VENABLE® LLP

750 E. PRATT STREET SUITE 900 BALTIMORE, MD 21202
T 410.244.7400 F 410.244.7742 www.Venable.com

March 3, 2009

Duties of Directors of Distressed Corporations under Maryland Law

In these uncertain times, boards of directors face many important decisions about a company's present and future actions, including reduction or suspension of dividends, layoffs, asset sales, unsolicited takeover offers, liquidation and even insolvency proceedings. In making these decisions, directors should remember their overarching responsibility for continuing oversight and informed decision-making.

The Maryland General Corporation Law ("MGCL") requires each director to act in good faith, with a reasonable belief that his or her action is in the best interests of the corporation and with the care of an ordinarily prudent person in a like position under similar circumstances. In general, the duties of a director of a Maryland corporation are to the corporation, not to the corporation's stockholders or any particular group of stockholders, or to creditors, employees, customers or any other group.

Maryland courts have taken the view, however, that the directors of an *insolvent* Maryland corporation may be required to consider the interests of the corporation's creditors, as well as the interests of its stockholders, in determining whether a potential action, especially a distribution or liquidation, is in the best interests of the corporation. There is no clear guidance under Maryland law as to when this duty attaches or how a director must balance the interests of a corporation's creditors with the interests of its stockholders. As it also may not be easy to determine if or when a corporation has become insolvent, a director of a Maryland corporation who has reason to believe that the corporation may be nearing insolvency may wish to seek more information regarding the corporation's financial situation.

Although the MGCL does not define insolvency, Section 2-311 of the MGCL imposes two requirements for making distributions. These requirements, often characterized as the "equity solvency" and "balance sheet solvency" tests, prohibit a Maryland corporation from paying a dividend or other distribution if, after giving effect to the distribution, (a) the corporation would not be able to pay its debts as they become due in the usual course of business or (b) the corporation's total assets would be less than the sum of its total liabilities plus, unless the charter permits otherwise, aggregate senior liquidation preferences. Although we would not be surprised if a Maryland court looked to the requirements imposed by Section 2-311 to determine whether the corporation's directors have a duty to consider the interests of the corporation's creditors, a Maryland court may also consider definitions of insolvency under the Bankruptcy Code or Maryland fraudulent conveyance statutes.

In addition, commentators and a number of older Delaware cases have suggested that the directors of a Delaware corporation that is approaching, but has not yet reached, insolvency have duties to the corporation's creditors. While a more recent decision of the

Delaware Supreme Court suggests that directors of a Delaware corporation do not have duties to creditors until the moment of insolvency, a Maryland court may conclude that there is no bright line between solvency and insolvency and that the extent to which a director should consider creditor interests gradually increases as the corporation moves closer to insolvency rather than suddenly shifting at the time of insolvency. We believe that this evolutionary approach is more consistent with the standard of director conduct discussed above.

When a corporation becomes unable to pay its obligations, creditors will often seek to minimize the risk of additional losses through immediate liquidation, regardless of whether liquidation is in the best interests of stockholders. Creditors, however, have many remedies other than claims against the directors of the debtor corporation that are unavailable to a corporation's stockholders, from contract rights under credit agreements to the right to petition for involuntary bankruptcy. Recognizing that creditors are better positioned to protect themselves against borrower insolvency than corporate stockholders, and that directors should not be the guarantors of a corporation's workout strategy, Vice Chancellor Strine of the Delaware Chancery Court concluded that the duties of directors of an insolvent Delaware corporation to its creditors do not preclude the directors from acting in good faith to maximize the corporation's long-term value, including authorizing the corporation to take on additional debt or pursuing a strategy that is ultimately unsuccessful. *Trenwick America Litigation Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168 (Del. Ch. 2006). In addition to being a sensible result, this approach is consistent with older Maryland cases discussing the obligation of directors of an insolvent Maryland corporation to consider the interests of both creditors and stockholders, and we expect that a Maryland court would reach a conclusion similar to that of Vice Chancellor Strine in *Trenwick*.

In light of Maryland and Delaware court decisions and the requirement in Section 2-405.1(a)(3) of the MGCL that directors act with the care of an ordinarily prudent person in a like position *under similar circumstances*, we believe that a director of a Maryland corporation should consider whether the corporation is in or nearing insolvency and, if it is, consider the interests of the corporation's creditors in determining whether an action is in the best interests of the corporation. However, directors should remember that creditors often have substantial contract and other legal rights that are not available to the corporation's stockholders and that the duties of directors to consider the interests of creditors do not preclude directors from acting to maximize the corporation's long-term value. In considering the interests of creditors, directors should not interfere with the creditors' ability to exercise their contract and other legal rights, but directors do not need to do more for creditors than required by applicable law or contract.

As always, we and our colleagues are available at any time to discuss these or other matters.

Jim Hanks
Greg Cross
Chris Pate
Carmen Fonda