II. The Onset of Insolvency or Financial Distress

A. Introduction

Because a Chapter 11 reorganization can be expensive and time consuming, a troubled corporation may seek to right itself through an out-of-court transaction—such as a recapitalization, merger or asset sale. These transactions and the directors' decisions concerning them are analyzed under state corporation law.

Corporation law also provides a state law alternative to a Chapter 7 liquidation through procedures for voluntary and forced dissolution as well as ancillary remedies such as the appointment of a receiver to marshal a corporation's assets, sell those assets, distribute the proceeds to creditors, and take other steps to wind down a corporation. That said, as discussed below, state law insolvency proceedings have limitations that often make them an unsuitable alternative to federal bankruptcy proceedings.

B. Director Duties in the `Zone of Insolvency' and Insolvency

As discussed in Chapter I, § 141(a) of the DGCL gives directors the authority and power to manage a corporation, and in exercising that authority directors are subject to the fiduciary duties of care and loyalty. Under ordinary circumstances, these fiduciary duties require that directors maximize the value of the corporation for the benefit of its stockholders, who are the beneficiaries of any increase in the value of the corporation. When a corporation is insolvent, however, the value of the corporation's equity may be zero. When this happens, the corporation's creditors become, in an economic sense, the beneficiaries of the residual value of the corporation and stand to benefit (or lose) from any increase (or decrease) in the corporation's value. The shifting interests of stakeholders do not change a director's fiduciary duties: a director must continue to seek, carefully and loyally, to maximize the value of the insolvent corporation.

However, insolvency makes a director's exercise of fiduciary duty more complicated in two ways. First, insolvency frequently gives rise to conflicting views between the different levels of the distressed corporation's capital structure as to what the best value maximizing alternative for the insolvent corporation is. Equity or junior creditors may favor pursuit of a high risk, high payoff strategy. Senior creditors may favor quick liquidation of assets to avoid any further losses of security for their debt. The directors of an insolvent corporation may be required to balance these competing interests in making decisions about how to manage, financially restructure, or liquidate the corporation. Second, when a corporation becomes insolvent, its creditors gain standing to bring claims derivatively to enforce a director's fiduciary duties. Accordingly, the directors of an insolvent corporation have additional constituencies that can scrutinize their decision making and seek to hold the directors accountable if they believe the directors have breached their duties.

1. Balancing creditor, shareholder and corporate interests

Insolvency does not change the nature of a director's fiduciary duties. But, insolvency can dramatically change the context in which those duties must be met. Under ordinary circumstances, the board does not owe creditors duties, fiduciary or otherwise, beyond the contractual rights the creditor has bargained for.[1]

> [D]irectors owe their fiduciary obligations to the corporation and its shareholders. While shareholders rely on directors acting as fiduciaries to protect their interests, creditors are afforded protection through contractual agreements, fraud and fraudulent conveyance law, implied covenants of good faith and fair dealing, bankruptcy law, general commercial law and other sources of creditor rights.[2]

Similarly, holders of warrants or convertible debentures are not owed fiduciary duties as stockholders unless and until the warrant or debenture is converted.[3] Thus, for the solvent corporation, directors do not need to consider how

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[1] *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 99 (Del. 2007).

[2] *Id.*

[3] *See Aspen Advisors LLC v. UA Theatre Co.*, 861 A.2d 1251, 1263 (Del. 2004) ("Just like convertible

their exercise of their fiduciary duties will impact creditors, except to the extent a corporation is taking action that violates a specific contractual or legal right held by the creditor. This makes economic sense because for the solvent corporation the stockholders' and creditors' interest are aligned. By advancing the stockholders' and corporation's interest in maximizing the value of the corporation, the directors are also advancing the creditors' interests in repayment.

As a corporation becomes insolvent, the interests of the stockholders and the creditors may diverge. A hypothetical investment illustrates this potential divergence: A corporation is considering an investment of $5 million of its assets that has with a 50 percent chance of returning $25 million in one year and a 50 percent chance of losing the $5 million. When the corporation is solvent and can pay its creditors, the stockholders will favor making the investment if they consider it a good risk adjusted return on their capital. The creditors will not oppose the investment because the chance that the investment may not be a success does not threaten the corporation's ability to repay the creditors. As a corporation nears insolvency, the investment may become more attractive to the stockholders. If the investment is not made, the value of the stockholders equity may be zero. The success of the investment may be the only chance for the stockholders' equity to have value. At the same time, the creditors will see the investment as adverse to their interests. The creditors will not benefit from the upside if the investment is a success, and if the $5 million is lost, fewer assets will remain to satisfy the creditors' claims. To the creditors, it may seem as though the stockholders are gambling with the creditors' funds. Directors considering whether the investment is in the corporation's best interests have the same fiduciary duties as before, but the lens through which the stockholders and creditors view that decision has changed radically.

Despite this divergence of stockholder and creditor interest, Delaware law is clear that insolvency does not change a director's fiduciary duties of care and loyalty. Regardless of whether a corporation is solvent, in the zone of insolvency, or insolvent, "the fact of insolvency does not change the primary object of the directors' duties, which is the firm itself."[4] The obligation of the directors is to continue to maximize the value of the corporation.[5] "If in either setting the directors remain responsible to exercise their business judgment considering the company's business context, then the appropriate tool to examine the conduct of the directors is the traditional fiduciary duty ruler."[6] When a corporation is insolvent "[t]he directors continue to have the task of attempting to maximize the economic value of the firm. That much of their job does not change. . . . [T]he fact that creditors become the residual risk-bearers does little to shape the fiduciary duties directors owe to particular creditors."[7] Similarly, directors may prefer the corporation's interests over the interests of the corporation's stockholders.[8] The directors have "an obligation to the community of interest that sustained the corporation, to exercise judgment in an informed, good faith effort to maximize the corporation's long-term wealth creating capacity."[9] Delaware courts afford directors'

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debentures—the holders of which are also not stockholders—the "convertibility feature" of warrants does not impart stockholder status unless and until the warrant is converted.").

[4] *Trenwick Am. Litig. Trust v. Ernst & Young, LLP*, 906 A.2d 168, 195, n.75 (Del. Ch. 2006) (quoting *In re Scott Acq. Corp.,* 344 B.R. 283, 2006 WL 1731277, *5–*7 (Bankr. D. Del. June 23, 2006), aff'd sub. nom. *Trenwick Am. Litig. Trust v. Billett*, 931 A.2d 438 (Del. 2007).

[5] *Id.* at 205, n.104.

[6] *Id.* at 205.

[7] *Prod Res. Group v. NCT Group, Inc.*, 863 A.2d 772, at 791–92 (Del. Ch. 2004).

[8] *Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp*., 1991 Del. Ch. LEXIS 215, at *108 n. 55 (Del. Ch. Dec. 30, 1991) (explaining the divergence of stockholders' interests from the corporation's interests and noting that the management and directors did not have a fiduciary duty to immediately facilitate a transaction in the stockholders', but not the corporation's, best interest).

