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Directors of Troubled Corporations and Their Fiduciary Duties

Difficult financial times often require corporate directors to make even more difficult decisions; decisions that can have widespread and long lasting affects for the corporation and anyone who has an interest in its success. This begs the question: Does a corporate directors' duties change when a corporation is in danger of becoming insolvent? According to corporate law in the state of Texas the answer is 'no'. However, while the duties themselves may not change, the beneficiaries of those duties may shift. When the time comes that corporate directors are operating under particular financial strain it becomes vitally important that they take into account the interest of corporate creditors as well as the continuing interests of their shareholders.

Under state law a corporate director is primarily responsible for two fiduciary duties; the duty of care and the duty of loyalty:

- **Duty of Care** – This duty stipulates that a director exercise the same degree of care that an ordinarily careful and prudent person would use in similar circumstances.
- **Duty of Loyalty** – This duty necessitates a director act in good faith for the best interest of the corporation and its shareholders without receiving any unauthorized or improper personal benefit from his position with the corporation.

These duties are required by state law whether the corporation is solvent or insolvent, however, as a corporation nears insolvency the beneficiaries of those duties do change. When a corporation is solvent and a corporate director fails to perform his or her fiduciary duties it is a shareholder of that company who may file a derivative action against the director on behalf of the corporation. Conversely, when a corporation is insolvent, and under Texas law, when it has also ceased to operate its business then the beneficiaries of a corporate director's duties shifts from the shareholders' interests to those of the corporation's creditors, and if a directors fails to perform his duties at that point, then the creditors may file a derivative action against the director.

Texas state law does not afford a corporation's creditors any oversight to enforce fiduciary duties until the corporation is insolvent and has also ceased its business activities. Unfortunately, it can sometimes be difficult to determine when a corporation has reached insolvency due to two noteworthy reasons.

- Legal – Under Texas state law there are varying definitions and legal standards used for determining a corporation's insolvency. The two methods used most often are the "equity" test and the "balance sheet" test. Using the "equity" test a corporation becomes insolvent when they are unable to pay their debts when they become due. According to the "balance sheet" test a corporation is insolvent when the reasonable market value of its assets has been outstripped by its liabilities.
- Factual – The law does acknowledge that depending on a corporation's specific situation different valuation analyses may be used to determine insolvency and that the determinations or calculations of value used may be subjective and uncertain.

Because of this uncertainty in the determination of a corporation's solvency, directors of a corporation in financial trouble or nearing the zone of insolvency will, in all likelihood, be unable to tell at exactly what point insolvency occurs. In fact, it is entirely possible that a corporation's insolvency will only be determined in retrospect after all disputes about the definition of "insolvency" as well as the proper valuation of corporate assets and liabilities have been settled.

In a situation where the issue of a corporation's solvency is muddled it would be wise for corporate directors to consider the interests of the corporation's creditors even if, strictly speaking, no fiduciary duties are owed to them. It is also worth mentioning that because creditors will be more aware and concerned about the corporation's business; directors should expect increased scrutiny of their activities and should ensure the careful fulfillment of all their fiduciary duties.

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