

Fiduciary Duties and Potential Liabilities of Directors and Officers of Financially Distressed Corporations

This memorandum provides a general review of the duties and potential liabilities of directors and officers of financially distressed corporations.¹ First, this memorandum discusses generally the fiduciary duties of directors in the context of financially healthy corporations and proceeds to describe how these duties shift in the context of financially distressed corporations. This memorandum then discusses briefly the duties and liabilities of non-director officers. Finally, the memorandum identifies certain statutory and other liabilities of both directors and officers that may be of particular relevance to officers and directors of financially distressed corporations. We have focused our discussion primarily on Delaware law because of the persuasiveness of Delaware court decisions in the area of corporate law. In our review, we have sought to identify the principal types of duties and liabilities that might be implicated when a corporation is facing financial difficulties. We have not attempted to conduct a comprehensive survey of every possible statutory or common law duty or liability that could conceivably exist.

I. Summary

- A. Directors of solvent corporations have two basic “fiduciary” duties, the duty of care and the duty of loyalty, owed to the corporation itself and the shareholders.
 - 1. Directors must act in good faith, with the care of a prudent person, and in the best interest of the corporation.
 - 2. Directors must refrain from self-dealing, usurping corporate opportunities and receiving improper personal benefits.
 - 3. Decisions made on an informed basis, in good faith and in the honest belief that the action was taken in the best interest of the corporation will be protected by the “business judgment rule.”

- B. Directors of insolvent corporations owe fiduciary duties to creditors; directors of corporations in the “vicinity of insolvency” probably owe fiduciary duties to creditors.
 - 1. Definition of insolvency is not hard and fast; definitions used by courts include (a) unable to pay debts as they become due and (b) assets worth less than liabilities.

¹ This memorandum is intended to provide a general overview of the fiduciary duties of officers and directors. It is not intended to provide legal advice. The reader should contact us regarding specific questions or advice tailored to any particular situation.

2. Majority view: upon insolvency, duties owed to creditors *and* shareholders.
 3. Directors should consider the advice of financial and legal advisors to determine when a corporation is insolvent or in the “vicinity of insolvency.”
 4. In discharging their expanded fiduciary duties, directors should exercise their business judgment to protect the value of the corporate enterprise for all its stakeholders (including creditors).
- C. Generally, officers owe the same fiduciary duties as directors.
1. Officers may owe duty to keep the Board informed.
 2. Officers with greater knowledge and involvement may be subject to higher standard of scrutiny and liability.
- D. Directors and officers risk liability to creditors for breaches of fiduciary duties.
- E. Certain statutes impose director and/or officer liability in specific situations. A few examples include failure to pay taxes and wages, unlawful payment of dividends, fraudulent transfers and breach of duty to an ERISA Plan.

II. Duties of Directors of Financially Healthy Corporations

A. Duty of Care; Duty of Loyalty

Under state corporate law, directors of solvent corporations have two basic “fiduciary” duties, the duty of care and the duty of loyalty. The duty of care, which is governed by statute in most states, usually requires that directors discharge their duties in good faith and with the care that an ordinarily prudent person in a like position would exercise under similar circumstances and in a manner the director reasonably believes to be in the best interests of the corporation. See, e.g., Or. Rev. Stat. § 60.357 (1). In some states, including Delaware, the standard of care, though essentially the same, is established by judicial decision. See, e.g., Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963). The duty of loyalty requires that directors act on behalf of the corporation and its shareholders and refrain from self-dealing, usurpation of corporate opportunity and any acts that would permit them to receive an improper personal benefit or injure their constituencies. See, e.g., Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939).