[9] *Id.* at *109.

decisions as to how to fulfill that obligation the traditional deference of the business judgment rule.[10]

2. Creditor standing to bring derivative litigation

Although insolvency does not change the nature of fiduciary duties, it does expand standing to enforce those fiduciary duties through derivative litigation on behalf of the corporation to include creditors. For a solvent company, the decision to bring litigation on behalf of the corporation is entrusted to a corporation's directors.[11] As a check on the directors' authority, stockholders may bring derivative litigation on behalf of the corporation in limited circumstances, such as where the board of the corporation either cannot disinterestedly consider or has improperly refused to pursue litigation.[12] However, when a corporation is insolvent, its stockholders may lose the incentive to continue to monitor the directors or bring derivative litigation because their financial stake in the corporation has been depleted; the stockholders are "out of the money." At the same time, the corporation's creditors become the beneficiaries of any residual increase in the corporation's value and thus gain the incentive to monitor the directors for breaches of fiduciary duty.[13]

a. Corporations—creditors have standing to bring derivative litigation when the corporation is insolvent

Recognizing creditors as the beneficiaries of any increase in the residual value of an insolvent corporation, under Delaware law, the creditors of an insolvent corporation have standing to bring derivative litigation on behalf of the corporation.[14] In contrast, creditors of a corporation that is "in the zone of insolvency" but not yet insolvent do not have standing to bring derivative litigation.[15] The Delaware courts have yet to give a test that would allow a board to tell with any precision when a corporation enters the "zone of insolvency" or the where the "zone of insolvency" becomes actual insolvency. Creditors need only plead—and later prove—that the corporation was insolvent at the

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[10] *See Nelson v. Emerson*, 2008 Del. Ch. LEXIS 56, at *39–43 (Del. Ch. May 6, 2008) (applying the business judgment rule when analyzing the directors' decision to file for bankruptcy in an effort to re-characterize the corporation's debt as equity to the benefit of the old equity and the detriment of the corporation's creditors); see also *Prod. Res. Group*, 863 A.2d at 790 ("Although it is easy to posit extreme hypotheticals involving directors putting cash in slot machines, the real world is more likely to generate situations when directors face a difficult choice between pursuit of a plausible, but risky, business strategy that might increase the firm's value to the level that equity holders will receive value, and another course guaranteeing no return for equity but preservation of value for creditors. Absent self-dealing or other evidence of bad faith, by what measure is a court fairly to critique the choice made through an award of damages?").

[11] DEL. CODE ANN. tit. 8 § 141(a) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.").

[12] *See King v. VeriFone Holdings, Inc.*, 12 A.3d 1140, 1146 (Del. 2011) (citing *Aronson v. Lewis*, 473 A.2d 805, 814–815 (Del. 1984)); Del. Ch. Ct. R.23.1.

[13] *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007) ("When a corporation is insolvent, however, its creditors take the place of the shareholders as the residual beneficiaries of any increase in value.").

[14] *Id.* ("the creditors of an *insolvent* corporation have standing to maintain derivative claims against directors on behalf of the corporation for breaches of fiduciary duties.").

[15] *Id.*

time the suit was filed to have standing.[16] Creditors are not required to show that corporate debtor was irretrievably insolvent to have standing.[17] The balance sheet test is used for determining whether a company is insolvent for the purpose of determining creditor standing.

In addition, the standing and pleading requirements that apply to creditors seeking to bring derivative claims are more permissive than those that apply to stockholders. Stockholder standing to bring derivative litigation is subject to a contemporaneous ownership requirement: a stockholder must show that they held stock at the time of the alleged breach of fiduciary duty and continue to do so throughout the litigation.[18] The one case that has considered the issue has held that derivative litigation brought by creditors is not subject to a similar contemporaneous ownership requirement.[19] Similarly, stockholders are subject to a continuous ownership requirement—if the stockholder suing derivatively loses ownership of his stock in a corporation during the pendency of the derivative suit, the stockholder loses standing to continue the derivative suit.[20] For creditors suing derivatively, there is no "continuous" insolvency requirement. So long as the corporate debtor is insolvent the date suit was filed, it may lapse in and out of solvency while the creditor's derivative suit is pending and the creditor will still retain standing.

Also, courts have repeatedly urged stockholders to use the tools at hand—most notably stockholders' § 220 informational rights—when drafting complaints bringing derivative claims. A stockholder bringing a derivative claim must make particular allegations that a majority of the board was not disinterested or that the board's decision violates the duty of care (i.e, gross negligence) to meet the pleading requirements of Delaware Court of Chancery Rule 23.1 and to overcome the protections of the business judgment rule. To meet this burden and show that demand is excused, extensive pre-suit investigation is frequently necessary. It is unclear whether similar expectations would apply to a creditor's bringing a derivative complaint on behalf of an insolvent company.

Other states have also found that creditors have standing to bring derivative claims on behalf of an insolvent corporation. Texas has followed *Ghewalla* in construing a creditor's rights under New York law.[21] Minnesota has held that its law concerning creditor standing is not distinguishable from Delaware's.[22] Tennessee has explicitly adopted Delaware's reasoning with respect to creditor standing.[23] And, Federal Courts have predicted that New York will also follow Delaware's lead addressing creditor standing to bring litigation.[24] At least one state has rejected

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[16] *Quadrant Structured Prods. Co. v. Vertin*, 115 A.3d 535, 556 (Del. Ch. May 4, 2015) *judgment aff'd* --- A.3d ----, 2016 WL 6438209 (Table) (Del. Oct. 31, 2016).

[17] *Id*. at 556–62

[18] *See* DEL. CODE ANN. tit. 8 § 327; Del. Ct. Ch. R.23.1.

[19] *Quadrant Structured Prods. Co. v. Vertin*, 102 A.3d 155, 177–82 (Del. Ch. 2014), *reconsideration denied*, 2014 WL 5465535 (Del. Ch. Oct. 28, 2014).

[20] *Ark. Teacher Ret. Sys. v. Countrywide Fin. Corp*., 75 A.3d 888, 894 n.15 (Del. 2013).

[21] *U.S. Bank Nat'l Ass'n v. Stanley*, 297 S.W.3d 815, 820 (Tex. App. Houston 14th Dist. 2009).

[22] *See Christians v. Grant Thornton, LLP*, 733 N.W.2d 803, 809 (Minn. Ct. App. 2007) ("We see no basis for concluding that Minnesota's law is in actual conflict with Delaware's law on this issue. Because Delaware's law on trustee standing is more clearly developed, we will, as a matter of judicial convenience, refer to Delaware cases.").

[23] *Sanford v. Waugh & Co*., 328 S.W.3d 836, 847 (Tenn. 2010) ("We agree with and adopt the Delaware Supreme Court's reasoning and holding in Gheewalla.").

[24] *See RSL Commc'ns PLC v. Bildirici*, 649 F. Supp. 2d 184, 206 (S.D.N.Y. 2009) (stating that "many courts—including this one—appropriately look to the views of Delaware's learned jurists when analyzing issues of

Delaware's approach: creditors lack standing to bring derivative litigation under Wisconsin law until the corporation has failed.[25]

b. LLCs and LLPs—creditors never have standing to bring derivative litigation

Unlike creditors of a corporation, creditors of a Delaware LLC or LP do not have standing to bring a derivative claim on behalf of an insolvent entity.[26] Delaware limits standing to bring a derivative action on behalf of an LLC to members or assignees by statute.[27] Delaware likewise limits standing to bring a derivative action on behalf of an LP to partners or assignees of partners.[28] Although from a policy perspective, the rationale for allowing the creditor of a corporation to bring a claim should apply equally to creditors of alternative entities, the statutory language governing derivative actions brought on behalf of LLCs or LPs clearly and unambiguously precludes any judicial creation of derivative standing on behalf of creditors of alternative entities.[29]

3. No creditor standing to bring direct claims for breach of fiduciary duty

A derivative claim for breach of fiduciary duty is brought on behalf of the corporation and seeks to redress an injury to the corporation. As a result, any recovery in a derivative action goes to the corporation. In instances where a director's breach of fiduciary duty has caused harm to the stockholders individually rather than harm to the corporation, the stockholders have direct claims for breach of fiduciary duty. To bring a direct claim for breach of fiduciary duty, the stockholder need not make a pre-suit demand on the board or show that demand is excused before bringing a lawsuit. Moreover, the stockholder who successfully brings a direct claim personally recovers all of the relief ordered.[30] Because of the absence of derivative standing and pleading requirements and the right to receive damages directly, creditors have sought to bring direct claims for breach of fiduciary duty against the directors of insolvent and near insolvent corporations. Those attempts have been unsuccessful.

