COVID-19's Impact on Directors' Fiduciary Duties to Distressed Companies

By John H. Bae and Jessica Kincaid

This article summarizes the basic legal principles that govern directors' fiduciary duties when the company they serve is facing financial distress and examines how those principles should guide them when making important decisions during this pandemic.

By John H. Bae and Jessica Kincaid I June 05, 2020, The New York Law Journal

The COVID-19 pandemic sweeping across the United States has triggered unprecedented disruption of corporate America. The virus's dangers and the speed at which it spreads through the population have caused state and local governments to force most "non-essential" businesses to temporarily scale back or even cease operations, resulting in many otherwise healthy companies facing financial distress and potentially teetering on insolvency. These companies' directors understandably may have questions about how this sudden change in financial health impacts the fiduciary duties they owe to the company.

And as state and local governments take steps to allow businesses to reopen and resume operations, directors of distressed companies must make a number of important decisions including whether to reopen and, if so, how and when to resume operations, whether to seek bankruptcy relief and whether to take on more debt to fund operations. As they make these determinations, directors may reasonably question what role COVID-19 should play in their decision-making process.

This article summarizes the basic legal principles that govern directors' fiduciary duties when the company they serve is facing financial distress and examines how those principles should guide them when making important decisions during this pandemic. Because a vast number of companies have been formed under Delaware law and the state has robust and well-developed laws addressing directors' fiduciary duties, this article focuses on Delaware law.

Delaware courts in *N. Am. Catholic Educ. Programming Found. v. Gheewalla*, 930 A.2d 92 (Del. 2007), *Quadrant Structured Prods. v. Vertin*, 102 A.3d 155 (Del. Ch. 2014) (*Quadrant I*), and *Quadrant Structured Prods. v. Vertin*, 115 A.3d 535 (Del. Ch. 2015) (*Quadrant II*), have provided directors with much-needed guidance on fulfilling their fiduciary duties to distressed companies, and these precedents remain good law today. While COVID-19 most certainly has thrown the corporate world into chaos, the legal principles enunciated by the courts have not changed.

Continue To Serve the Company

The fiduciary duties of directors who serve healthy, solvent companies are clear: They must make decisions that fulfill their duties of care and loyalty to best serve the company's interests and those of its shareholders. The duty of care requires that directors exercise the degree of care that an ordinary prudent person would exercise. While §102(b)(7) of Delaware General Corporation Law permits companies to exculpate directors from monetary damages arising from a breach of the duty of care, directors should still exercise the duty of care that serves the company's interests. A complete and intentional disregard of the duty of care could theoretically lead to a violation of the duty of loyalty, which requires that directors act in good faith and in the corporation's best interests.

Some have questioned whether directors' duties must shift to benefit creditors when a company becomes insolvent. The argument for this shift was premised on the notion that when a company becomes insolvent, the shareholders no longer retain an economic interest in the company and the company's creditors become its ultimate risk bearers. Following on that premise, questions arose as to whether the directors' duties should shift to serve the creditors' interests even when the company is not yet insolvent, but is merely in the "zone" of insolvency. This raised further questions about whether directors are required to hold the company's assets in trust for the benefit of creditors, whether they owe fiduciary duties directly to the creditors and whether the creditors have a right to assert direct claims against the directors for breach of duty.

In *Gheewalla*, the Delaware Supreme Court answered many of these questions, ruling that directors' duties do not change when the company enters the zone of insolvency and they must continue to discharge their fiduciary duties to the corporation and its shareholders. The court also confirmed that even when a corporation is insolvent, the directors continue to owe fiduciary duties to the corporation and not directly to creditors. As residuary interest holders, however, an insolvent company's creditors may bring derivative claims against directors on behalf of the corporation for a breach of fiduciary duty owed to the corporation.

The Delaware Chancery Court in *Quadrant I* provided further clarity, stating that while creditors become the primary residual claimants when a company becomes insolvent, there is no "conflict between the interests of the primary residual claimants (the creditors) and the interests of secondary residual claimants (the stockholders)." *Quadrant I*, 102 A.3d at 192. The court went on to explain that "[t]he fiduciary duties that creditors gain derivative standing to enforce are not special duties to creditors, but rather the fiduciary duties that directors owe to the corporation to maximize its value for the benefit of all residual claimants." Id. at 193.

In a subsequent decision, the Delaware Chancery Court in Quadrant II succinctly outlined directors' duties to insolvent companies:

- Directors' fiduciary duties do not change when a company enters the zone of insolvency.
- Delaware does not recognize the theory of "deepening insolvency," and directors do not have a duty to shut down the insolvent corporation to marshal assets for creditors.
- Directors of insolvent companies do not owe fiduciary duties to creditors.
- Creditors may not bring direct claims against directors for breach of fiduciary duty.
- Directors owe fiduciary duties to the corporation and must make decisions that benefit the corporation, which in turn will benefit all residual interest holders—both creditors and shareholders.

Practical Implications During the COVID-19 Crisis

Despite the chaos of COVID-19 possibly having driven otherwise healthy companies into financial distress or even insolvency, nothing really has changed for directors from the perspective of discharging their fiduciary duties. While creditors may have become residual interest holders, directors do not directly owe them fiduciary duties. Creditors do not have standing to bring direct claims against directors, and the directors' fiduciary obligations to the company do not change whether the company is in the zone of insolvency or has become insolvent. Directors should continue to fulfill their duties of care and loyalty owed to the corporation, which will benefit creditors and shareholders alike.

The disruption created by COVID-19 does, however, alter the information directors must consider in fulfilling their duties of care and loyalty. To make decisions that they reasonably believe are in the company's best interests, they must be well-informed and knowledgeable about facts and circumstances surrounding the company, which necessarily requires an understanding and consideration of the impact COVID-19 could have on the company's operations.

This includes weighing the benefits of opening for business, which mainly would be revenue generation, against the potential costs of resuming operations, such as costs of operating at less than full capacity and possible liability resulting from employees or customers who may become infected on the company's premises. Directors should be well-informed about the company's potential need for additional financing and assess COVID-19's conceivable impact on the company's business and its ability to generate adequate revenue to service the debt. They also should evaluate the stimulus packages provided by the federal government and their possible benefits for the company's finances. There are numerous other issues related to COVID-19 that will affect different companies in different ways that directors should also consider. The obvious point here is that COVID-19 has had and will continue to have an undeniable impact on how companies operate and that impact must inform the decision-making process.

Directors are not fortune tellers, and they legally cannot in hindsight be faulted for making the wrong decisions. They will be protected under the business judgment rule so long as they act using their knowledge of critical facts affecting the company. They must carefully deliberate and make decisions based on the facts in front of them, which now includes COVID-19's impact on the company and its operations. The decision process has not changed; all that has changed is that COVID-19 must now be part of the discussion.

John Bae *is a partner in Thompson Hine's business restructuring, creditors' rights & bankruptcy practice group in New York* ***Jessica Kincaid*** *is an associate in the group.*