Fox Rothschild LLP
ATTORNEYS AT LAW

Director Conduct in the Face of Corporate Insolvency

by David A. Jaffe

In the current economic environment, risk and uncertainty seem to be the dominant themes of the day. While the future remains murky, in hindsight some lessons appear clearly out of the trauma that has engulfed the economy during the past two years. Among the more important lessons is the seemingly obvious notion that events in the financial economy have a significant impact in the real economy. At some point relatively late in the crisis, Americans became aware that difficulties originally thought to be contained within the financial sector had spilled over into the real economy. As this realization surged into the public consciousness, the perceived scope of crisis enlarged significantly.

In the credit markets, as the smoke clears above the smoldering remains left in the wake of the securitization excesses still wreaking havoc on that market, the convergence between the financial and real economies becomes evident. Without appropriate regulatory oversight, asset securitization resulted in the decoupling of underwriting risk from ownership and balance sheet risk. When the last buyer purchased the last tranche of debt issued by the last marginally solvent borrower and backed by the last nominally solvent ratings agency or insurer, the house of cards began to tumble. And tumble it did, with a velocity and magnitude not seen previously in modern history.

As this article goes to press, banks are continuing to retrench and massive deleveraging is under way throughout the economy. At many banks, underwriting standards have become unrealistically strict. Despite valiant efforts by the Fed to restore liquidity to the credit markets, traditional forms of credit remain largely unavailable. Many companies in dire need of financing for various purposes are unable to obtain it. Whether the need stems from working capital constraints, debt refinancing or capital expenditures, companies are facing exigencies beyond their immediate capacity to address them.

In this recessionary period, where macroeconomic growth is negative, over-reliance on classic cost-cutting measures can exacerbate the very symptoms those measures are intended to remedy. In the absence of fully functioning credit markets, companies are facing an array of sub-optimal choices in the struggle to survive. Against this backdrop, corporate boards and management are under considerable pressure and scrutiny.

As the delicate community of corporate interests is strained to the breaking point, stakeholders who were once colleagues in the corporate enterprise become rivals. The cracks in the corporate façade lay bare a multitude of conflicting interests among the company's creditors, shareholders,

© 2009 David Jaffe | All rights reserved.

employees, management and directors. As boards deliberate over restructuring alternatives in such an environment, they begin to realize that there are no “win/win” options and that their decisions are very likely to be challenged by stakeholders who are adversely affected by corporate decisions. This article addresses some of the legal standards applicable to the conduct of directors and officers as they consider restructuring alternatives in the face of corporate insolvency.

What Is the Basic Standard of Review of Director Conduct?

Directors have a legal obligation to manage the business and affairs of the company in good faith and in a manner they reasonably believe to be in its best interests. In fulfilling this function, directors are viewed as fiduciaries of the company and must fulfill two essential duties in that role – the duty of loyalty and the duty of care. In discharging those duties, directors are generally insulated from judicial second-guessing by a legal doctrine known as the “business judgment” rule (BJR). The BJR originated as a judicial rule (subsequently codified in the statutory corporate law of many states) that protects disinterested corporate directors from liability for corporate acts or omissions through a presumption that they have exercised due care and loyalty and have acted in the company’s best interests.

There are exceptions to the BJR where courts will examine a board’s conduct more closely and more actively. Generally speaking, this “enhanced scrutiny” can occur in a variety of circumstances including situations where the board is negligent or has failed to properly inform itself, where certain kinds of transactions are implicated (generally, change of control transactions or corporate responses to change of control transactions initiated by others) or where conflicts of interest have emerged. Outside of a merger or change of control context, most transactions will fall within the BJR absent any board negligence or conflicts of interest. With respect to its consideration of restructuring transactions specifically, including the filing of a voluntary petition in reorganization under the federal bankruptcy laws, the board will be afforded the benefit of the BJR presumption unless negligence or self-dealing implicate the higher “enhanced scrutiny” standard of review.

In a conflict scenario, when a director has interests in a transaction on both sides of the table – on one side as a fiduciary of the corporation and on the other side, for example, as a principal beneficiary or counterparty under the deal – the BJR will not apply because any form of director self-dealing will be perceived to compromise director independence. In those circumstances it is well settled under the law, that the board has the burden of establishing the entire fairness of the transaction, sufficient to pass the test of careful scrutiny by the courts. An especially vexing form of this dilemma arises in an insolvency context where a director is also a creditor. That situation is described more fully below.

© 2009 David Jaffe | All rights reserved.

Fox Rothschild LLP
ATTORNEYS AT LAW

Some Special Considerations for Boards of Financially Distressed Companies

There are a few fundamental points that corporate directors should understand regarding their legal duties. In addition to understanding their substance, directors need to know to whom the duties are owed. The corporate entity is the primary beneficiary of the fiduciary duties that are owed by the board and the officers. In a solvent company, the shareholders as the residual risk-bearers have the right to seek enforcement of these duties, but they do so on behalf of the company as a whole rather than as direct beneficiaries. When a corporation is near a state of insolvency, the class of parties who may derivatively enforce directors' duties expands to include creditors as well as shareholders. Even without the presence of conflicts of interest, this expansion of obligation exposes directors to an inherent quandary. In determining what actions to take (or not to take) in discharging their duties, directors will be answerable to two constituencies that often have directly conflicting objectives for the corporation. Once the corporation is insolvent, creditors replace the shareholders as the indirect corporate beneficiaries. At that point, the creditors have standing to sue directors for fiduciary breaches on behalf of the company.

