May 20, 2020

Financially Distressed Businesses: Revisiting the Business Judgment Rule and the Entire Fairness Doctrine

Authored by Patrick M. Birney and Shant H. Chalian

Introduction

Overnight, seemingly-healthy companies have seen their business models collapse, revenues evaporate, cash reserves dwindle, and valuations impaired. Some corporate boards, which in recent memory have focused almost exclusively on capital raising and unprecedented expansion, are confronting financial distress, many for the first time. While the "business judgment rule" and "entire fairness standard" are familiar concepts to most directors, it is important at this time to revisit both in the context of financial distress. This article will revisit the "business judgment rule" in the context of companies that are insolvent or operating in the zone of insolvency. It also will provide a short primer on the "entire fairness doctrine," which demands that transactions that purport to transfer the value of an insolvent corporation to a controlling shareholder or related party must be inherently fair to the residual claimants, by both demonstrating fair dealing (i.e., process) and fair price (i.e., substance).

The Business Judgment Rule

Directors continue to owe their fiduciary duties to the corporation after the corporation becomes insolvent; however, creditors displace shareholders as the main beneficiaries of those fiduciary duties. By way of background, a solvent corporation's creditors are protected by their contractual agreements with the corporation, as well as statutory and common law protections, including the Uniform Fraudulent Transfer Act and the implied covenant of good faith and fair dealing. The corporation's insolvency jeopardizes the creditors' contractual rights of repayment and decisional law recognizes additional protections for the creditor based on such insolvency. Notwithstanding this shift in the residual beneficiary to creditors, it is important to note that directors continue to owe a duty of care to act on an informed basis, a duty of loyalty to the corporations on whose boards they serve, and a duty of good faith. The business judgment rule insulates a director of a corporation from liability for a business decision made in good faith if the director is not interested in the subject of the business decision, is informed with respect to the subject of the business decision to the extent he reasonably believes to be appropriate under the circumstances, and rationally believes that the business decision is in the best interests of the corporation.

As a result of this presumption, courts will not substitute their own notion of what is or is not the exercise of sound business judgment, although the corporation's financial predicament, including insolvency or operating within the zone of insolvency, will greatly vary the underlying fact pattern. The approval of a transaction by a majority of independent and disinterested directors almost always bolsters the presumption that the business judgment rule attaches to transactions approved by a board of directors that is later attacked on grounds of lack of due care. The business judgment rule has been stated as a presumption not only by the courts applying Delaware law but also by courts applying the laws of a sizable majority of other jurisdictions and analyzing corporate resolutions made under the protections of the United States Bankruptcy Code.

The business judgment rule has two components. The first component immunizes directors from personal liability if they act in accordance with its requirements while the second component insulates the court from intervening in management decisions made by the directors. The protection the business judgment rule affords is generous to the point where the mere fact that a corporation takes on business risk and suffers losses — even catastrophic losses — does not evidence misconduct, absent additional negative circumstances concerning director conduct.

The initial burden of proof is on the party challenging a director's decision. If the claimant fails to meet the evidentiary burden, the business judgment rule attaches to protect directors and the decisions they make. If the party is able to allege and prove facts sufficient to overcome the business judgment rule presumption, such as a breach of a fiduciary duty, the burden then shifts to the director defendants to demonstrate that the challenged act of transaction was entirely fair to the corporation and its residual beneficiaries.

Entire Fairness Doctrine

A determination of the fairness of a transaction becomes an issue only if the presumption of the business judgment rule is defeated. The fairness test is designed to test whether a self-dealing transaction should be given deference. The court's decision does not turn on whether the interested directors acted in good faith but whether, in the absence of arms-length bargaining, the transaction, viewed objectively, is fair and reasonable. In other words, the fairness requirement examines whether the transaction is entirely fair to the insolvent corporation's residual beneficiaries.

If the board breaches one of its fiduciary duties, the business judgment rule protection is lost. In such case, the presumption of the business judgment rule is rebutted and the entire fairness rule is implicated. The entire fairness standard is a strict standard meant to apply to transactions that have conflicts in which the majority of the board is interested or stands to receive a material benefit, a director has financial incentives adverse to the corporation, or a conflicted director or equityholder controls or dominates the board as a whole. Directors are found to be interested if they appear on both sides of a transaction or expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all residual beneficiaries, generally.