"[T]he creditors of a Delaware corporation that is either insolvent or in the zone of insolvency have no right, as a matter of law, to assert direct claims for breach of fiduciary duty against the corporation's directors."[31] The Delaware Supreme Court has explained the policy foundation for this rule.

> [A]n otherwise solvent corporation operating in the zone of insolvency is one in most need of effective and proactive leadership--as well as the ability to negotiate in good faith with its creditors--goals which would likely be significantly undermined by the prospect of individual liability arising from the pursuit of direct claims by creditors.

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corporate law" and concluding that it "agrees with the Delaware Supreme Court's position in Gheewalla").

[25] *Polsky v. Virnich*, 2010 WI App 20, P12 (Wis. Ct. App. 2010).

[26] *CML v. Bax*, 28 A.3d 1037 (Del. 2011) (addressing LLCs).

[27] *See* DEL. CODE ANN. tit. 6 § 18-1002.

[28] *See* DEL. CODE ANN. tit. 6 § 17-1002.

[29] See *CML*, 28 A.3d at 1043 ("the General Assembly is free to elect a statutory limitation on derivative standing for LLCs that is different than that for corporations, and thereby preclude creditors from attaining standing. The General Assembly is well suited to make that policy choice and we must honor that choice. In this respect, it is hardly absurd for the General Assembly to design a system promoting maximum business entity diversity. Ultimately, LLCs and corporations are different; investors can choose to invest in an LLC, which offers one bundle of rights, or in a corporation, which offers an entirely separate bundle of rights.").

[30] *Tooley v. Donaldson, Lufkin, & Jenrette, Inc.*, 845 A.2d 1031, 1038–39 (Del. 2004).

[31] *N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 94 (Del. 2007).

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When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners.[32]

The Delaware Supreme Court has explicitly rejected the possibility that even a "marked degree of animus towards a particular creditor with a proven entitlement to payment" could give rise to a direct claim by a creditor for breach of fiduciary duties.[33]

4. Claims for deepening insolvency

It is also clear that Delaware law does not allow claims for "deepening insolvency." A significant question for the directors of any corporation in financial distress is whether the corporation should continue to operate, and thus potentially incur more losses, or cease operating and try to salvage value through a sale or liquidation. Claims that directors improperly continued to operate an insolvent corporation or lenders lent to an insolvent corporation, damaging the corporation's stockholders or creditors, are described as claims for deepening insolvency. The term "`[d]eepening insolvency' refers to the `fraudulent prolongation of a corporation's life beyond insolvency,' resulting in damage to the corporation caused by increased debt."[34] Some federal courts have predicted that deepening insolvency would be a recognized cause of action or theory of recovery under the laws of various states.[35] Those states that have directly considered the question, including Delaware, have generally rejected the theory.[36]

a. Delaware does not recognize a claim of deepening insolvency

Delaware does not recognize a claim for deepening insolvency. Delaware courts reason that, "[i]f a board of an insolvent corporation, acting with due diligence and good faith, pursues a business strategy that it believes will increase the corporation's value, but that also involves the incurrence of additional debt, it does not become a guarantor of that strategy's success."[37] The board of an insolvent Delaware corporation remains entitled to exercise

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[32] *Gheewalla* at 100–01 (internal citations and footnotes omitted).

[33] See *Gheewalla* at 103 n.43 (rejecting possibility raised in *Prod. Res. Group, L.L.C. v. NCT Group, Inc*., 863 A.2d 772, 798 (Del. Ch. 2004), and *Big Lots Stores, Inc. v. Bain Capital Fund VII, LLC*, 922 A.2d 1169, 1179 (Del. Ch. 2006), that a marked degree of animus towards a particular creditor with a proven entitlement to payment might expose directors to a direct claim for breach of fiduciary duty).

[34] *Kittay v. Atl. Bank (In re Global Serv. Group LLC)*, 316 B.R. 451, 456 (Bankr. S.D.N.Y. 2004) (quoting *Schacht v. Brown*, 711 F.2d 1343, 1350 (7th Cir. Ill. 1983)).

[35] See *id.* at 457–458.

[36] *See Trenwick Am. Litig. Trust v. Ernst & Young, LLP*, 906 A.2d 168, 205 (Del. Ch. 2006) (rejecting “deepening insolvency” as a cause of action under Delaware law), *aff'd*, 931 A.2d 438 (Del. 2007). *See also* Sabin Wilett, The Shallows of Deepening Insolvency, 60 Bus. Law. 549 (Feb. 2005).

[37] See *Trenwick* at 205 (rejecting “deepening insolvency” as a cause of action under Delaware law), *aff'd*, 931

its good faith business judgment when determining whether the corporation should continue operating; the decision for the corporation to continue operating when insolvent is not subject to a heightened standard of review by reason of the corporation's insolvency.[38] "Put simply, under Delaware law, `deepening insolvency' is no more of a cause of action when a firm is insolvent than a cause of action for `shallowing profitability' would be when a firm is solvent."[39] Consequently, "Delaware law imposes no absolute obligation on the board of a company that is unable to pay its bills to cease operations and to liquidate."[40]

b. States other than Delaware have similarly rejected deepening insolvency

Delaware is not alone in rejecting deepening insolvency as a measure of damages or a cause of action.[41] Other state courts directly addressing the question have explained that where an insolvent corporation's life is wrongfully extended, any cause of action or theory of damages are already encompassed by existing law and existing theories of damages.[42]

c. Federal courts have hypothesized that some state courts would recognize claims for `deepening insolvency'

Although a creature of state law, claims for deepening insolvency are most commonly discussed in federal court. Many federal courts have, at times, hypothesized that various states, including Pennsylvania, New York, North Carolina, Illinois, and (incorrectly) even Delaware, would recognize a claim for deepening insolvency.[43] However, the federal courts' speculation as to state law in this area is inconsistent from federal court to federal court, even with respect to any given state.[44] When state courts have addressed the question of deepening insolvency as a separate

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A.2d 438 (Del. 2007).

[38] *Shandler v. DLJ Merch. Banking, Inc*., 2010 Del. Ch. LEXIS 154, at *56 (Del. Ch. July 26, 2010).

[39] *Trenwick* at 174.

[40] *Trenwick* at 204–206. See also *Shandler* at *55 ("Even when [the company] was insolvent, the board was entitled to exercise a good faith business judgment to continue to operate the business if it believed that was what would maximize [the company's] value.").

[41] *See, e.g.*, *Bondi v. Citigroup, Inc.*, 423 N.J. Super. 377, 387 (App.Div. 2011) (deepening insolvency is not a cause of action under Illinois law); *Coroles v. Sabey*, 79 P.3d 974, 983, 2003 UT App 339 (Utah Ct.App. 2003) (rejecting deepening insolvency as a theory of damages because shareholders rather than the corporation suffer harm).

[42] *See, e.g.*, *Christians v. Grant Thornton, LLP, 733 N.W.2d 803, 811 (Minn. Ct. App. 2007)* (rejecting deepening insolvency as a measure of damages on the grounds that it is duplicative of other theories); Commercial Fin. Servs., Inc. v. J.P. Morgan Sec., Inc., 152 P.3d 897, 900 (Okla. Civ. App. 2006) (rejecting deepening-insolvency damages under Oklahoma law), cert. denied (Okla. Jan. 16, 2007).