Directors’ discharge of their fiduciary duties is measured against the “business judgment rule,” a presumption that in making business decisions directors acted on an informed basis, in good faith and in the honest belief that the action was taken in the best interests of the corporation. Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (Court held that to invoke the protection of the “business judgment rule,” directors have a duty to inform themselves of all

material information reasonably available to them).² The basis for the rule is that corporate management knows what is best for a particular corporation and judicial second-guessing would chill corporate initiative. The business judgment rule thus provides significant protection to directors (and officers) from personal liability for their good faith, informed, business decisions. The presumption may be rebutted where it is shown that a director had a personal financial interest in a transaction, lacked independence, did not inform himself of all information that was reasonably available, failed to exercise the requisite level of care, or stood on both sides of the transaction; in these circumstances, the director must show that his conduct meets the stricter standard of “entire fairness” to the corporation.³ It should be noted that this obligation to prove the entire fairness of a transaction applies where the same person holds dual or multiple directorships, as in parent-subsidary contexts.⁴

B. General Rule: Fiduciary Duties owed to Corporation and Shareholders

Directors of financially healthy corporations owe fiduciary duties to the corporation itself and its shareholders. See, e.g., Revlon v. MacAndrews & Forbes Holdings Inc., 506 A.2d 173, 179 (Del. 1986). Courts have generally held that directors of such corporations do not owe fiduciary duties to other constituencies, such as creditors, whose rights are purely contractual. See, e.g., Katz v. Oak Indus., 508 A.2d 873, 879 (Del. Ch. 1986). Some states have adopted “other constituencies” statutes which permit directors to consider the interests of non-shareholder constituencies, including creditors, in making corporate decisions. In general, however, these statutes are permissive⁵ and do not appear to create new fiduciary obligations for directors but merely allow them to consider other constituencies as a factor in determining the best interests of the shareholders; directors of a solvent corporation who favor another constituency over its shareholders may violate their duty of loyalty. Revlon, 506 A.2d 173 (Court held that the Board breached duty of loyalty by entering into a lockup agreement on the basis of impermissible considerations of the noteholders’ interests at the expense of the shareholders).

² In Brehm v. Eisner, 746 A.2d 244 (Del. Super. 2000) the court over-ruled the portion of Aronson suggesting that abuse of discretion was the appropriate standard of review for Rule 23.1 actions (shareholder derivative suits). Id. at 254. The underlying legal premises pertaining to the business judgment rule were not disturbed by this opinion. Id.

³ In establishing the “entire fairness” of the transaction sufficient to pass the test of careful scrutiny by the courts, directors are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain. The concept of fairness has two basic aspects: fair dealing and fair price. Fair dealing examines timing, structure, initiation, disclosure and approval of the transaction, while fair price focuses on economic and financial considerations. Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983).

⁴ The court stated that “[I]ndividuals who act in a dual capacity as directors of two corporations, one of whom is parent and the other subsidiary, owe the same duty of good management to both corporations, and in the absence of an independent negotiating structure, or the directors’ total abstention from any participation in the matter, this duty is to be exercised in light of what is best for both companies.” Id.

⁵ Oregon has enacted (permissive) Nonshareholder Constituency statutes. See Or. Rev. Stat. § 60.357(5) (1997). But see Conn. Gen. Stat. § 33-756 (2000) (requiring consideration of other constituents).

III. Duties of Directors of Financially Distressed Corporations

A. Expanded Duties

It is generally accepted that when a corporation becomes insolvent, directors owe fiduciary duties to creditors.⁶ See, e.g., Geyer v. Ingersoll Publ'n Co., 621 A.2d 784, 787-90 (Del. Ch. 1992) (Directors of insolvent corporation have fiduciary duty to act for benefit of corporate creditors). As set forth below, the existence of a duty to creditors does not necessarily mean that duties to shareholders are eliminated. In addition, a Delaware court has stated that when a corporation is in the “vicinity of insolvency” directors owe their duties to the corporate enterprise, which the court described as a “community of interests” that includes stockholders, creditors, employees and any other group interested in the corporation. Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., No. 12150, 1991 WL 277613, *34, *36 n.55 (Court held that where foreseeable financial effects of a board decision may importantly fall upon creditors as well as holders of common stock, as where the corporation is in the vicinity of insolvency, an independent board may consider impacts on all corporate constituencies in exercising its good faith business judgment for the benefit of the “corporation”).⁷ Under this view, the board of directors has an obligation to exercise its judgment in an informed, good faith effort to maximize the corporation’s long-term wealth-creating capacity; if directors conceive of the corporation as a single legal and economic entity, they are less likely to adopt high-risk strategies that might benefit shareholders, who have no downside risk at insolvency, to the detriment of other interested constituencies.