The entire fairness standard is the most exacting standard, requiring a judicial determination of whether a transaction is entirely fair to the insolvent corporation's residual beneficiaries. The burden of proving that a challenged transaction is entirely fair falls on the relevant directors and/or equityholders. Those insiders carry the burden of proof that the transaction was approved either by a special committee of independent directors or by an informed vote of the majority of the disinterested stockholders. In addition, when the board of an insolvent corporation does not consist of a majority of disinterested directors, the entire fairness test applies, and the challenged actions will be upheld only if they are fair to the residual beneficiaries.

When the entire fairness test applies, a transaction must be fair as to both process and price. "Fair dealing" encompasses questions of process, including how the transaction is timed, initiated, structured, negotiated, and disclosed, and how the approvals of the directors and the stockholders are obtained. "Fair price" relates to the economic and financial terms of the transaction, including any relevant factors that affect the intrinsic or inherent value of the corporation, such as the market value and assets of the corporation, a pro forma analysis or other valuation metrics, and possibly a solvency opinion to ensure that the transaction will not render the corporation insolvent. The fair dealing and fair price components are not viewed in isolation, but, rather, in conjunction. Entire fairness requires the court to strictly scrutinize all aspects of a transaction to ensure fairness.

Even under the weight of the entire fairness doctrine, targets may shift the burden of proof back to the claimant by utilizing procedural safeguards. The most prominent and frequent of these safeguards is to establish and empower a functioning special committee of independent and disinterested directors to safeguard the interests of all the corporation's stakeholders. However, the special committee must function in a manner that indicates that the controlling shareholder did not dictate the terms of the transaction and that the committee exercised real bargaining power "at an arm's length." In other words, the special committee must be empowered with the ability to reject the proposed transaction.

Another frequently used safeguard is to obtain a solvency opinion from independent financial advisors stating that, after giving effect to a transaction, the corporation's assets will exceed its debts, the corporation should be able to pay its debts as they come due, the corporation will not be left with unreasonably small assets or capital and, if applicable, there will be sufficient surplus to effect a distribution to equityholders. Although not required, special committees and solvency opinions provide an important shield in deflecting creditor attacks on business decisions and in helping the board satisfy its obligation to exercise sound business judgment in approving transactions.

However, courts have long provided some leeway to corporations that are insolvent or in the zone of insolvency, particularly if it can be shown that a proposed transaction maximizes the value of the corporation or, at the very least, mitigates a further deterioration in value. [1] For example, the Delaware Court of Chancery opined that business decisions which affect the value of the entity as a whole, without conferring specific benefits on the directors themselves or, in the case of dual fiduciaries, on the competing beneficiaries of fiduciary duty, are reviewed under the deferential business judgment standard of review. The court explained that when directors make decisions that appear rationally designed to increase the value of the firm as a whole, "Delaware courts do not speculate as to whether those decisions might benefit some residual claimants more than others." [2]

Conclusion

The business judgment rule serves to protect and promote the role of the board as the ultimate manager of the corporation, even when the corporation is insolvent or operating in the zone of insolvency. However, the protections of the deferential business judgment rule are not absolute, and the fairness review of any one particular transaction can undergo a scrutiny by bankruptcy and non-bankruptcy courts. Where there exists a heightened potential for diverging interests among directors and stockholders, proving fairness can be a tough burden to overcome. Depending on the nature of the transaction and situational conflict, boards of directors must take appropriate procedural safeguards, such as engaging special committees and obtaining solvency opinions, to thwart claims of a breach of a director's fiduciary duty.

ENDNOTES

[1] See "WeWork's Legal Floodgates May Have Just Opened," published in Fortune on November 19, 2019 – while the "burden of proof is on the company to show that what they did was fair" … "one possible defense against the entire fairness standard could be that the company in question found itself in a 'distressed situation'.

[2] In Quadrant Structured Prods. Co., Ltd. v. Vertin,102 A.3d 155,185-92 (Del. Ch. 2014).

FOR MORE INFORMATION

Contact any member of Robinson+Cole's Distressed Companies and Special Situations Group listed below:

Patrick M. Birney | Shant H. Chalian | Jamie L. Edmonson | Michael R. Enright

Mark A. Fink | Brian M. Flaherty | Matthew J. Guanci Jr.

Stephen P. Hanson | Eric M. Kogan | Leslie J. Levinson | Natalie D. Ramsey

For insights on legal issues affecting various industries,
please visit our Thought Leadership page and subscribe to any of our newsletters or blogs

Robinson+Cole
A History of Embracing Change

Boston | Hartford | New York | Providence | Miami | Stamford | Los Angeles | Wilmington | Philadelphia | Albany | New London