[43] See, e.g., *In re Citx Corp.*, 448 F.3d 672, 681 (3d Cir. Pa. 2006) (applying what the 3rd circuit predicts that Pennsylvania's law would be if Pennsylvania Courts had addressed the issue; hypothesizing that Pennsylvania would recognize a claim for deepening insolvency if culpability beyond negligence were shown); *Kirschner v. K&L Gates LLP*, 2012 PA Super 102, at *38 (Pa. Super. Ct. 2012) (noting the federal court's hypothesis that Pennsylvania would recognize a claim for deepening insolvency, and holding that the particular case before the court did not state such a claim, without addressing whether Pennsylvania law would recognize such a claim).

[44] *See OHC Liquidation Trust v. Credit Suisse First Boston (In re Oakwood Homes Corp.)*, 340 B.R. 510, at

cause of action without rejecting the theory outright, they have not clarified whether it would be a valid theory under their law, or what the requirements for such a claim or measure of damages would be.[45]

While directors should be cognizant of the possibility that a claim for deepening insolvency may be brought in certain jurisdictions if they attempt to revitalize an insolvent corporation rather than immediately reorganize, there is no set standard for such a claim or consensus as to whether such a claim or measure of damages is valid as a matter of law.

d. Threat of deepening insolvency lawsuits may incentivize troubled companies to terminate restructuring efforts early

Despite the lack of clarity with respect to claims for deepening insolvency, the specter of such claims or theory of damages is itself harmful because it may cause directors to cut short efforts to revitalize a corporation outside of bankruptcy. Bankruptcy is itself costly and disruptive to a business; limiting the option of out-of-court efforts at restructuring or resuscitation comes with a potentially high cost. The potential chilling effect of the ambiguous state of the law in many jurisdictions is doubly problematic where the law is unclear with respect to whether mere negligence could be sufficient to trigger liability.

C. Sources of Conflict of Interest—Common Director and Officer Scenarios

To mount a successful challenge to a board's conduct of an insolvent corporation, the creditor or other plaintiff must overcome the protections of the business judgment rule. It can be extraordinarily hard to plead much less prove a violation of the duty of care. It requires some facts showing the board was grossly negligent. In addition, showing gross negligence will not be sufficient to win an award of monetary damages because of the exculpation clauses permitted under § 102(b)(7) and contained in nearly every corporate certificate of incorporation. Absent a conflict of interest, the plaintiff assailing board action will need to show the board committed waste (that the board's decision is so wholly irrational it cannot be explained) or that the board did not act in good faith (*i.e*, the board intended harm to the corporation). Because an actionable violation of the duty of care is so difficult to establish, most successful challenges to directorial decision-making and misconduct are predicted on the existence of a conflict of interest that tainted the director's decision-making. A director or an officer suffers a conflict of interest wherever they are interested in a transaction or in one of the possible courses of action under consideration by the board or where they are not independent from another party who has a conflict of interest.[46] Conflicts of interest can arise from a myriad of sources and insolvency tends to increase the number of conflicts directors may face.

1. Continued employment by the company

Continued employment by the corporation can create a conflict of interest. Delaware law presumes that a director does not have a material interest in remaining a director, with limited exceptions.[47] And the receipt of ordinary

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*528–529 (Bankr. D. Del. 2006) (among other things, incorrectly predicting that Delaware would recognize a claim for deepening insolvency).

[45] *See, e.g.*, *Holland v. Arthur Andersen & Co*., 212 Ill. App. 3d 645, 652 (Ill. App. Ct. 1st Dist. 1991) (noting that the 7th Circuit has recognized a claim for deepening insolvency, but finding that the allegations in the particular case failed to state a claim, without addressing whether such a claim could ever exist under Illinois law); *Bowler v. Arthur Andersen, LLP*, 20 Mass. L. Rep. 85 (Mass. Super. Ct. 2005) (finding that theory of deepening insolvency may apply to an insurance company under Massachusetts law under certain circumstances).

[46] *See, e.g.*, *Hartsel v. Vanguard Group, Inc*., 2011 Del. Ch. LEXIS 89, at *104 (Del. Ch. June 15, 2011) Under this court's demand futility jurisprudence, “disinterested” generally means “that directors can neither appear on both sides of a transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally.” “Independence” generally means “that a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences.” (citations omitted).

[47] *See, e.g.*, *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 833 A.2d 961, 978 (Del. Ch. 2003)

directors' fees will generally not create a conflict of interest for a director.[48]

However, where a director is an employee of the company as well as a director, the director likely has a material interest in the director's continued employment,[49] unless neither the job nor the compensation received are material to the director.[50] Where a director has a material interest in ongoing employment, the director suffers a conflict of interest wherever the director is asked to make a decision potentially affecting the director's employment.[51] The director also suffers a conflict of interest with respect to any transaction in which someone with control over the director's employment, such as a controlling stockholder, has an interest.[52] Such conflicts may easily arise where the corporation is in financial distress, if, for example, the board considers whether to liquidate the corporation or to engage in a merger or other transaction that would foreseeably affect the employment of the director.

2. Conflicts between companies within a corporate family

When one member of a corporate family is in financial distress the interests of that corporation may differ materially from the interests of other members of the corporate family, which may be stockholders, creditors or potential acquirers of assets from the financially troubled corporation. A director or officer may face a conflict of interest where the individual serves as a director or officer of multiple entities within the corporate family.

When a wholly owned subsidiary is solvent, it may be managed exclusively for the benefit of its parent entity.[53]

(controlling stockholder's ability to remove directors did not create a conflict of interest disabling directors from considering whether to cause the company to bring litigation against the controlling stockholder).

[48] *See Cinerama, Inc. v. Technicolor, Inc*., 663 A.2d 1156, 1169 (Del. 1995); *Orman v. Cullman*, 794 A.2d 5, 42 n. 62 (Del. Ch. 2002) (noting that generally directors' fees do not establish a material interest, but warning that the “Court's view of the disqualifying effect of such fees might be different if the fees were shown to exceed materially what is commonly understood and accepted to be a usual and customary director's fee.”).

[49] See, e.g., *In re Western Nat'l Corp. S'holders Litig.,* 2000 Del. Ch. LEXIS 82, 65–66 (Del. Ch. May 22, 2000) (noting that “Graf's and Scott's conflict of interest—continued employment in the combined entity—and Buckwalter's lack of independence—an employment relationship with one of the parent company's lenders—are the sort of fiduciary problems that typically require additional evidence before the court will consider such directors interested in the transaction or beholden to the parent company[,]” before concluding the mere existence of such relationships was insufficient to demonstrate conflict of interest where the plaintiff had had the opportunity to develop evidence showing that the employment was material to the directors, but failed to do so.).

[50] *See, e.g., Selectica, Inc. v. Versata Enters.*, 2010 Del. Ch. LEXIS 39, at *50 (Del. Ch. Feb. 26, 2010) (directors were disinterested in their continuing employment where they had assumed the position as a favor to the company after retiring from long and successful careers).

[51] *See, e.g., Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 833 A.2d 961, 977–978 (Del. Ch. 2003) (“Based on the magnitude of compensation described flowing to Patrick from her work at MSO, I find that Patrick has a material interest in her own continued employment.”).

[52] *See, e.g., Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 833 A.2d at 978 (Del. Ch. 2003) (“Because Stewart is the company's chairman and chief executive, controls over 94% of the shareholder vote, and is the `personification of [MSO's] brands as well as [its] senior executive and primary creative force,' Stewart certainly has the ability to affect Patrick's employment and compensation at MSO. As described above, Stewart is personally interested in the subject matter of Count I. This raises a reasonable doubt whether Patrick can evaluate and respond to demand on Count I without being influenced by improper consideration of the extraneous matter of how pursuit of that claim would affect Stewart's interests.”).

[53] *Quadrant Structured Prods. Co. v. Vertin*, 102 A.3d at 182–185.

