Fiduciary Duties: Who Owes What to Whom - and When?

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- Fiduciary Duty – in General
  - Officers and directors generally have the following fiduciary duties to the company they serve:
    - Duty of Care
      - what would an ordinarily prudent and careful person do?
      - be informed and act as an advisor
    - Business Judgment Rule
      - a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company
    - Duty of Loyalty
      - undivided and unselfish loyalty
      - actions should be in the best interests of the corporation
      - must act with unbiased judgment
    - Duty of Courage
      - must ask the tough questions

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- **Duty of Inquiry**
  - must diligently ask questions and make inquiries into financial statements, proposed transactions, and other issues brought before the board

- *In re Performance Nutrition, Inc.*, (Bankr N.D. Tex 1999)
  - Chapter 7 trustee sued CEO
  - CEO failed to have a valuation done, to investigate the open market, or to have a bid process; conflict issues as well

  - Board did not review financials prior to leveraged buyout

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- **Fiduciary Duty – Around Insolvency**
  - The obligations of officers and directors change once the company enters the “zone of insolvency”
  - Solvent Corporations: Fiduciary duty is to the company and shareholders
  - Insolvent Corporations: Fiduciary duty is to the company, its creditors and shareholders
    - assets become a trust for creditors
  - “Trust Fund” Theory
    - directors become “trustees” for the corporation’s creditors and hold corporate assets as a trust fund
  - “At Risk” Theory
    - directors must not succumb to the pressure to adopt high-risk strategies to save value for shareholders and the expense of creditors
  - Bankrupt Corporations: Fiduciary duty is to the creditors
    - trustee or debtor-in-possession has a duty to protect and conserve assets for the creditors

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- Corporate Governance Hypothetical – Stephen Grace
  - Using a hypothetical corporation, walk through the duties that officers and directors have, how they are manifested, and how they change based on the insolvency of a corporation

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Deepening Insolvency
General Analytical Framework

Is There Such a Cause of Action?

Look to State Law

Elements: Fraudulent Prolongation, Asset Dissipation, Increased Debt

Stop Here or Appeal

Estate Property: Harm to Corporation versus Harm to Individual Creditors

Defenses: Pari Delicto?

Measure of Damages? Loss of Value? Expense of Bankruptcy?

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- Deepening Insolvency
  - “The fraudulent prolongation of a corporation’s life beyond insolvency, resulting in damage to the corporation caused by increased debt.” - In re VarTec Telecom, Inc.
  - “[T]he corporate body is ineluctably damaged by the deepening of its insolvency, through increased exposure to creditor liability.” - Schacht v. Brown
  - “The distinction between ‘deepening insolvency’ as a tort or a damage theory may be one unnecessary to make. Prolonging an insolvent corporation’s life, without more, will not result in liability under either approach.” - In re Global Service Group
  - Theories of Deepening Insolvency
    – Defendant’s actions damaged the debtor so irreparably that it had to file for bankruptcy
    – Defendant’s actions artificially propped-up the debtor, delaying the filing of bankruptcy

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- Deepening Insolvency (cont’d)
  - Harms of Deepening Insolvency
    - forced bankruptcy and the related legal and administrative costs
    - dissipation of corporate assets arising from not dissolving the corporation in a timely manner
    - increased corporate debt
  - *In Pari Delicto*
    - sometimes used as a defense to deepening insolvency actions
  - Post-Bankruptcy Petition Deepening Insolvency
    - *In re LTV Steel Co.*
      - administrators of a bankruptcy estate may be liable under a deepening insolvency theory

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- **Now What?**
  - View corporate assets as trust fund assets or is that a distinction without a difference?
  - Are existing fiduciary duties sufficient or is there a need for a stricter liability standard?
  - While transactions with insiders are subject to special scrutiny, are they automatically improper or unfair?
  - At what point does the governance group need to contact advisors with expertise to assist them?
  - What steps can be taken once in bankruptcy to lessen the risks of claims for breach of duties?
    - Communication.
    - Constituency participation.
    - Open kimono.
    - Bankruptcy Court approval.
  - Is it any different outside of bankruptcy?
    - Running the business.
    - Avoiding unnecessary confidence loss.
    - Steering a sinking ship to the nearest port.