COVID-19 and Director Liability: Discharging Fiduciary Duties While Navigating the Financial Distress and Business Uncertainty Caused by the Pandemic
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The COVID-19 pandemic has caused unprecedented economic disruption at virtually every level of a business, from alarming declines in demand and revenue, operational and supply chain problems, employee issues, roadblocks to proposed mergers and acquisitions, and financing and liquidity concerns. As companies continue to feel the impact and uncertainty brought on by COVID-19, boards of directors face the challenging task of managing these issues and the unexpected and sudden financial distress caused by a global pandemic with an unknown duration. Directors facing these challenges must remember their fiduciary duties as they navigate these issues and make critical and time-sensitive business decisions, often with imperfect or unclear information, that may be second-guessed by shareholders or creditors in the future.

This article reviews the basic fiduciary duties that govern the conduct of directors of Delaware corporations and of corporations organized in states that generally follow Delaware corporation law, with an emphasis on the discharge of those duties in the wake of financial distress and uncertainty caused by the COVID-19 crisis. While directors should seek the advice of counsel about their fiduciary duties in the context of their company's specific situation, the following information provides directors with practical considerations and steps they should be taking to both discharge their fiduciary duties and help protect themselves from exposure to potential liability during this crisis.

Basic Fiduciary Duties
Directors of Delaware corporations owe fiduciary duties of care and loyalty to the corporation.

1. The Duty of Care. Requires directors to make informed and deliberative decisions based on all material information reasonably available.

2. The Duty of Loyalty. Requires directors to act (or decide not to act) in a disinterested and independent manner, with an honest belief that the action or inaction is in the best interests of the company and its shareholders.

Included within these principal duties are the duties of good faith, oversight, and disclosure.

The COVID-19 pandemic does not relieve directors of their fiduciary duties. Indeed, the importance of director involvement and oversight is increased due to the heightened risks and need for quicker decision-making created by the immediate financial impact of the pandemic. To make an informed and disinterested decision, directors should ensure at the outset that they determine (i) what information they need, both internally from management, board committees, and company records, and externally from third-party experts or other professionals; and (ii) how best to obtain that information promptly and efficiently. A process in which the board is intimately involved in approval of major decisions, through a documented record of communications and meeting minutes demonstrating informed and deliberative decision-making based on all material information reasonably available will serve as critical evidence in establishing that the directors satisfactorily discharged their fiduciary duties.

Courts evaluating board decisions under Delaware law generally look to the “business judgment rule” in the first instance and the rebuttable presumption that directors satisfied their fiduciary duties in making
decisions. Where that presumption is negated, such as in cases of related party transactions or lack of director independence, Delaware courts apply the more exacting “entire fairness” standard in reviewing and evaluating board decisions, which normally shifts the burden to directors to prove the fairness of a challenged corporate transaction or decision.

Fiduciary duties to whom? Solvency versus Insolvency and the “Zone of Insolvency”

Directors always owe fiduciary duties to the corporation itself and are tasked with maximizing the corporation’s economic value. When a company is solvent, the shareholders are the beneficiaries of corporate decision-making, and thus, shareholders maintain standing to assert derivative claims for breach of fiduciary duty against directors. When a company becomes insolvent (e.g., the company is unable to pay its debts as they come due or its liabilities exceed its assets), the directors still owe their fiduciary duties to the corporation. Upon insolvency, however, the company’s creditors also gain standing to assert derivative claims for alleged breaches of fiduciary duties against directors, as the creditors become the primary beneficiaries of increases in corporate value.

Until a corporation is actually insolvent, creditors have no right to bring derivative claims, but determining when a company has crossed the zone of insolvency into actual insolvency is often a difficult determination. This is especially true in the current economic climate where the COVID-19 pandemic is causing such a rapid and unexpected onslaught of financial distress. Solvency is a fact-intensive determination that is often made with the benefit of hindsight or during litigation. Accordingly, directors should tread carefully while making decisions during this crisis and assume that their decisions will be scrutinized and second-guessed by creditors, as well as shareholders. During this challenging time, we think it advisable that directors consider the interests of all relevant stakeholders—the corporation, its shareholders, and its creditors—in making corporate decisions.

Discharging Fiduciary Duties During Financial Distress Caused by COVID-19

There are several considerations and critical steps that directors must keep in mind and take to help ensure they sufficiently discharge their fiduciary duties during this uncertain time of financial distress:

- Implement a COVID-19 committee or similar task force that reports to the board of directors on a regular basis (at least weekly) to discuss all COVID-19-related issues that are affecting, or could affect, the company. The committee or task force should include members of management, legal, finance, compliance, operations, HR, and IT.
- Directors should take a more active role than in normal times and ensure that they are well informed about all aspects of the company’s financial and operational situation as a result of COVID-19, the new risks that it faces and its plans and strategies to manage the many issues related to the pandemic, including:
  - business continuity
  - financial contingency plans
  - supply chain interruption
  - relations with the workforce
  - legal issues regarding force majeure, contract termination, breach of contract, indemnity, or other performance-related provisions
  - managing cybersecurity and data privacy issues (including company trade secrets), especially due to employees working remotely
  - negotiating with creditors and lenders on the restructuring of loans and debts, or obtaining additional liquidity; consideration of the lender’s or creditor’s legal rights and potential remedies
  - consideration of federal disaster relief funding
- This more active role should include gathering and reviewing all material information that is reasonably available; consulting with management and relevant outside legal and financial advisors; and conducting more frequent board meetings with management and outside legal and financial advisors.
• Directors should ensure that important discussions and decisions are documented contemporaneously, including by maintaining minutes of all meetings to record director oversight activities and evidence an informed, deliberative decision-making process.

• Consider the implications of decisions on all stakeholders, including creditors, and ensure that decisions are focused on maximizing value for all stakeholders.

• Consider if appropriate company restructuring and wind-down options, such as Chapter 11 bankruptcy, assignment for the benefit of creditors, or other measures to conserve cash, and, in doing so, consult with restructuring advisors.

• Consider a sale of the company, or segments of it, that provides substantial value to creditors.

This unprecedented time requires fresh and creative thinking in place of a business as usual approach because there is nothing usual about the challenges businesses, and their boards of directors, are facing from the COVID-19 pandemic.

For more information on the matters discussed in this Locke Lord QuickStudy, please contact the authors.

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Visit our COVID-19 Resource Center often for up-to-date information to help you stay informed of other legal issues related to COVID-19.