Directors do not breach fiduciary duties when they cause a wholly-owned, solvent, subsidiary to engage in transactions with the subsidiary's parent that are disadvantageous to the subsidiary. Such transactions may include transferring assets to a different subsidiary of the same parent, allowing the parent to use the subsidiary's assets to secure a loan to the parent, or entering into service agreements with the parent or other subsidiaries of the parent that are not set at a market rate.

But, when a wholly owned corporation becomes insolvent, its dealings with its parent entity are judged under the same entire fairness standard. This shift is the result of creditors becoming residual interest holders. At that point, the creditors, not the controlling stockholder pay the price of any lopsided transactions between the subsidiary and its parent. When the entire fairness standard applies, a controlling stockholder that stands on both sides of a transaction is obligated to demonstrate that the transaction was entirely fair to the subsidiary.

This rule curtails the freedom that a parent has to engage in transactions with its subsidiaries. As a result, directors of an insolvent subsidiary must scrutinize transaction between the parent and affiliates for fairness to the subsidiary itself. Similarly, a director or officer may suffer a conflict of interest where the director serves on the boards of multiple corporations with divergent interests.[54]

3. Personal financial interest in distressed company

Directors' ownership of stock of the corporation on whose board they serve is ubiquitous. A 2009 survey of 186 of the 250 largest companies in the S&P 500 found that the companies had a median director stock ownership requirement of $300,000.[55] Indeed it is generally considered a healthy corporate governance strategy for companies to align their directors' financial interests with those of the common shareholder.[56] Outside of bankruptcy, a director's ownership of stock generally does not give rise to a conflict of interest, because generally the stockholders' interests are aligned with the corporation's interests and the beneficiary of the directors' fiduciary duties.

When an insolvent corporation's interests diverge from those of its stockholders, stock ownership may present a conflict of interest for directors.[57] Similarly, where a transaction is beneficial or detrimental to various classes of a corporation's equity, a director's financial interest can present a conflict.[58] These types of conflicts may well emerge in times of financial distress despite not existing previously.

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[54] See, e.g., *In re Trados Inc. S'holder Litig.*, 73 A.3d 17, at *83 (Del. Ch. Aug. 16, 2013) ("there was `no dilution' of the duty of loyalty when a director `holds dual or multiple' fiduciary obligations. [] If the interests of the beneficiaries to whom the dual fiduciary owes duties are aligned, then there is no conflict. . . . But if the interests of the beneficiaries diverge, the fiduciary faces an inherent conflict of interest." (citations omitted)).

[55] *See* Frederic W. Cook & Co., Inc., *Stock Ownership Guidelines: Prevalence and Design of Executive & Director Ownership Guidelines Among the Top 250 Companies* 9 (2009).

[56] *See, e.g.*, *LC Capital Master Fund, Ltd. v. James*, 990 A.2d 435, 452 (Del. Ch. 2010) ("[I]t has been thought that having directors who actually owned a meaningful, long-term common stock stake was a useful thing, because that would align the interests of the independent directors with the common stockholders and give them a personal incentive to fulfill their duties effectively."); ISS, *2011 U.S. Proxy Voting Guidelines Concise Summary* 15 (2011) ("ISS favors stock ownership on the part of directors.").

[57] C.f. *In re FLS Holdings, Inc. Shareholders Litig*., 1993 Del. Ch. LEXIS 57, at *11–12 (Del. Ch. Apr. 2, 1993) (refusing to approve settlement agreement releasing claims that the directors improperly favored the interests of common stockholders over the interests of preferred stockholders in choose to merge a corporation rather than restructure the corporation on the grounds that the claims had value, in part because the directors owned substantial amounts of common stock).

[58] *In re Trados* at *84 (discussing whether directors' affiliation with owners of preferred equity created a conflict of interest for the directors).

4. Ties to a controlling shareholder or creditor

Perhaps the most common conflict of interest that a director may suffer arises where the director has ties to a creditor of the corporation or to the controlling stockholder of the corporation. In either case, the director's lack of independence from the creditor or controlling stockholder creates a conflict of interest for the director wherever the interests of the creditor or the controlling stockholder differ from those of the corporation.

5. Other business dealings with the distressed company

Directors and officers will also suffer a conflict of interest with respect to their management of a financially troubled corporation in any other situation in which their interests differ from those of the corporation or its stockholders generally. Thus, for example, where a financially troubled corporation sells assets in an effort to repair its balance sheet, its directors will have a conflict of interest if they are affiliated with the buyer of the corporation's assets.[59]

In a refinancing or recapitalization, it is not unusual for the new capital to come from someone who already has a position in the troubled company's capital structure. This can create conflicts of interest to the extent the new financing impairs the position of the other members of the capital structure.

When a controlling or majority equity holder in a troubled company provides additional capital, it will often want additional protection for the new money, perhaps in the form of preferred stock with superior rights to the common, or to greater ownership percentage than the existing stockholders believe the new equity should get, in effect a delusion. To the extent there are directors or officers in the troubled company that are non-independent of the equity sponsor, these transactions can be attacked as breaches of the duty of loyalty. Even when there is no potential conflict of interest, they can be attacked on duty of care grounds.

Additional financing provided by an existing secured lender can give rise to conflicts as well. If a director or officer has ties to the lender, the existing secured lender may seek to use the refinancing negotiation as a chance to improve its secure position or at the expense of more junior creditors and equity.

D. Controlling Stockholder Duties

The controlling stockholder of a corporation owes the corporation and its minority stockholders fiduciary duties: "[W]hen a shareholder, who achieves power through the ownership of stock, exercises that power by directing the actions of the corporation, he assumes the duties of care and loyalty of a director of a corporation."[60] Among other things, these fiduciary duties prevent a controlling stockholder from using its voting control over the corporation to cause the corporation to engaging in a transaction with the controlling stockholder that is not entirely fair to the corporation.[61]

Nonetheless, a controlling stockholder's fiduciary duties has limits. "A controlling shareholder . . . has the right to act in its own self-interest when it is acting solely in its capacity as a shareholder[,]" for example, by voting against a

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[59] *See, e.g., Shandler v. DLJ Merch. Banking, Inc.*, 2010 Del. Ch. LEXIS 154, at *42 (Del. Ch. July 26, 2010) (denying motion to dismiss claims brought by creditor trustee for an insolvent corporation that four directors breached their fiduciary duties by causing the corporation to sell an asset to the directors' employer at an unfair price through an unfair process).

[60] *Pfeffer v. Redstone*, 2008 Del. Ch. LEXIS 12, at *48 n.72 (Del. Ch. Feb. 1, 2008) (quoting *Cinerama, Inc. v. Technicolor, Inc.*, 1991 Del. Ch. LEXIS 105 (Del Ch. June 24, 1991), *aff'd in part, rev'd on other grounds sub nom.*, 634 A.2d 345 (Del. 1993)). *See also Allied Chem. & Dye Corp. v. Steel & Tube Co. of Am.*, 120 A. 486, 492 (Del. Ch. 1923) ("wherever the question of whether the fiduciary character which the law attaches to the majority … is considered and the charge made that its quasi trust obligations are ignored, the personal advantage which the alleged wrongdoers attempt to garner to themselves *is in some way directly incident to the very property towards which they stand in a fiduciary relationship*.") (emphasis added).

