CARLTON FIELDS

Treating Creditors as Shareholders: Fiduciary Duties of Directors and Officers of Insolvent Corporations in Florida

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When a Florida corporation experiences sustained financial distress, the options considered by its leadership are numerous and can include seeking bankruptcy protection and winding up affairs pursuant to a state-court assignment for the benefit of creditors. As the options are weighed, directors and officers of insolvent or potentially insolvent corporations should bear in mind their responsibilities to a growing constituency that includes both shareholders and the corporation's creditors. For the most part, directors and officers can discharge their duties to creditors by acting diligently and with the best interests of the corporation in mind and by using measured and prudent judgment in all matters. This article outlines these fiduciary duties and explains how they can be discharged.

Fiduciary Duties of Directors and Officers in Florida

Under applicable Florida corporate law, a director must perform his or her corporate duties 1) in good faith; 2) with such care as an ordinary prudent person in a like position would exercise under similar circumstances; and 3) in a manner the director reasonably believes to be in the best interests of the corporation.[1] "Florida law has long recognized that corporate officers and directors owe duties of loyalty and a duty of care to the corporation."[2] The first duty, the duty of good faith, is general and requires that directors and officers act at all times with honesty of purpose and in the best interests and welfare of the corporation.

The fiduciary duty of care requires that directors and officers use the amount of care that ordinarily careful and prudent men would use in similar circumstances, and consider all material information reasonably available in making business decisions.[3] The duty of loyalty to the corporation obligates directors and officers to devote themselves to the affairs of the corporation with a view toward promoting the interests of the corporation. Directors and officers run afoul of this duty when they either appear on both sides of a transaction involving the corporation or when they receive a personal benefit from a transaction not received by shareholders generally.[4] All three duties referenced in the statute are owed to the corporation and, therefore, the corporation's shareholders. They apply in all actions taken by officers and directors in connection with the corporation.

Insolvency and the Vicinity of Insolvency — Fiduciary Duties to Creditors
In Florida, officers' and directors' fiduciary duties are extended to the corporation's creditors when the corporation is insolvent or is in the "vicinity of insolvency."[5] Accordingly, insolvency does not create a new duty for directors, it "simply adds beneficiaries" of existing duties.[6]

- *When is a Corporation Insolvent?* — Under F.S. §607.01401(16), a corporation is considered insolvent when it is unable to pay its debts as they come due in the ordinary course of its business. A company could also be insolvent or in the vicinity of insolvency if 1) its assets lack short-term liquidity; 2) its liabilities exceed the fair market value of its assets; and/or 3) its capital may not be able to support the financing of its future operations.[7]

- *What is Required to Discharge Fiduciary Duties if a Corporation is Potentially Insolvent?* — As previously noted, insolvency or the vicinity of insolvency does not create a new duty for directors and officers, it only causes the existing duties to apply to the corporation's creditors. Accordingly, after a corporation becomes insolvent or enters into the vicinity of insolvency, directors and officers must simply continue to put the interests of the corporation before their own and exercise reasonable and measured judgment in the supervision and management of the corporation. Courts have held that, with respect to the duty of care, directors, and officers must simply act as a reasonable person would in the supervision and management of the company and the performance of his or her duties for the benefit of the corporation's creditors.[8] With respect to the duty of loyalty, directors and officers are precluded from engaging in self-dealing or self-preferment *to the detriment of creditors*, for example, through taking a corporate opportunity that, if left for the corporation, could allow for a greater recovery by or distribution to creditors.[9] However, a transaction involving a director's or officer's personal interests can benefit the corporation and its creditors under certain circumstances. Factors to consider in determining whether an interested transaction is being conducted in fairness and good faith are 1) the adequacy of consideration; 2) the degree to which the officer or director represented the corporation; 3) the disclosure to and knowledge of the full board of directors and/or shareholders; and 4) the necessity of the transaction to the corporation.[10]

Specifically, directors and officers should take steps to minimize loss to creditors, maximize wealth-creating capacity when possible, and act in good faith when borrowing funds, among other things.[11] Making decisions rashly or such that directors and officers benefit from transactions at the expense of the corporation — and thereby its creditors — will, in most cases, constitute a breach of the fiduciary duties. Examples of transactions that could violate the fiduciary duties of directors and officers while a company is insolvent and fiduciary duties are owed to a corporation's creditors are 1) transferring corporate assets allowing the directors and officers to recover a greater percentage of debt than the corporation's creditors; 2) preferential transfers of the corporation's assets; 3) actions that dissipate or unduly risk corporate assets that might otherwise be used to pay creditor claims; 4) under certain circumstances, incurring additional debt.[12]