B. Issues Regarding When Expanded Duties Arise

1. Test for Determining Insolvency

Determination of exactly when their fiduciary duties to creditors arise is a critical issue for directors seeking to make corporate decisions in a manner consistent with these duties. There is no single, clear definition of insolvency used by all courts. While some courts have used the “equity” definition (which provides that a corporation is insolvent when it is unable to

⁶ A number of rationales support this situational fiduciary duty to creditors. The “Trust Fund Doctrine” posits that upon insolvency the directors effectively become trustees of the corporate assets which should be held first for the creditors’ benefit and then for that of the shareholders. See, e.g., American Nat’l Bank v. Mortgage America Corp., 714 F.2d 1266, 1268-69 (5th Cir. 1983). Anyone who breaches this trust may be held personally liable for the damage he causes. Id. at 1269. Perhaps the most widely-accepted rationale is that upon insolvency, a creditor can no longer expect to be paid by enforcing his contractual or legal rights and thus, his interest becomes an equitable one which the directors have a duty to protect.

⁷ Not every state has considered the issue of whether there is a duty to creditors when a corporation is nearing insolvency, but some have followed Delaware and recognize that such a duty may arise. See, e.g., Weaver v. Kellogg, 216 B.R. 563 (S.D. Tex. 1997) (holding that under Delaware and Texas law, corporate insiders, such as officers and directors, may have fiduciary duties to creditors, even though the corporation is not actually insolvent, if the corporation stands in the vicinity of insolvency, if a transaction leads to insolvency or is a fraudulent conveyance).

pay its debts as they become due in the ordinary course of business), other courts use the “balance sheet” definition (which considers whether a corporation’s assets are worth less than its liabilities). In practice, however, these definitions have not been used in widely divergent ways and some courts have blended them together.⁸ Thus, because the definition of insolvency can vary subtly in different situations and jurisdictions, it is impossible for directors to predict with confidence which definition a court would use in a creditors’ suit for breach of fiduciary duties.

2. Vicinity of Insolvency

The court in Credit Lyonnais further muddied the waters in this regard when it held that expanded fiduciary duties arise when a corporation is in the “vicinity of insolvency.” Id. at *34. Adoption of this nebulous threshold places directors and officers in a tenuous position because no court has expressed a view on exactly how one determines whether a corporation is in the “vicinity” of insolvency for the purposes of applying this test.⁹ Thus, while it seems clear that when a corporation’s financial health deteriorates, it will eventually reach a threshold -- the “vicinity of insolvency” -- that expands the scope of its fiduciary duties, it is unclear how directors (or officers) can determine exactly when that threshold is reached. The ambiguity in the legal standards relating to determination of insolvency may encourage corporate fiduciaries (directors or officers) to act conservatively in situations where the outcome might materially affect the financial position of the corporation.¹⁰ As a practical matter, in cases of doubt regarding the application of the “insolvency” or “vicinity of insolvency” standards, competent financial and legal advisors should be consulted for their informed views.

C. Scope of the Expanded Duties

Courts are divided on the issue of the scope of directors’ fiduciary duties once a corporation becomes insolvent or enters the vicinity of insolvency. Some courts appear to hold that directors of insolvent corporations no longer have duties to shareholders, see, e.g., FDIC v. Sea Pines Co., 692 F.2d 973, 977 (4th Cir. 1982) (when a corporation becomes insolvent, or in a failing condition, the officers and directors no longer represent the stockholders, but become trustees for the creditors), cert. denied, 461 U.S. 928 (1983), while other courts, including Delaware, have held that at or near insolvency, directors’ duties are owed to the corporate enterprise, including both shareholders and creditors, and a board may consider impacts on all

⁸ In Geyer the court essentially combined the equity and balance sheet definitions when it determined that “[An] entity is insolvent when it is unable to pay its debts as they fall due in the usual course of business. That is, an entity is insolvent when it has liabilities in excess of a reasonable market value of assets held.” Id. at 789.