[61] *In re S. Peru Copper Corp. S'holder Derivative Litig*., 52 A.3d 761, 787 (Del. Ch. 2011).

transaction with a third party.[62] "A controlling shareholder is not required to give up legal rights that it clearly possesses; this is certainly so when those legal rights arise in a non-stockholder capacity."[63] Moreover, "[w]hen a controller exercises contractual or statutory rights as a third-party lender, its actions are not subject to fiduciary review."[64] For example, a creditor who is also a controlling stockholder has no fiduciary duty to refrain from foreclosing on the borrowing corporation's assets, even if the effect of doing so is to render the common stock of the corporation worthless.[65] When bidding in a foreclosure sale, a controlling stockholder has no obligation to pay a fair price for the assets of the borrowing corporation.[66] In essence:

> Fiduciary obligation does not require self-sacrifice. More particularly, it does not necessarily impress its special limitation on legal powers held by one otherwise under a fiduciary duty, when such collateral legal powers do not derive from the circumstances or conditions giving rise to the fiduciary obligation in the first instance. Thus one who may be both a creditor and a fiduciary (e.g., a director or controlling shareholder) does not by reason of that status alone have special limitations imposed upon the exercise of his or her creditor rights.[67]

However, while a controlling stockholder is free to use whatever contractual or statutory powers the controlling stockholder obtains as a creditor to further the controlling stockholder's interests as a creditor, the controlling stockholder is not permitted to use advantages obtained by reason of being a controlling stockholder to advantage the controlling stockholder in its capacity as creditor or otherwise.[68]

E. Creditors' Aider and Abettor Liability

Creditors of an insolvent corporation may be liable for aiding and abetting a board's breach of fiduciary duties if they knowingly participated in the board's breaches, for example by intentionally capitalizing on directors' self-interest.[69] Under Delaware law, a third party may be liable for aiding and abetting a breach of fiduciary duty.

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[62] Stephen A. Radin, *The Business Judgment Rule: The Fiduciary Duties of Corporate Directors,* 1171 (6th ed. 2009) (citing *Thorpe v. CERBCO, Inc*., 676 A.2d 436, 440–41, 443–44 (Del. 1996); *Williams v. Geier*, 671 A.2d 1368, 1380-81 (Del. 1996); *Stroud v. Grace*, 606 A.2d 75, 83–84 (Del. 1992); *Bershad v. Curtiss-Wright Corp*., 535 A.2d 840, 845 (Del. 1987); *In re Digex, Inc. S'holders Litig*., 789 A.2d 1176, 1190 (Del. Ch. 2000)). See also *Allied Chem.*, 120 A. at 493; *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 958 (Del. 1985) (citing *DuPont v. DuPont,* 251 F. 937 (D. Del. 1918), *aff'd* 256 F. 129 (3d Cir. 1918)) ("nothing precludes [a stockholder] from acting in its own self-interest"); *Ringling Bros.-Barnum & Bailey Combined Shows, Inc. v. Ringling*, 53 A.2d 441, 447 (Del. 1947) (a group of shareholders may, without impropriety, vote their respective shares so as to obtain advantages of concerted action and may lawfully contract with each other to vote in the future in such way as they may determine); *Heil v. Standard Gas & Elec. Co.*, 151 A. 303, 304 (Del. Ch. 1930) (stockholders have the right to exercise wide liberality of judgment in the matter of voting and may admit personal profit or even whims and caprice into the motives which determine their choice).

[63] *Solomon v. Pathe Commc'ns Corp*., 1995 Del. Ch. LEXIS 46, at *16 (Del. Ch. Apr. 21, 1995).

[64] *In re* CNX Gas Corp. S'holders Litig., 4 A.3d 397, 409 (Del. Ch. 2010).

[65] See *Solomon,* at *16–17.

[66] *See Odyssey Partners, L.P. v. Fleming Cos.*, 735 A.2d 386, 414 (Del. Ch. 1999).

[67] *Odyssey Partners* at *10.

[68] *Odyssey Partners* at *11.

[69] Claims for aiding and abetting have been leveled against creditors at least twice, although the plaintiff was not

The elements of such a claim are: "(1) a fiduciary relationship; (2) a breach of that relationship; (3) that the alleged aider and abettor knowingly participated in the fiduciary's breach of duty; and (4) damages proximately caused by the breach."[70]

F. Conflicts Arising in Purchase of Outstanding Debt by Fund as Part of a "Loan-To-Own" or "Ride Through" Strategy

Several of these potential conflict situations can come into play when a fund employs "loan-to-own" or "ride through" strategies. Loan-to-own strategies vary, but a common scenario involves a hedge fund where a distressed, or "vulture," investor makes a secured loan while also taking a significant but minority equity stake in the borrower. In the event that the borrower's business falls deeper into financial distress, the loan-to-own investor will use its leverage as a secured creditor to squeeze out-of-the-money creditors and other equity out of the business and take control. A "ride through" strategy typically involves a private equity fund that buys the distressed debt in a company in which it has an existing equity stake. The private equity fund buys the debt with an eye toward being able to control the company's restructuring and emerge with a significant equity stake in the company post-restructuring. But the proposed restructuring or sale may leave the other rungs of the capital structure out of money or highly diluted. Different levels of the capital structure frequently have different risk appetites as to future business strategy. The secured lenders may prefer the strategy that poses minimal risk to their ability to satisfy their secured loan through liquidation of collateral. Out-of-the-money or near out-of-the-money equity may prefer a more risky strategy that gives it some chance to recovery even if it involves an offsetting risk of increased deterioration of the business. All of this creates an incentive for the more junior members of the capital structure to attack the proposed transaction as being the product of a bad and conflicted process. Accordingly, vulture and private equity funds need to be attuned to potential conflicts of interest and methods of conflict sterilization and mitigation.

To the extent the vulture investor or private equity fund wants existing management or the board to carry through to new company, those directors and management are subject to claims of conflict of interest and, in particular, that the existing management made an inadequate effort to find a better transaction than the restructuring favored by the vulture investor or the private equity fund. Because the director or officer of a distressed company has been offered continued employment following the transaction, there will be an argument that it favored the interests of the proponent of that transaction. The out-of-the money or heavily diluted creditors and equity holders may argue that the borrower made inadequate effort to obtain a better proposal. This may involve trying to show that alternative transactions were ignored or not pursued or that the process for finding alternative transactions was unfairly limited. The out–of-the-money creditors and investors may also try to show that the corporation had greater value as a standalone corporation and that it was a mistake to pursue any transaction. However, this can be difficult to show in a distressed scenario.

The fund may also have bargained for and received director appointment and other governance rights. But a board member that has been designated by a private equity fund and serves both on the board of a distressed company and the board of the financial sponsor will not be considered independent. A director or officer may have a personal financial interest in the distressed company or be beholden to someone who does through ties to a controlling shareholder or creditor. To the extent an officer or director has ties to a lender or significant holder of equity, conflicts of interest may arise from the different interests between different levels of the distressed company's capital structure.

G. Use of Independent Fiduciaries and Advisors to Address Conflicts or Provide Defense of Reasonable

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successful in either case. *See Radnor Holdings Corp. v. Tennenbaum Capital Partners*, 353 B.R. 820 (D. Del. 2006) (rejecting claim that creditor aided and abetted a breach of fiduciary duties by advancing funds to an insolvent corporation on the grounds that borrowing funds was not a breach of fiduciary duty by the board under *Trenwick Am. Litig. Trust v. Ernst & Young, LLP*, 906 A.2d 168, 204 (Del. Ch. 2006)); *Official Comm. of Unsecured Creditors v. CIT Group/Business Credit, Inc. (In re Jevic Holding Corp.)*, 2011 Bankr. LEXIS 3553 (D. Del. 2011) (dismissing claim for aiding and abetting a breach of fiduciary duty for failure to adequately plead knowing participation in the breach by the creditor or damages).

[70] *Gatz v. Ponsoldt*, 925 A.2d 1265, 1275 (Del. 2007).