As the corporation's financial difficulties mount and the board begins to examine restructuring alternatives, it will be critical for the board to determine when the corporation has reached the point of insolvency because, among other reasons, insolvency is the point at which directors' duties shift to the creditors. Board decision-making will be heavily influenced by that shift. Transactions that may have been prudent calculated risks aimed at increasing shareholder value at a time when the corporation was solvent, and the directors' duties inured to the benefit of shareholders, will be deemed to be imprudent acts that erode asset values necessary to protect creditors' claims on assets when the company is insolvent. Moreover, while insolvency in fact is not a prerequisite for relief under federal bankruptcy laws, it does trigger certain legal rights in the debtor relating to preferential and/or fraudulent transfers to creditors.

Under the law there are three basic tests for determining insolvency. The first test, known as the "balance sheet" test, is a measure of whether the fair value of the company's assets exceeds the amount of its liabilities. The second test, known as the "cash flow" test, is a measure of whether the company is able to pay its debts as they come due. The third test, known as the "capital adequacy" test is a measure of whether the company is perceived to have sufficient capital to operate its business taking into account current and anticipated operating expenses, capital expenditures and long-term debt.

The Creditor/Fiduciary Conflict Scenario

In public and privately held companies alike, certain types of creditors are often represented on a company's board of directors. This scenario arises frequently where hedge funds, private equity investors and other non-traditional lenders have made investments in convertible debentures or

© 2009 David Jaffe | All rights reserved.

other debt obligations of the issuer. When this occurs, regardless of the company's solvency, the director designee is burdened with two conflicting sets of obligations – one of a fiduciary nature to act in the best interests of the company and the other to act in the interests of the creditor who appointed that individual to fill the board seat. Faced with this dilemma, the conflicted director serves neither of his corporate masters effectively. On one hand, his fiduciary obligations as a director will preclude him from taking actions that may maximize a recovery for his creditor-principal. On the other hand, his interests as a creditor cast a dark cloud over his impartiality as a director. If the corporation is insolvent, and the board is considering various restructuring alternatives, our creditor-director will feel significant pressure to act in the interests of his principle, even if those actions are not optimal for the corporation.

In order for the board to preserve its autonomy and decision-making discretion under the BJR in this context, it must identify and call out all potential conflicts of interest among the directors and in the management ranks. It must undertake prophylactic measures to insulate corporate decision-makers from any actual or potential undue influence by interested parties. After a dispute has arisen (and therefore with the benefit of hindsight) courts will examine carefully the board's deliberative processes in order to ascertain whether or not it implemented procedural safeguards to ensure fair and informed decision-making.

The Role of the Special Committee

Among other mechanisms that may be employed, the proper use of a special committee of independent directors is often afforded great deference by the courts in establishing prima facie evidence of procedural fairness. However, as with any mechanism, the "devil is in the details." If the facts surrounding the board's conduct in establishing the committee, or the behavior of the committee itself, suggest that the special committee is a sham or merely window dressing, courts will disregard the BJR and apply the higher standard of enhanced scrutiny to the board's behavior regarding the transaction.

Recent cases out of the Delaware Chancery Court suggest some clear guidelines for boards to follow when they establish a special committee of independent directors. First and foremost, each director appointed to the committee must be truly independent. The board should be able to demonstrate that every member of the committee is free from undue influence by controlling stockholders, influential creditors and other members of the board or senior management. Second, the mandate of the special committee must be clear and unambiguous and the committee should be vested with a level of authority sufficient to accomplish that mandate. The special committee must have authority to exercise real bargaining power (including the authority to reject a transaction) and not act merely in an advisory capacity to the board. Third, the special committee must have the authority to hire its own legal and financial advisors who should be separate from, and independent of, the corporation's legal and financial advisors. In situations

© 2009 David Jaffe | All rights reserved.

where the special committee has relied upon the company's advisors, courts have found the advice provided to the committee to be tainted because of the financial inducements inherent in the advisor's relationship with the corporation and its control parties.

Similarly, in light of the considerable risks facing the directors of an insolvent company, the board will be well-advised to engage an independent financial advisor to perform a solvency analysis. While the subtleties and nuances of the analysis might not be beyond the capabilities of management to perform, the importance of obtaining a solvency opinion from a third party should not be underestimated. When litigation is commenced, in addition to having to defend claims for fraudulent and preferential transfers, directors can anticipate personal claims for breach of fiduciary duty in approving the disposition of corporate assets and the incurrence of corporate liabilities. Claims alleging breach of the duty of loyalty have the potential to expose directors to personal liability for which corporate indemnification may not be available.

Conclusion

The financial pressure upon U.S. corporations will continue unabated for the foreseeable future. In this new "normal" environment investors, creditors and other corporate stakeholders who have suffered financial losses are likely to attempt to hold directors accountable for ignoring warning signals, taking undue risks and engaging in reckless behavior. If any form of director self-dealing or conflict of interest is implicated , the risk to corporate decision-makers is greatly enhanced. Directors, officers and their advisors need to be proactive in addressing these situations in the manner described in this article.

© 2009 David Jaffe | All rights reserved.