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TO: Harry Hardnose, GC of Delicious Delights, Inc.

FROM: Shane Sigler, Esq.

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RE: Fiduciary Obligations of Directors and Officers of Financially Troubled Companies

Fiduciary duty law is judicial review of corporate decision making to determine whether a fiduciary should be held liable for poor or incorrect decisions. As discussed further below, courts look to the *process* by which a decision was reached in assessing the decision making. In certain circumstances, a court will also look to the actual *substance* of the decisions that directors and officers of a corporation made. A court will be asked to determine whether the process or, in some cases, the substance of the decision was so poor such that the law should impose financial liability on the directors and officers for those decisions.

A corporation's officers and directors are fiduciaries of and for the corporation. That is, the law imposes upon them an affirmative duty to act in the best interests of the corporation. This is a significantly higher standard of conduct than in other commercial relationships, which may only impose an obligation to deal with counterparties in good faith. When a corporation is financially healthy, the interests of shareholders are paramount and, in the exercise of their fiduciary obligations, directors and officers will generally make decisions intended to maximize the value available for shareholders. However, as a debtor becomes financially distressed, the interests of debtors and creditors usually diverge.[1] Because directors and officers owe fiduciary duties to the corporation, as a debtor becomes financially distressed, the law permits directors and officers to consider the interests of creditors in the discharge of their fiduciary obligations.

Directors and officers owe two principal fiduciary duties to a corporation: they owe a duty of loyalty and a duty of care. The duty of loyalty ordinarily requires that directors and officers be free from conflicting loyalties in the making of decisions for the corporation. When a director or officer has economic or other interests on both (or

[1] Creditors only have a legal interest in being repaid and have a legal priority of payment over shareholders. Therefore, as a company's finances become impaired, creditors may desire that the corporation undertake only conservative financial enterprises intended to ensure creditors' repayment, even if such a course may fully impair the shareholders. In contrast, a shareholder (who may be fully impaired or very close to fully impaired) may have an interest in having the corporation undertaking high-risk /high-return opportunities to avoid shareholder impairment.

multiple) sides of a transaction, the law will deem them to be conflicted and not to have met the duty of loyalty. The duty of care requires that directors and officers have exercised adequate care in reaching a corporate decision. For instance, if directors are deciding whether to incur substantial additional debt financing, a reviewing court may look to evidence of whether the directors adequately informed themselves of the corporation's ability to finance the debt in assessing whether the directors have met their fiduciary duty of care.

In assessing corporate decision-making, courts are conscious of the fact that, in the first instance, directors and officers – and not courts – are charged with operating a corporation's business and making decisions for the corporation. Furthermore, directors and officers are not insurers of the corporation's business. Therefore, in reviewing corporate decision making, courts have developed a rule known as the business judgment rule. The business judgment rule provides that, if a decision was made in good faith and without conflicting loyalties (i.e., if the decision maker satisfies the duty of loyalty), then a court will only impose liability on the decision maker if the decision that was made was so improper that no reasonable decision maker would have reached the decision that was actually made. In practice, the business judgment rule, when invoked, is a powerful protection for corporate decision makers. It helps to ensure that the decision maker will not later be second guessed by a reviewing court other than in the most extreme circumstances. Review by a court under the business judgment rule focuses principally on the *process* by which a decision was made (i.e., was it made without conflicting loyalties) and less on the *substance* of the decision that was made (i.e., liability will only be imposed if the decision was so bad that no rational decision maker would have made a similar decision).

If, on the other hand, a reviewing court finds that the decision maker did not make a decision free from conflicting loyalties (if the decision maker breached the duty of loyalty), then a court will not invoke the business judgment rule and will, instead, impose on the decision maker the obligation of showing that the business decision that was made was "entirely fair." Unlike business judgment review, entire fairness review is a searching inquiry by a court and a court will require that the decision maker establish that the decision was both the product of a fair process and that the decision that was actually reached was substantively fair. In practice, this is frequently a difficult standard to meet and therefore, when a court determines not to apply the business judgment rule, a decision will more frequently be subject to successful attack and a decision maker will more frequently be subject to liability for breach of fiduciary duty.

Decisions made at or near the point of insolvency frequently create the potential for a breach of the duty of loyalty (and, as such, imposition of entire fairness review) that may not exist with a financially healthy entity. For instance, when directors are substantial shareholders, decisions made if the corporation is financially healthy may not be subject to attack because of the directors' substantial shareholdings. However, as the corporation becomes financially weaker, the conflict that emerges between the interests

of shareholders and creditors may lead to a situation where a court later reviewing a decision may not grant the director the benefit of the business judgment rule because of the conflict between shareholders and creditors. In short, as a corporation edges towards insolvency, the fiduciary duty analysis becomes progressively more complicated.