Reliance
If challenged, a decision made by a conflicted board, in which a majority of the directors are interested or lack independence, will be subject to the highest level of scrutiny—entire fairness—by the reviewing court.[71] The burden of proving entire fairness will fall upon the defendants.[72]

In contrast, where the board delegates an otherwise interested decision to a properly formed, empowered, and functioning special committee, the decision of the special committee will generally be subject to the deferential business judgment standard of review, with any stockholder challenging the decision bearing the burden of demonstrating the directors' lack of independence.[73] Even in the narrow circumstances in which the decision of a properly formed, empowered and functioning, a special committee is not accorded the deferential business judgment standard of review, it is reviewed with greater deference by the courts.[74]

There are three slightly different situations in which a corporation would strongly benefit from forming a special committee. First, and most commonly, a special committee provides a useful independent voice when a board is considering a transaction or business decision in which a majority of the board is interested. In this situation, a properly formed, empowered and functioning special committee's decision will generally be afforded the business judgment standard of review.[75] Second, where demand has been found to be excused with respect to derivative litigation brought on behalf of a corporation, a special litigation committee can wrest control of that litigation away from a plaintiff and control or dismiss the litigation as the best interests of the corporation dictate.[76] Third, where a controlling stockholder seeks to engage in a transaction with the corporation, a special committee can shift the burden of proving the entire fairness of the transaction from the board to the plaintiff in subsequent litigation.[77]

1. Special committees must be properly formed
A properly formed special committee must consist exclusively of disinterested and independent directors.[78] Although it is possible to create a special committee with a single member, the member of such a committee must be "like Caesar's wife, above reproach."[79] The more prudent approach is to include at least two, and preferably three disinterested and independent directors in every special committee.[80]

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[71] *In re Trados Inc. S'holder Litig*., 73 A.3d 17, at *46 (Del. Ch. Aug. 16, 2013).

[72] *Kahn v. Tremont Corp*., 694 A.2d 422, 428 (Del. 1997).

[73] See, e.g., *In re Resorts Int'l S'holders Litig. Appeals*, 570 A.2d 259, 266–267 (Del. 1990).

[74] *See e.g., Zapata Corp. v. Maldonado*, 430 A.2d 779, 788–789 (Del. 1981); *Kahn at* 428.

[75] See, e.g., *In re Resorts Int'l* at 266.

[76] *Zapata Corp.* at 788–789.

[77] *Kahn* at 428.

[78] *See, e.g., Perlegos v. Atmel Corp*., 2007 Del. Ch. LEXIS 25, at *61 (Del. Ch. Feb. 8, 2007) ("As one might expect, the composition of such committees is "of central importance." The inquiry into a special committee's independence is a fact-intensive one, "turn[ing] not simply upon formality but upon the reality of the interests and incentives affecting the independent directors.").

[79] *Lewis v. Fuqua*, 502 A.2d 962, 967 (Del. Ch. 1985).

[80] See *id.*

2. Special committees must be properly empowered
Where a board delegates a decision or other authority to a special committee in order to avoid a conflict situation, the special committee must have the real bargaining power necessary to ensure a fair outcome for the corporation.[81] The special committee must be aware of the scope of its bargaining power.[82] Where bargaining power is insufficient (or not germane), the special committee must have whatever other power it requires to act as an independent party would.[83] The committee's deliberations must also be kept confidential from negotiators for the interested party.[84] Finally, the special committee must be free from threats by persons interested in the transaction.[85]

3. The special committee must be properly functioning
For a committee to function properly it must have access to the independent resources necessary to carry out its task. This means that the committee must have access to legal and financial advisors of its own choosing to the extent it requires them.[86] The committee must also be aware of all material facts: all material terms of the transaction under consideration, all material information related to use or value of any assets involved in the transaction, and all material facts related to the market value of the subject matter of the transaction, including legal or technological changes that would affect its value.[87] The committee must then use these resources to proactively fulfill its mandate.[88]

H. Director Liability for Unlawful Dividends
The directors of a troubled company should pay special attention to decisions to declare a dividend because of the significant liability they may face if a corporation pays an unlawful dividend. Under Delaware law, dividends can only be paid out of surplus or net profits.[89] There is no bright line test for determining whether a corporation has sufficient surplus or net profits, and the determination can be a complex matter.[90] In determining whether there is

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[81] *Ams. Mining Corp. v. Theriault*, 2012 Del. LEXIS 459, at *65–66 (Del. Aug. 27, 2012).

[82] *In re TeleCommunications, Inc. S'holders Litig.*, 2005 Del. Ch. LEXIS 206, at *37 (Del. Ch. Dec. 21, 2005).

[83] *Perlegos* at *53 (special committee needed the power to discipline or terminate officers to carry out travel investigation).

[84] *Rosenblatt v. Getty Oil*, 493 A.2d at 929, 938–39 (Del. 1985).

[85] *Kahn v. Lynch Commc'n Sys*., 638 A.2d 1110, 1120 (Del. 1994).

[86] *In re Fort Howard Corp. S'holders Litig.*, Consol. C.A. No. 9991, 30 (Del. Ch. Aug. 8, 1988).

[87] *Kahn v. Tremont Corp*., 694 A.2d 422 (Del. 1997).

[88] *GPC XLI L.L.C. v. Loral Space & Commc'n Consol. Litig. (In re Loral Space & Commc'n Consol. Litig.)*, 2008 Del. Ch. LEXIS 136, 79–80 (Del. Ch. Sept. 19, 2008) (finding special committee ineffective in part due to one member's passivity).

[89] DEL. CODE ANN. tit. 8 § 170.

[90] *SV Inv. Partners, LLC v. ThoughtWorks, Inc.*, 7 A.3d 973, 982 (Del. Ch. 2010) (discussing how to measure surplus).

sufficient surplus or net profits to support a lawful dividend, directors have a fair amount of informed discretion.[91] Directors can protect themselves by relying on the books of the corporation and experts; therefore, directors of a troubled corporation will want to receive a significant amount of valuation and financial analysis before declaring a dividend. This is because directors are personally liable for their willful or negligent decision to pay an unlawful dividend.[92] This liability may not be exculpated through the corporation's certificate of incorporation.[93] Moreover, the directors are jointly and severally liable for the full amount of the unlawful dividend to both the corporation and, in the event of dissolution or insolvency of the corporation, to its creditors.[94] In addition, directors face liability for six years after the time of payment of the unlawful dividend.[95] Given the severity of these potential penalties, directors of distressed companies deciding whether to declare a dividend should do so only after careful consideration.

I. State Law Insolvency and Dissolution Proceedings

There are several methods through which an insolvent or troubled corporation can liquidate under state corporation law.

1. Asset sale followed by dissolution

a. Asset sale techniques

A board can decide to sell all the corporation's assets and then distribute the proceeds to creditors and stockholders as part of a dissolution proceeding.[96] However, a sale of all or substantially all the assets under § 271 of the DGCL requires both a board resolution and approval by a majority of the stockholders. A sale of all the assets may be feasible if the proceeds are sufficient to pay the corporation's creditor and return some money to the corporation's stockholders. But if the stockholders will receive none of the sale proceeds and the asset sale will thus leave them out of the money, it likely will be difficult to get a majority of the stockholders to vote in favor of the sale.

The distressed corporation's secured creditors can conduct a foreclosure sale of the corporation's assets under Article 9 of the Uniform Commercial Code. But the foreclosing secured creditor should anticipate that junior creditors and equity holders will object to the sale on the basis that the public auction through which the collateral is sold was not properly run and that the junior creditors and equity holders lost the chance to recover.[97]

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[91] *Klang v. Smith's Food & Drug Centers, Inc.*, 702 A.2d 150, 152 (Del. 1997) (explaining that "[d]irectors have reasonable latitude to depart from the balance sheet to calculate surplus, so long as they evaluate assets and liabilities in good faith, on the basis of acceptable data, by methods that they reasonably believe reflect present values, and arrive at a determination that is not so far off the mark as to constitute actual or constructive fraud").

[92] DEL. CODE ANN. tit. 8 § 174(a).

[93] DEL. CODE ANN. tit. 8 § 102(b)(7).

[94] DEL. CODE ANN. tit. 8 § 174(a).