⁹ See Donald S. Bernstein & Amit Sibal, Fiduciary Duties of Directors and Corporate Governance in the Vicinity of Insolvency, 767 PLI/Comm 167, *174.

¹⁰ Some commentators reason that the law frequently creates vague standards to deter undesirable conduct. See, e.g., Niels Schaumann, The Lender as Unconventional Fiduciary, 23 Seton Hall L. Rev. 21, 31 (1992) (stating that the scope of conduct prohibited by fiduciary duties is vague to induce fiduciaries to act conservatively).

corporate constituencies. See, e.g., Equity-Linked Investors, L.P. v. Adams, 705 A.2d 1040 (Del. Ch. 1997).¹¹

Under the latter view, which appears to be the majority view, directors of financially distressed corporations face the dilemma of how to simultaneously discharge fiduciary duties to distinct constituencies. Current case law does not provide much guidance in this regard as it does not clearly identify how these potentially conflicting duties should be resolved or whether a primary fiduciary duty is owed to one particular constituency.¹² Cases suggest that directors faced with this conflict may continue to be protected by the business judgment rule. The reasoning is that courts are no more likely to second-guess board decisions in the troubled and/or insolvent corporation context than under ordinary circumstances.¹³

D. Suggested Standards to Meet the Expanded Duties

The court in Geyer suggested that directors' fiduciary duties after insolvency may be best served by exercising business judgment to protect the value of the enterprise for all its stakeholders (including creditors). Id. at 789.

1. The existence of expanded fiduciary duties to creditors at the moment of insolvency should cause directors to choose a course of action that best serves the entire corporate enterprise rather than any single group, at a point in time when shareholders' wishes should not be the directors only concern.
2. In the context of an insolvent corporation or a troubled corporation struggling to avoid bankruptcy, directors must continue to fulfill the duties of care and loyalty according to the standards set forth above.
3. The nature of the issues involved when a corporation is financially distressed, however, will mean that acting on an informed basis will entail a heightened duty of inquiry and a need for directors to devote more time and attention to the corporation's affairs than is required when a corporation is financially healthy.

¹¹ The court stated that "where foreseeable financial effects of a board decision may importantly fall upon creditors as well as holders of common stock, as where the corporation is in the vicinity of insolvency, an independent board may consider impacts upon all corporate constituencies in exercising its good faith business judgment for the benefit of the 'corporation.'" Id. at 1042 n.2.

¹² William E. Knepper & Dan A. Bailey, Liability of Corporate Officers and Directors, (6th Ed. 1998), Vol. 1, p. 205.

¹³ "Courts can be expected to continue along the path they have for the most part followed to date, and look to business judgment rule principles for guidance in assessing the conduct of directors of troubled and/or insolvent corporations owing fiduciary duties to creditors. The same business judgment rule principles likely will be followed by courts assessing the conduct of directors who in good faith and on an informed basis determine that a corporation is not insolvent, and that they therefore do not owe fiduciary duties to the corporation's creditors." Dennis J. Block, Nancy E. Barton & Stephen A. Radin, The Business Judgment Rule (5th Ed. 1998) Vol. 1, p. 627.

