liability are:

- Hiring a "rainmaker" at a huge salary in the hope that she/he will generate sales to right the ship;
- Acquiring a new class of assets or business segments to "fix" what went wrong with the prior set – especially if that retooling has a large start-up cost;
- Ironically, the contrary – jettisoning assets at fire sale prices solely to maximize cash flow;
- Increasing inventory while failing to pay for ordinary purchases.

Insolvency is "Trending"

COVID-19 has exacerbated the danger inherent in shifting the fiduciary duties owed to creditors because of the definition of insolvency. While a business may have a solvent balance sheet, it can still be insolvent under the Cash Flow Test. The wholesale disruption of ordinary commerce caused by the pandemic has created enormous cash flow problems for nearly every business. Based on cash flow, alone, a decent argument could be made that all but a few businesses are insolvent. That being the case, directors of all companies should assume that their decisions will be viewed in hindsight through the lens of the fiduciary duty to creditors and to act accordingly.

Please feel free to contact your Momkus LLC attorney with questions or concerns. Our office is operating at 100% and we've been designated as an "essential service" during the crisis; your calls and emails will receive prompt attention, even if we can't personally shake your hand.