[95] *Id.*

[96] DEL. CODE ANN. tit. 8 § 271 (procedures for the sale of all or substantially all the assets of a corporation); DEL. CODE ANN. tit. 8 § 275 (procedures for dissolution).

[97] *See, e.g.*, *Edgewater Growth Capital Partners LP v. H.I.G. Capital, Inc.*, 68 A.3d 197, 203 (Del. Ch. 2013) (rejecting challenge to secured creditors' purchase of corporations assets pursuant to a foreclosure sale under article 9 of the UCC).

b. Dissolution procedures

After all of a corporation's asset shave been sold and if there is no ongoing business for the corporation to conduct, it is time to bring the corporation's existence to an end. Delaware corporation law provides for both voluntary and involuntary dissolutions. A voluntary dissolution requires a board of directors to adopt a resolution deeming it advisable to dissolve the corporation, and also requires the majority vote of the outstanding shares of stock.[98] Alternatively, a corporation can be dissolved without board action if all the stockholders entitled to vote consent in writing.[99] Winding up requires the sale and disposition of assets, notifying claimants, settling claims, establishing provisions for contingent and unknown claims, and distributing the corporation's remaining assets to its stockholders.[100] The dissolving corporation can choose between the procedure that involves notice and claims administration requirements under judicial supervision or a procedure that leaves the dissolved corporation's board of directors in charge of the decision making process.[101] Voluntary dissolutions do not require court proceedings. The judicially supervised alternative can provide more comfort and repose to directors than the extrajudicial procedure.

A dissolution does not resolve all claims against the corporation or potential liabilities on the part of the directors immediately. A Delaware corporation that has been dissolved continues to exist as a body corporate for a period of three years for the purposes of prosecuting and defending suits and enabling the corporation to gradually wind up its affairs and discharge its liabilities.[102] And even the end of the corporation's legal existence does not leave creditors, stockholders, and other claimants without recourse. Corporate existence can be extended by the Court of Chancery.[103] Thus, state court dissolution may not provide directors the finality of federal bankruptcy proceedings.

Involuntary dissolution does require court proceedings. Court compelled dissolution of a Delaware corporation usually requires that the party seeking dissolution show fraud, management differences reaching a deadlock, that the corporation has no available assets, or other extreme misconduct by management.[104] Dissension on business issues among the corporation's stockholders "seldom, if ever, justifies the appointment of a receiver for a solvent corporation . . .."[105] There must be a showing of "gross mismanagement, positive misconduct by corporate officers, breach of trust, or extreme circumstances showing imminent danger of great loss to the corporation which,

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[98] DEL. CODE ANN. tit. 8 § 275.

[99] DEL. CODE ANN. tit. 8 § 275(c).

[100] *Akande v. Transamerica Airlines, Inc. (In re Transamerica Airlines, Inc.)*, 2006 WL 587846, at *7 n.31 (Del. Ch. Feb. 28, 2006) ("[T]he purpose of Section 280-282 is to provide a judicial mechanism to afford fair treatment to foreseeable future, yet unknown, claimants of a dissolved corporation, while providing corporate directors with a mechanism that will both permit distributions on corporate dissolution and avoid risk that a future corporate claimant will, at a later time, be able to establish that such distribution was in violation of a duty owed to the corporation's creditors on dissolution.").

[101] DEL. CODE ANN. tit. 8 § 281(b) (extrajudicial procedures), §281(a) (judicially supervised procedures).

[102] DEL. CODE ANN. tit. 8 § 278.

[103] *Id.*; *cf. In the matter of Dow Chemical Int'l Inc.*, 2008 Del. Ch. Lexis 147, at *5 (Oct. 14, 2008) (refusing to appoint a petitioner for a dissolved corporation which had been dissolved for more than 20 years).

[104] *Warshaw v. Calhoun*, 221 A.2d 487, 491 (Del. 1966); *Carlson v. Hallinan*, 925 A.2d 506, 543 (Del. Ch. 2006).

[105] *Carlson*, 925 A.2d at 543.

otherwise, cannot be prevented."[106]

2. Appointment of a receiver

a. Receiver for a dissolving corporation
Under § 279 of the DGCL, the dissolving corporation can seek appointment of a creditor or stockholder to be the receiver or trustee to act in the dissolution.[107] In Delaware, the appointment is approved by the Court of Chancery upon the application of the creditor stockholder or director. The receiver takes charge of the dissolved corporation's property and winds up its affairs under court supervision. This includes the power to bring claims on the dissolved corporation's behalf. A trustee or receiver appointed under § 279 owes a fiduciary duty to the corporation's stockholders and creditors.[108] The trustee's or receiver's significant decisions are made with the approval and under the supervision of the Court of Chancery, which reduces the potential personal liability of the trustee or receiver.

b. Receiver for an insolvent corporation
Section 291 of the DGCL gives the Court of Chancery the power to appoint a receiver for an insolvent corporation upon the application of any creditor or stockholder. Under § 291, a receiver manages the property and affairs of the corporation.

3. Arrangement between creditors
A corporation may enter into a compromise arrangement between the corporation and creditors or stockholders.[109] This is sometimes called an assignment for the benefit of creditors or a Chancery receivership. In a compromise arrangement with creditors, a receiver is appointed whose job usually is to gather the corporation's assets and then sell them through some type of marketing process or auction. The receiver then takes the proceeds and distributes them to the creditors. A liquidation through a compromise holds out the possibility that it will be cheaper than bankruptcy proceedings in federal bankruptcy court. But a compromise does not bring two of the main benefits of bankruptcies. First, the assets the receiver sells may not be free and clear of all liens. Second, litigation against the directors and officers of the company can continue because there is no automatic stay.[110]

4. The limited effectiveness of state insolvency proceedings
State law insolvency and receivership proceedings can provide low cost alternative to federal bankruptcy proceedings for corporations with a limited number of stockholders, creditors and other claimants. But as the number of interested parties and complexity of the business grow, the advantages to federal bankruptcy proceedings become evident. To start, federal bankruptcy proceedings allow for nationwide service of process.[111] State court proceedings are limited to the personal jurisdiction of the state court. As a result, it may be difficult in state court receiverships to settle all the claims against the corporation because the court may not be able to obtain personal

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[106] *Id.*

[107] DEL. CODE ANN. tit. 8 § 279.

[108] *Gans v. MDR Liquidating Corp.*, 1991 Del. Ch. Lexis 110, at *8 (Del. Ch. June 25, 1991).

[109] DEL. CODE ANN. tit. 8 § 302. In order for Section 302 arrangement of compromise to be permitted, the corporation must have a "Section 102(b)(2) provision" in its certificate of incorporation.

[110] The Honorable J. Travis Laster, *The Chancery Receivership: Alive and Well*, 28 Del. Lawyer 12 (Fall 2010); *see also* Del. Code Ann. tit. 8 § 291 (allowing appointment of receiver for insolvent corporation).

[111] Fed. R. Bankr. P. 7004(d).

jurisdiction over all the claimants. Relatedly, state court proceedings may not be able to provide the debtor, its affiliates and directors with releases matching the scope of those obtainable in federal bankruptcy court, clear liens, or stay litigation. Because state law insolvency proceedings cannot provide all the benefits of federal bankruptcy proceedings, they are not used as frequently, particularly when there is hope of reorganizing the distressed corporation into a successful going concern.[112]

[112] *Siegman v. Palomar Med. Techs.*, 1998 Del. Ch. Lexis 22 at *4 n.1 (Feb. 2, 1998) (noting the utility of Section 302 as "been preempted by Chapter 11 of the Federal Bankruptcy Code"); James B. Shein, *Reversing the Slide, a Strategic Guide to Turnaround and Corporate Renewal* (Jossey-Bass 2011).