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## NEW DELAWARE COURT RULINGS ALLOW MANAGERS OF INSOLVENT COMPANIES TO PURSUE RISKY STRATEGIES – BUT THEY CANNOT BENEFIT INSIDERS

Two recent decisions from Delaware state and federal courts reaffirm a fundamental principle of U.S. corporate insolvency law: insolvency does not require a corporation to shut down and liquidate. Moreover, management of an insolvent company may continue pursuing corporate strategies in good faith, and may even undertake risky maneuvers in an effort to revive the enterprise, without fear of breaching fiduciary duties. Along with this broad corporate freedom comes a significant responsibility: an insolvent company's directors, officers, and direct and indirect controlling shareholders – and their legal, financial, and accounting professionals – may not act to benefit themselves at the expense of "outsider" creditors.

### Despite Insolvency, Management May “Swing for the Fences” as it Tries to Resuscitate a Troubled Company

In *Nelson v. Emerson*, decided May 6, 2008, the Delaware Chancery Court upheld the long-standing principle that the directors of an insolvent company may continue to do business, and may even pursue high-risk, high-reward strategies, when they believe that their plan has a reasonable chance of saving the company. The case involved a dispute between majority (the Emersons) and minority (Nelson) shareholders, all of whom were directors, following the failure of a business that developed and marketed customer relationship software. Nelson, who was also the firm's primary secured creditor, sued the Emersons for breaching their fiduciary duties as directors after they obtained a final round of outside debt financing, attempted a bankruptcy reorganization, and sought to subordinate Nelson's secured claim, all of which occurred while the company was insolvent and proved unsuccessful in rescuing the company. When considering the duties of directors of an insolvent company, the court noted, "It is settled Delaware law that an insolvent company is not required to turn off the lights and liquidate when that company's directors believe that continuing operations will maximize the value of the company." According to the *Nelson* court, directors may continue operations, without fear of breaching fiduciary duties, as long as they believe in good faith that their actions will ultimately benefit the equity holders of the firm, under deferential business judgment standards. This remains true even if the directors' strategy to resuscitate the company ultimately fails. Federal bankruptcy law supports this principle, as the Delaware court explained, by providing "procedures that enable an insolvent company to continue its operations while at the same time balancing the interests of the affected corporate constituencies."

*Nelson* also reaffirmed an earlier Delaware ruling that "deepening insolvency" is not an independent cause of action in that state. The theory is based on the principle that acts or omissions which fraudulently or negligently prolong the life of an entity, and thereby increase the entity's debt and level of insolvency, create liability for those responsible for such acts – much like a corporate "wrongful life" claim, without bounds as to the range of managers, lenders, consultants, and professionals who might get swept up in its storm. Although recently in vogue as a separate cause of action, the *Nelson* court reaffirmed that claims based on "deepening insolvency" are no longer recognized in Delaware, thus providing further assurance that directors and managers of insolvent companies who wish to continue business operations in good faith can do so with reduced exposure to liability.

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*Nelson* highlights a critical distinction between American law and that in much of the rest of the world. Other countries' laws often provide that, upon insolvency, a corporation must stop conducting business immediately. In fact, in many countries management may be thrown in jail if they keep doing business after the enterprise passes the threshold of insolvency. Not so in the U.S. Courts have recounted that we are a nation founded to a significant degree by debtors fleeing from their creditors and seeking a fresh start. Thus, the law favors good faith attempts by corporate managers to continue trying to build corporate value, create jobs, and augment the national economy. For corporations in this country, "It's not over 'til it's over."

## **Management and Other Insiders of an Insolvent Company May Not Benefit Themselves at the Expense of Outside Creditors**

Management's right to take good faith actions to revive an insolvent company ends when insiders (even insider creditors) seek to benefit themselves at the expense of outside creditors. The Delaware Bankruptcy Court made that limitation clear on April 24, 2008, when it issued its opinion upholding creditors' claims against directors, officers, a corporate parent, and an outside law firm in *In re Brown Schools*. There, shortly before bankruptcy, the debtor corporation undertook a restructuring that resulted in payments and the granting of liens to its parent company and additional payments to lawyers who were hired to effectuate the strategy. The bankruptcy trustee eventually sued everyone involved under theories including breach of fiduciary duty (for those who were fiduciaries of the debtor), aiding and abetting (for those who were not), civil conspiracy, and fraudulent transfer.

Although the recent trend in Delaware law has been to protect management from claims for breach of the fiduciary duty of care, "deepening insolvency," or breach of fiduciary duties to creditors, the *Brown Schools* court held that trend inapplicable when management and other insiders engage in self-dealing transactions – here, by benefiting the corporate parent to the detriment of outside creditors. The court provided, "For breach of the duty of loyalty claims, on the other hand, the plaintiff need only prove that the defendant was on both sides of the transaction." Thus, the court held that the bankruptcy trustee had valid claims against directors and officers who were affiliated with the corporate parent and against the corporate parent itself. Furthermore, the court held that any outside professionals who facilitated the illegal transaction could be sued, and any compensation paid to them could be recovered, because the payments were made to benefit the parent and not the debtor corporation that was the professionals' client. *Brown Schools* stands as a warning that in pursuing a strategy to revitalize a troubled company, management and its outside professionals must keep their focus on the enterprise itself and its outside stakeholders and may not seek to benefit themselves or their affiliates as insiders.

The attorneys in HRO's Corporate Law and Securities and Bankruptcy, Restructuring, and Creditors' Rights practice groups are experienced in guiding business organizations of all types and their management through the maze of laws affecting enterprises dealing with fiduciary duty and insolvency issues. Those issues may affect client companies themselves, as well as other companies with which our clients do business, and may have dramatic effects on the wisdom and likely success of various strategies. We would welcome the opportunity to assist you in seeking to maximize the value and success of your business venture. For more information, please contact any of the attorneys listed on this bulletin or any other attorney at HRO.

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