



**Timely Topics in
Restructuring**

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
- *In re HealthCo Int'l, Inc.*, (Bankr D. Mass 1997)
 - Board did not review financials prior to leveraged buyout



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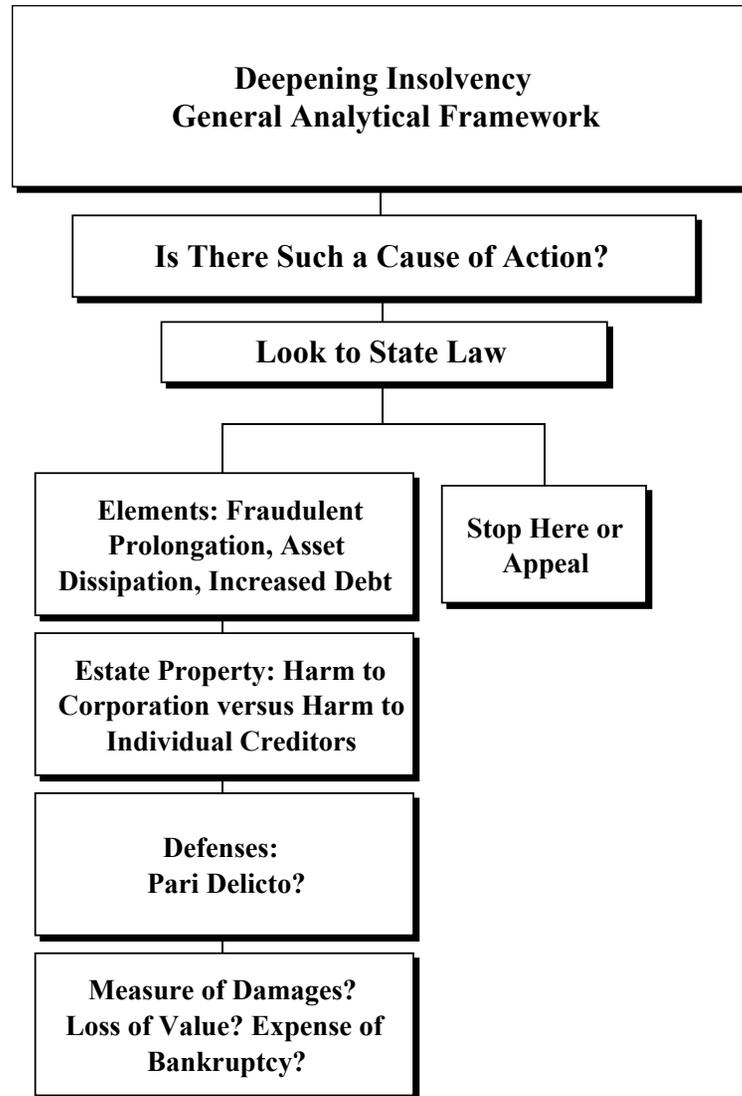
- Fiduciary Duty – Around Insolvency
 - The obligations of officers and directors change once the company enters the “zone of insolvency”
 - Solvent Corporations: Fiduciary duty is to the company and shareholders
 - Insolvent Corporations: Fiduciary duty is to the company, its creditors and shareholders
 - 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
 - “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.