4. Directors of struggling companies therefore should consider carefully, with the assistance of experienced business, financial and legal advisors, whether the line separating solvency from insolvency has been crossed or will be crossed as a result of a particular proposed transaction, and, if so, what the effect of the proposed transaction will be upon corporate creditors, as well as shareholders and the corporate entity itself.
5. Upon choosing a course of action while in the vicinity of insolvency, or which may push the corporation into the vicinity of insolvency, officers and directors should consider the impact of the decision on the entire community of interests of the corporation. Disinterested directors who follow these procedures and act on such an informed basis are less likely to be second-guessed by the courts if their decisions turn out to be less than prescient.
6. Directors who have substantial stockholdings or who represent a major stockholder, may be considered “interested” vis à vis creditors when voting on transactions while the corporation is at or near insolvency. In re Healthco Int’l, Inc., 208 B.R. 288 (Bankr. D. Mass. 1997). Such directors are not entitled to the benefit of the business judgment rule and absent approval by a majority of disinterested directors, must prove the entire fairness of the transaction. Id. at 303 – 4 (citing Del. Code Ann. tit. 8 § 144 (1996)).

IV. Duties and Liabilities of Non-Director Corporate Officers

A. General Rule: Officers Owe Same Fiduciary Duties As Directors

In the context of corporate law, the term “officer” applies to those to whom administrative and executive functions have been assigned by a corporation’s bylaws or by board resolution, and who have discretion as to corporate matters. Although there is little law and commentary on the subject of the duties and liabilities of corporate officers, most authorities suggest, as a general proposition, that officers owe the corporation the same fiduciary duties as directors.¹⁴ See, e.g., William M. Fletcher, Fletcher Cyc Corp § 846 (perm. ed. 1994). The Revised Model Business Corporation Act also states that non-director officers must discharge their duties with the same standards of care as directors. Revised Model Bus. Corp. Act § 8.42. Thus, officers may be said to owe the corporation and its shareholders a duty to exercise due care and a duty of loyalty parallel to the directors’ duties discussed above.

The duty of loyalty is of general applicability, but is frequently implicated in the areas of corporate opportunity, competition with the corporation, and use of trade secrets. Accordingly, a corporate officer should not: usurp an opportunity that rightfully belongs to the

¹⁴ As regards Delaware case law, one commentator has observed; “with respect to the obligation of officers to their own corporation and its stockholders, there is nothing ... which suggests that the fiduciary duty owed is different in the slightest from that owed by directors.” David A. Drexler, et al., Delaware Corporation Law and Practice, § 14.02, at 14-5 to 14-6.

corporation; engage in competitive business conduct that is detrimental to the corporation; or abuse corporate trade secrets and inside information.¹⁵

Officers may have an additional duty to keep their corporation's board informed. Although no Delaware case specifically supports this proposition, it may be possible to infer this duty from the statutory requirement that directors, in managing the corporation, may rely on the information and opinions presented by the corporation's officers.¹⁶ This duty, in addition to the broader duty of loyalty, is also owed by officers as agents of the corporation, under general principles of agency law. There is also authority that implies that officers have a duty to disclose to the board any fraud or wrongdoing of which they have knowledge and any situations calling for oversight attention, even where the behavior involved is not dishonest or inequitable.¹⁷

B. Officers' Conduct May be Subject to Higher Level of Scrutiny

Officers may be subject to a higher standard of scrutiny than directors by virtue of their greater accessibility to corporate information and their more intimate knowledge of the day-to-day operations of the corporation. See, e.g., Sparks & Hamermesh at 218. Officers may, however, be more limited than non-officer directors in relying on information and reports from third parties by virtue of their greater first-hand knowledge of the corporation's affairs. See Masonic Bldg. Corp. v. Carlsen, 128 Neb. 108 (1934) (Court held that members of an executive committee are bound to scan critically the detailed reports which are made to them and their diligence is therefore greater and the rule of their liability more strict than that of a director not a member of that committee).¹⁸

Non-director officers and inside directors who are also officers are usually the real managers of a corporation and thus, the standards applied to them are high to reflect their greater familiarity with the corporation and their corresponding responsibilities. This approach, based on the principle that accountability should reflect actual knowledge and involvement, can result in a higher level of liability for non-director officers than for directors. This may simply reflect an officer's greater intimacy with the corporation, rather than a different legal standard applicable to the president as an officer. See Bates v. Dresser, 251 U.S. 524, 530-31 (1920) (Court imposed personal liability on officer who was "practically master of the situation" for fraud which was chargeable to his fault). This approach also suggests that directors who are officers may be subject to a higher standard of scrutiny and greater liability than non-officer directors.

