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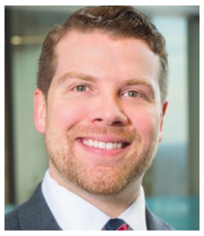
DIRECTORS & OFFICERS MAY FACE PERSONAL LIABILITY IN SUBSEQUENT LITIGATION FOR ACTIONS TAKEN DURING COMPANY INSOLVENCY



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The COVID-19 pandemic has imposed revenue losses, economic uncertainties and unique new challenges on many industries. Adding to the list of challenges is that many vendors and suppliers that companies rely on are also facing new challenges. These difficulties can tend to create ripple effects and lead to increases in litigation. Amidst all of this, company directors and officers will continue to feel mounting pressure, and should also be cognizant that they will face a different standard for personal liability in their roles if the company nears insolvency.

When a company is solvent, the directors and officers owe their fiduciary duties of due care and loyalty to the corporation and its stockholders. The Delaware Chancery Court—a leader in development of corporate law throughout the country—introduced the terms "vicinity of insolvency" and "zone of insolvency" into the legal and business lexicon in a case called *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.* Since then, the Delaware Chancery Court has examined many times whether creditors can sue directors of insolvent corporations, or those in the zone of insolvency, for breach of fiduciary duty. In the seminal case of *North American Catholic Educational Programming v. Gheewalla*, the Delaware Supreme Court was emphatic that directors' fiduciary duties do not shift from shareholders to creditors when a corporation is operating in the "vicinity" or the "zone" of insolvency.

When a company is insolvent and will not be able to pay its creditors in full, directors and officers still owe their fiduciary duties of due care and loyalty to the corporation. Upon insolvency, however, their creditors have the right to bring derivative (but not direct) claims for breach of fiduciary duty against directors and officers. Furthermore, discharging fiduciary duties when a company is insolvent requires a focus on maximizing enterprise value.

Directors of a corporation in the zone of insolvency should make a good faith balancing of benefits and losses, recognizing that any loss to creditors may well be more significant than the corresponding benefit to stockholders. Directors of a corporation in the zone of insolvency should note the following suggestions to limit exposure:

• Actions that increase stockholder return by impairing creditors' claims should be scrutinized.

• Stockholders should not be given preference at the expense of creditors (e.g., directors should not authorize and fund a dividend or a stock redemption at such time).

• Transactions that would constitute a fraudulent conveyance (e.g., a transfer for less than fair value) or a preferential payment to one creditor should not be approved.

• To avoid the appearance of a conflict of interest, directors should fully disclose any personal or business relationships with parties on the other side of transactions.

• While a director is always free to resign under state law and under the corporation's charter and by-laws, resignation does not provide total protection. A director will continue to have liability for pre-resignation acts and omissions.

There is no bright-line test used by courts to determine if a corporation is in the zone of insolvency. In general, if a corporation is in dire financial condition, a court will likely find that the corporation is in the zone of insolvency. Accordingly, when a corporation is in financial distress, its directors and officers should assume that they are in the zone of insolvency and should be making decisions and taking actions on the basis that they may now also owe fiduciary duties to creditors. But, by ensuring that all transactions involving the corporation are entered in good faith and without self-dealing or favoritism toward any group of stakeholders, directors can limit their excess exposure when the company is near insolvency.

JOIN US FOR A CONVERSATION ON OCT. 8 WITH LAWYER AND AUTHOR NITA SWEENEY AS SHE SHARES HER PERSONAL STRUGGLE WITH DEPRESSION IN *DEPRESSION HATES A MOVING TARGET*: CBALAW.ORG

CARES ACT EXPANDS ELIGIBILITY FOR NEW SMALL BUSINESS BANKRUPTCIES

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Much of the focus of the CARES Act has been on the Paycheck Protection Program, and rightly so. But as companies begin to exhaust their PPP funds—and as creditors begin to lose patience and want to be paid—many businesses are struggling to stay afloat. Thankfully, however, the CARES Act has given additional relief for small businesses through an easily overlooked bankruptcy reform.

The CARES Act expanded eligibility for a new and powerful type of bankruptcy reorganization called Subchapter V. This new type of bankruptcy, a subset of Chapter 11, became effective in February of this year, but it was initially limited to businesses with debts of less than $2.7 million. In response to the economic impact of COVID-19, that eligibility limit has been raised to allow filings from businesses with up to $7.5 million in debt.

Subchapter V provides much needed reforms to small business bankruptcies. It removed a rule that was often a barrier to small business owners retaining their ownership interest in their company. It made it easier to confirm a plan of reorganization over the objection of a creditor, so long as the Bankruptcy Court finds that the plan is fair and equitable. It installed a Subchapter V trustee to help bring parties to the negotiating table. And, perhaps most significantly, this new type of bankruptcy filing substantially reduced the administrative burdens, attorney fees and costs that previously made Chapter 11 relief impossible for small businesses.

As forbearance agreements with lenders expire, as landlords start asking for back rent, and as trade creditors stop selling on credit, a Subchapter V bankruptcy may be the lifeline needed to keep many companies in business. Until next spring, the eligibility covers many more entities that were not previously covered, and hopefully many business owners can use Subchapter V to find the relief they need.