In re SOL, LLC, 2012 WL 2673254 (Bankr. S.D. Fla. July 5, 2012), illustrates realistic circumstances in which an individual owing fiduciary duties to an entity's creditors ran afoul of those duties. In *Sol*, an LLC/franchisee experienced economic difficulty and fell behind in its payments to a franchisor/creditor. The LLC's principal caused it to enter into an agreement under which the LLC transferred its franchise rights, valuable real-estate listings, and commissions to the franchisor in full satisfaction of the past-due obligations. The assets transferred arguably were worth considerably more than the royalties and fees owed to the franchisor. Additionally, the transaction benefitted the LLC's principal because he had personally guaranteed the obligations being satisfied. The U.S. Bankruptcy Court for the Southern District of Florida found that the principal likely breached his fiduciary duties in effectuating the transaction without regard to the LLC's creditors when the LLC was insolvent or in the vicinity of insolvency.[13]

It is clear from *Sol* that corporate management cannot simply throw the keys to the corporation to a creditor when the corporation is insolvent. However, it may not be as obvious that directors and officers cannot discharge their duties to creditors by entrusting certain insolvency-related management decisions to an independent restructuring advisor. *In re Bridgeport Holdings, Inc.*, 388 B.R. 548, 564 (Bankr. D. Del. 2008), involved a technology company that experienced significant financial distress after the dot-com bubble burst in the early 2000s. Bridgeport's directors and officers did little to correct the company's course and only hired a restructuring advisor at the insistence of the company's secured lenders and after it was arguably too late. After appointing the restructuring advisor as COO, the directors and officers abdicated further decision-making authority to him.

The COO hastily arranged a sale of substantially all of Bridgeport's assets without employing any competitive bidding process or soliciting other potential offers. Bridgeport's directors made no substantial effort during the due diligence and negotiation period to identify other potential buyers or otherwise vet the proposed sale. After the sale was consummated, Bridgeport entered into Ch. 11 bankruptcy, and a liquidating trustee was appointed to prosecute the claims of the estate. The liquidating trustee sued Bridgeport's directors and officers, alleging a breach of their fiduciary duties by failing to supervise the restructuring advisor and the arranged sale. The court denied the director's and officers' motion to dismiss the action and clarified that fiduciaries did not need to engage in an interested transaction to breach the duty of loyalty — a claim for breach of duty of loyalty could be supported by facts demonstrating that directors and officers consciously disregarded their duties. Accordingly, even if corporate management has engaged specialized professionals to assist in restructuring or winding the company down, management must still carefully scrutinize the actions of the professionals and remain actively involved to ensure that management is still satisfying their obligations to the corporation.

- *Deepening Insolvency as a Measurement of Damages* — Deepening insolvency refers to the extension of a corporation's existence and/or the expansion of its debt while insolvent or in the vicinity of insolvency.[14] Under Florida law, deepening insolvency is not an independent basis for a claim against directors and officers and does not impose any additional duties on them. Instead, the concept of deepening insolvency can serve as a measure of damages in connection with claims for breach of the existing fiduciary duties.[15] Accordingly, although deepening insolvency is not an independent cause of action in Florida, directors and officers should take care not to take any action that would have the known effect of exacerbating the corporation's insolvency and causing damage to creditors.

- *Insolvency Duties and Deepening Insolvency Under Delaware Law* — Florida courts often look to Delaware law when defining the duties of directors and officers of a corporation.[16] Accordingly, Delaware law is also important in Florida companies' navigation of insolvency. Under Delaware law, like Florida law, a corporation's creditors have standing to assert breach of fiduciary duty claims against directors on behalf of the corporation when it is insolvent. This is because of the view that "[w]hen a corporation is insolvent…its creditors take the place of the shareholders as the residual beneficiaries of any increase in value."[17] However, under Delaware law, creditors do not have standing to bring claims while a company is merely in the vicinity (or zone) of insolvency.[18] In *Quadrant Structured Products Co., Ltd. v. Vertin*, 115 A.3d 535, 546 (Del. Ch. 2015), one of the most recent cases on the subject, the Delaware Court of Chancery clearly held that "[t]here is no legally recognized 'zone of insolvency' with implications for fiduciary duty claims. The only transition point that affects fiduciary duty analysis is insolvency itself."