¹⁵ See A. Gilchrist Sparks and Lawrence A. Hamermesh, Common Law Duties of Non-Director Corporate Officers, 48 Bus. Law 215 (Nov. 1992).

¹⁶ Id. (citing Del. Code Ann. tit. 8, §§ 141 (a) and (c) (1974)).

¹⁷ See, e.g., Bennett v. Propp, 187 A.2d 405 (Del. 1962).

¹⁸ See also Revised Model Bus. Corp. Act § 8.42 and the comments thereto.

C. Applicability of the Business Judgment Rule

Courts are divided as to whether the business judgment rule is available to non-director officers. Although several Delaware decisions have held that the rule is available to officers,¹⁹ a Pennsylvania federal court applying Delaware law²⁰ and a California appellate court have stated the opposite.²¹ One pair of commentators has concluded that most recent authority from jurisdictions other than Delaware suggests the rule is applicable to non-director officers. See Sparks & Hamermesh. These commentators reason that in light of the extensive delegation of managerial authority by boards of directors “the rationales for the Rule, although typically phrased with reference to directors, should apply to officers to whom the board’s discretionary authority is delegated, at least where the officer is discharging such authority.” Id. at 234. Furthermore, although there are no cases on point, this concept of officer as repository of delegated management authority suggests the rule may only be available to an officer acting within the scope of delegated authority. Thus, officers may risk liability for acting outside the scope of their delegated authority or for failing to act on a matter within that scope.

D. Suggested Measures to Meet Higher Level of Scrutiny and Minimize Officer Liability

1. To fulfill their fiduciary duties, which arguably include a duty to inform, officers should apprise the board of directors of activities or circumstances within the board’s decision-making purview, of which an officer is aware and which might materially affect the corporation’s best interests.
2. Boards of directors must ensure that delegations of authority, whether in the bylaws, board resolutions or other documents, accurately delineate the scope of authority and specific duties of particular officers.

V. Deepening Insolvency

Federal courts, most notably the Third Circuit, have allowed creditors’ committees to pursue claims against directors for “deepening insolvency.” See Off. Comm. of Unsecured Creditors v. Lafferty & Co., Inc., 267 F.3d 340, 350-51 (3d Cir. 2001) (collecting cases). “Deepening insolvency” claims are based on the theory that to the extent that liquidation is not already a certainty, the additional incurrence of debt or other actions make a saveable situation impossible. Id. at 350.²² In Lafferty, the creditors alleged an injury to corporate property from

¹⁹ See Kelly v. Bell, 266 A.2d 878, 879 (Del. 1970).

²⁰ See Platt v. Richardson, Fed. Sec. L. Rep. (CCH) 94,786, at 94,231 (M.D. Pa. 1989).

²¹ See Gaillard v. Natomas Co., 256 Cal. Rptr. 702, 711 (1989).

²² One bankruptcy judge faced with a claim for “deepening insolvency” against a financial advisor and its employees drew the following analogy: “The Debtor’s situation was not like an individual who sits in the rain all day and simply cannot get more wet. It is more akin to a boxer with one black eye who, despite being injured, might still persevere and win the fight. If that boxer (the debtor) winds up losing the fight and landing in the hospital (bankruptcy court), the doctor (judge) might find that it was the additional injuries (deepening insolvency) which put him there.” In re Flagship Healthcare, Inc., 269 B.R. 721, 728 n.4 (S.D.Fla. 2001).

the “fraudulent expansion of corporate debt and the prolongation of corporate life.” Id. at 347. The court found that these dealings permitted a separate cause of action, as they were distinct from the creditors’ claims for fraud, mismanagement, and breach of fiduciary duty. Id. at 349-50.²³

