Director and Officer Liability: Some Things to Consider

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The issue of personal liability of officers and directors of an enterprise is complex and replete with nuances. Any discussion of the topic requires one to make distinctions between the various types of enterprises, types of liability, and nature of any malfeasance or misfeasance.

In the bankruptcy context, one will also consider whether the enterprise was approaching or in a state of insolvency. And beyond all that is the question of piercing the corporate veil or alter ego theories which may eliminate any wall between the individual and the corporate entity.

In addition to those factual variants, one must also evaluate personal liability based upon state law, which may vary from state to state, as well as federal law.

The following is intended to be a broad overview rather than a dispositive discussion. A good point of departure would be consideration of the type of entity the officer or director serves.

If one conducts business, under an assumed name or their own, without creating an entity, they will be personally liable for any debts, trade or otherwise. Therefore, most business in America is conducted through an entity. Such entities may be corporations, limited liability companies, or partnerships. Corporations will provide the most insularity, but other factors, including tax considerations, may influence the choice of entity.

Generally speaking, the officers and directors of a corporation are not personally liable for the trade debts of a corporation. However, if the corporate integrity was violated so that it can be shown that there was a merger between the individuals and the corporate entity, called piercing the corporate veil, individuals may be liable for the corporate debts, and the assets of the individual may be judicially, determined to be part of the corporation's assets.

In the corporate setting, also, officers and directors may be liable for their own misfeasance or misconduct. Generally, corporations will provide officer and director liability insurance, which can be used to pay the cost of defense or judgments entered.

Officers and directors of a corporation ordinarily have a duty owed to the corporation and it's owners and shareholders. Their actions will be evaluated as to whether they breached that duty. However, when a corporation is insolvent or approaching insolvency, there have been arguments raised that the fiduciary duties

owed by officers and directors also runs to the creditors of the corporation.

When a company is insolvent, fiduciary duties may be extended to the creditors of a corporation. Known as the "insolvency exception, . . . fiduciary duties held ordinarily for the benefit of shareholders should shift to creditors who 'now occupy the position of residual owners.'" *RSL COM Primecall, Inc. v. Beckoff (In re RSL COM Primecall, Inc.)*, 2003 Bankr. LEXIS 1635, at *25 (Bankr. S.D.N.Y. 2003).

However, the Supreme Court has made it clear that officer and director fiduciary duties *do not* extend to creditors when an entity is still solvent and only within the "zone of insolvency." When analyzing the responsibilities of the officers and directors of a Delaware corporation, the Supreme Court stated that "[w]hen a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interest of the corporation for the benefit of its shareholder owners." *N. Am. Catholic Edu. Programming Fund, Inc. v. Gheewalla*, 930 A.2d 92, 101 (2007). Thus, there are no fiduciary duties owed to creditors when a corporation is in the zone of insolvency.

There are similar protections for entities formed as limited liability companies or partnerships under state law.

In New York, "creditors are owed a fiduciary duty by officers and directors of a corporation *only* when the corporation is insolvent." *RSL Communs. PLC v. Bildirici*, 649 F. Supp. 2d 184, 202 (S.D.N.Y. 2009). Further, New York is defined by the "trust fund doctrine," where "officers and directors of an insolvent corporation are said to hold the remaining corporate assets in trust for the benefit of its general creditors." *Id.*

Insolvency raises additional questions, as noted above. Moreover, in contradistinction to the European practice, there is no duty under American law for officers and directors to file for bankruptcy for their corporation. However, there is a duty to act with reasonable business judgment.

"The business judgment rule is a presumption that in making a business decision. . .the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." *Lowinger v. Oberhelman*, 924 F.3d 360, 366 (7th Cir. 2019).

Thus, officers and directors must make decisions based on what is best for the business and should not continue operating a business that only creates additional debt.

When considering litigation, and once a determination is made that there is a colorable cause of action, the next step is to determine whether a potential judgment is collectible. In most cases, there are insurance policies covering such breaches of duty and the damage caused thereby.

Please note this is a general overview of developments in the law and does not constitute legal advice. Nothing herein creates an attorney-client relationship between the sender and the recipient. If you have any questions regarding the provisions discussed above, or any other aspect of bankruptcy law, please contact Michael H. Traison (mtraison@cullenllp.com) at 312.860.4230, Michael Kwiatkowski (mkwiatkowski@cullenllp.com) at 516.357.3700 or Kelly McNamee (kmcnamee@cullenllp.com) at 516.296.9166.

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