The court also clarified a few other matters in the *Quadrant* opinion. It confirmed that, in Delaware, deepening insolvency is not a recognized theory of liability and that, if directors and officers are otherwise discharging their duties carefully and under the good-faith belief that their actions will benefit the corporation and its creditors and shareholders, they cannot be liable for the subsequent deterioration of the company's financial condition if their strategies prove unsuccessful.[19] Additionally, the court noted that if a company capitulates between solvency and insolvency, there will be times when both shareholders and creditors will have standing to raise claims for breach of fiduciary duties.20 Accordingly, directors and officers must vigilantly protect the corporation's interests because doing so will ensure proper action with respect to both shareholders and creditors.

Conclusion

It is generally held that a corporation's board is not the guarantor of a business strategy's success.[21] And the business judgment rule applies to officers' and directors' decisions when an entity is insolvent.[22] Accordingly, the financial situation of a company, the circumstances in which it is operating, and the directors' sound business judgment should inform a decision regarding whether to initiate bankruptcy proceedings or an assignment for the benefit of creditors. Depending on the circumstances, directors and officers can discharge their duties to creditors of a corporation by continuing the business, filing for bankruptcy, or attempting other restructuring alternatives. As long as they act with due care and put the corporation's interests first, directors and officers will avoid liability for a company's financial decline. This article was originally published in *The Florida Bar Journal*, Volume 90, No. 10 (December 2016).

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1 Fla. Stat. §607.0830(1).

2 *In re Aqua Clear Techs., Inc.,* 361 B.R. 567, 575 (Bankr. S.D. Fla. 2007).

3 *See Mukamal v. Bakes*, 378 Fed. Appx. 890, 901 (11th Cir. 2010).

4 *In re Toy King Distributors, Inc.*, 256 B.R. 1, 170 (Bankr. M.D. Fla. 2000).

5 *In re Florida Coastal Airlines, Inc.*, 361 B.R. 286, 287 (Bankr. S.D. Fla. 2007) (citing Toy King Distributors, Inc., 256 B.R. 1).

6 *In re Fundamental Long Term Care, Inc.*, 507 B.R. 359, 376 (Bankr. M.D. Fla. 2014).

7 *See* John A. Pearce II & Ilya A. Lipin, *The Duties of Directors and Officers Within the Fuzzy Zone of Insolvency*, 19 Am. Bankr. Inst. L. Rev. 361, 380 (2011) (describing tests employed by courts in determining whether a company is insolvent).

8 *In re Aqua Clear Techs., Inc.*, 361 B.R. 567, 575 (Bankr. S.D. Fla. 2007).

9 *In re Toy King Distributors, Inc.,* 256 B.R. at 171.

10 *Id.* at 174.

11 Pearce, *The Duties of Directors and Officers Within the Fuzzy Zone of Insolvency*, 19 Am. Bankr. Inst. L. Rev. at 382.

12 *Id*.

13 *In re SOL, LLC*, 2012 WL 2673254 at *16 (Cristol, J.).

14 *See Official Committee of Unsecured Creditors v. R.F. Lafferty & Co. Inc.*, 267 F.3d 340 (3d Cir. 2001).

15 *See In re Sw. Florida Heart Grp., P.A.*, 346 B.R. 897, 898 (Bankr. M.D. Fla. 2006).

16 *See Connolly v. Agostino's Ristorante, Inc.*, 775 So. 2d 387, 388 n. 1 (Fla. 2d DCA 2000) (quoting *International Ins. Co. v. Johns*, 874 F.2d 1447, 1459 n. 22 (11th Cir. 1989)).

17 *See N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007).

18 *Quadrant Structured Products Co., Ltd. v. Vertin*, 115 A.3d 535, 546 (Del. Ch. 2015).

19 *Id*.

20 *Id*.

21 *See Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 205 (Del. Ch. 2006).

22 *See Toy King Distributors, Inc.*, 256 B.R. at 168.

Related Practices

Creditors' Rights and Bankruptcy