Most cases recognizing deepening insolvency as a cause of action involve parties who created the false appearance of solvency in an insurance company or other financial institution.²⁴ The theory has not been applied to an officer or director permitting a company to incur additional debt in the ordinary course of business. Instead, the courts have focused on acts which did not benefit the debtor in any way. See Schact v. Brown, 711 F.2d 1343, 1347 (7th Cir. 1983); In re Latin Inv. Corp., 168 B.R. 1, 5 (D.C. 1993).²⁵

VI. Certain Statutory and Other Liabilities of Corporate Directors and Officers

Under certain statutes, directors and officers may be held personally liable for acts performed in their official capacity and certain debts incurred by the corporation. The following sections provide several examples of obligations for which officers and directors may be held liable.²⁶

²³ In Schact v. Brown, 711 F.2d 1343 (7th Cir. 1983), officers, directors and parent corporation allegedly continued insurer in business past the point of insolvency in order to loot it of its most profitable and least risky business. Id. at 1347-1348. The court held that the illegal activities which aggravated the insurer’s insolvency were sufficient to state a claim for a civil violation of the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. §§ 1961-1968 (“RICO”). Id. at 1359.

²⁴ See Lafferty, 267 F.3d at 342-346 (bankruptcy of two lease financing corporations); Schact, 711 F.2d at 1345 (insurance company); In re Latin Inv. Corp., 168 B.R. 1 (D.C. 1993) (directors knowingly participated in and aided and abetted illegal efforts to loot the debtor, a financial institution). Deepening insolvency claims have also been permitted against auditors and financial advisors. See In re Flagship Healthcare, Inc., 269 B.R. at 724-25; Corcoran v. Frank B. Hall & Co., Inc., 149 A.D.2d 165, 545 N.Y.S.2d 278 (1989) (claim against auditors); Allard v. Arthur Anderson & Co., 924 F. Supp. 488 (S.D.N.Y. 1996) (same).

²⁵ It is also important to note that the theory has not been universally embraced. See Florida Dep’t of Ins. v. Chase Bank of Texas Nat’l Assoc., 274 F. 3d 924, 935-36 (5th Cir. 2001) (refusing to impose liability under the deepening insolvency theory on the facts presented).

²⁶ The discussion in this section provides a few examples of potential liabilities for illustration purposes. In any particular situation, the laws of the applicable states and the applicable federal statutes should be specifically reviewed. Moreover, in addition to the liabilities listed in this section, officers and directors should be aware that personal liability has been imposed in connection with many other activities, including the following: negligent mismanagement of corporate business; participation in fraudulent activity; tortious acts; reckless failure to act in the presence of an affirmative duty to act; performing or authorizing violations of public health regulations or improper disposal of hazardous waste; performing an illegal act; failure to comply with the Fair Housing Act; providing false information on any certificate, report or public notice; and authorizing or performing violations of the anti-trust laws.

This list is by no means exhaustive and does not purport to identify more than a sample of potential liabilities for officers and directors. It is beyond the scope of this memo to identify and discuss all potential liabilities to which officers and directors may be exposed.

A. Failure to Pay Withholding and Sales Taxes

Several states and the IRS have enacted statutes which impose liability on directors and officers for the failure to remit taxes collected in trust for the benefit of the government. Directors and officers may be liable for withholding and sales taxes, including interest and penalties. TEX. TAX CODE ANN. § 111.016 (Vernon 1999); In re Cooley, 166 B.R. 85 (Bankr. S.D. Tex. 1993).

B. Failure to Pay Wages

In certain situations, officers and directors may be liable for unpaid wages and benefits of employees. For example, directors can be held liable to employees for willful failure to pay wages if there is evidence that the directors had the ability to cause the corporation to pay wages and consciously failed to do so.²⁷ Stafford v. Purofied Down Prod. Corp., 801 F.Supp. 130 (N.D. Ill. 1992). Additionally, directors may be liable for delinquent pension contributions, Plumbers' Pension Fund, Local 130 v. Niedrich, 891 F.2d 1297 (7th Cir. (Ill.) 1989), and union dues and welfare contributions, Johnson v. Western Amusement Corp., 510 N.E.2d 991 (Ill. App. Ct. 1987).

C. Unlawful Payment of Dividends

Willful or negligent conduct in connection with the unlawful payment of a dividend may result in personal liability for officers and directors. For example, Delaware imposes personal liability on directors for the unlawful payment of a dividend or an unlawful stock purchase or redemption.²⁸ Similarly, under Article 2.41 of the Texas Business Corporation Act, directors who vote for or assent to distributions not allowed by Article 2.38 of the Texas Business Corporation Act may be personally liable. Article 2.38 states that a distribution may not be made by a corporation if the distribution would render the corporation insolvent or the distribution exceeds the surplus of the corporation.²⁹ See also Wieboldt Stores, Inc. v. M. Schottenstein, 94 B.R. 488 (1988) (Illinois law).

D. Failure to Pay Franchise Taxes

In Texas, if the corporate privileges are forfeited for the failure to report or pay a tax or penalty, each director and officer is liable for each debt that is created in the state after the date on which the report, tax or penalty is due. A director or officer is not liable for a debt of the

One statute that is relevant to troubled companies contemplating plant closings or layoffs is the Workers Adjustment and Retraining Notification Act (WARN). However, one case has found that individual officers and directors of corporate employers will not be held individually liable for back pay for failure to give employees the statutorily required 60 days' notice of closings or layoffs. Carpenters District Council of New Orleans v. Dillard, 778 F.Supp. 297 (E.D. La. 1991), aff'd in part, rev'd in part, 15 F.3d 1275 (5th Cir. 1994).

²⁷ N.Y. LAB. LAW § 198-a (McKinney 1999).

²⁸ DEL. CODE ANN. tit. 8 § 160, 173 and 174.

²⁹ TEX. BUS. CORP. ACT ANN., art. 2.38 and art. 2.41 (Vernon 1999).

corporation if the director or officer shows that the debt was incurred either over the director's objection or without the director's knowledge (constructive knowledge will be imputed).³⁰ Cooley, 166 B.R. 85.

E. Failure to Pay Taxes Generally

Under Illinois law, any corporate officer who has the control, supervision or responsibility of filing returns and making payment of any tax and willfully fails to file the return or make the payment, may be held personally liable for a penalty equal to the total amount of tax unpaid by the corporation. 35 ILL. COMP. STAT. 735/3-7 (2001); see also Stoecker v. State of Illinois, Department of Revenue, 179 F.3d 546 (7th Cir. 1999) (President of bankrupt corporation may be held personally liable for unpaid taxes owed by the debtor corporation).

F. Fraudulent Transfers

Fraudulent transfers by a corporation may result in director liability.³¹ For example, breach of fiduciary duty claims have been asserted against directors in connection with their actions in approving transactions that are challenged as fraudulent transfers. See, e.g., Wieboldt, 94 B.R. 488 (alleging breach of fiduciary duty in connection with leveraged buy out transaction); Healthco, 208 B.R. 288 (same).

G. Breach of Fiduciary Duty to ERISA Plan

When an officer or director is able to exercise control over an ERISA plan, that individual may owe fiduciary duties to the plan. A breach of these fiduciary duties would result in personal liability for the officer or director. For example, if a director of the corporation withdraws money from the plan and uses it for purposes inconsistent with the fiduciary obligations owed to the plan, that director would be held personally liable.³²

³⁰ TEX. TAX CODE ANN. § 171.255 (Vernon 1999).

³¹ There are a number of grounds for challenging a transfer as a fraudulent transfer, which vary somewhat under the statutes of various states and the Federal Bankruptcy Code. Generally speaking, the most common challenge is made against a transfer (which is defined to include both the transfer of an asset and the incurrence of an obligation as, for example, under a promissory note) by an insolvent corporation that receives less than reasonably equivalent value in exchange for the transfer. The theory is that creditors of insolvent corporations are harmed when an insolvent corporation disposes of assets (or incurs obligations) and receives less than fair value in exchange.

³² 29 U.S.C.A. § 1104.