Excerpts from Director's Handbook: A Field Guide to 101 Situations Commonly Encountered in the Boardroom, Placenti, Frank M., editor, American Bar Association, Section of Business Law, Corporate Governance Committee, First edition, Chicago: 2017.

SECTION TWELVE

THE TROUBLED COMPANY

12.1 THE BOARD'S FIDUCIARY DUTIES IN AN INSOLVENT (OR NEARLY INSOLVENT) CORPORATION

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As a corporation becomes financially distressed, insolvent, or files for bankruptcy, directors' and officers' fiduciary duties remain the same—duty of care and duty of loyalty. Regardless of whether a corporation is solvent, in the zone of insolvency, or insolvent, the primary job of directors remains the same—to continue to maximize the value of the corporation by exercising judgment in an informed, good faith effort to maximize the corporation's long-term wealth-creating capacity. Moreover, distress or insolvency does not change the standard of review that Delaware courts apply to directors' decisions as to how to fulfill their fiduciary duties. Their decision-making, when not conflicted, retains the traditional deference of the business judgment rule. Entire fairness review will apply to conflicted decision making.

But insolvency does change who may seek to enforce the director's duties. As poor economic performance drives a troubled corporation toward little or negative equity (i.e., insolvency), the corporation's stockholders may find themselves "out of the money." With a diminished economic stake in the corporation's performance, the stockholders may be

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without means or incentive to use the stockholder franchise to elect the board, approve fundamental transactions, or bring derivative claims against derelict directors.

Under ordinary circumstances, the board does not owe creditors duties, fiduciary or otherwise, beyond the contractual rights the creditor has bargained for. With the insolvent corporation, the creditors' contractual rights under lending agreements, particularly when secured by liens, may make the creditors the de facto economic owners of the distressed corporation and the parties with the greatest interest in the corporation's restructuring, reorganization, or liquidation. Thus, once insolvent, the corporation's creditors become the beneficiaries of any residual increase in the corporation's value and thus gain the incentive to monitor the directors for breaches of fiduciary duty. Reflecting the shifting interests and incentives insolvency brings, the creditors of an insolvent corporation gain standing to bring claims derivatively to enforce a director's fiduciary duties.

With a troubled or insolvent corporation, the business risk tolerances of the stockholders and the company's creditors may diverge. Out-of-the-money stockholders may favor a riskier path that plays out over a longer time horizon than that favored by the corporation's creditors, who are looking for repayment of what is owed to them quickly, before things might turn even worse. Common stockholders may lose control in favor of preferred stockholders as a corporation acknowledges its financial distress. Junior creditors may favor riskier strategies than senior creditors who feel as though repayment of their credit is secure. In addition, due to the active market for trading in the debt of distressed companies, there may be conflicts between creditors at the same level of priority who have different cost bases in the debt and, often, different investment horizons. Creditors who buy into their position at a steep discount with a short investment horizon may favor near-term liquidation of the debtor—even at a "fire sale" price—if it would yield them their targeted internal rate of return within the targeted time frame. The directors of an insolvent corporation may need to consider these competing interests in making decisions about how to manage, financially restructure, or liquidate the corporation.

Under Delaware law, creditor standing to bring derivative litigation does not arise until the corporation is insolvent. Creditors of a corporation that is "in the zone of insolvency," but not yet insolvent, do not have standing to bring derivative litigation. The Delaware courts have yet to give a test that would allow a board to tell with any precision when a corporation enters the "zone of insolvency" or the where the "zone of insolvency" becomes actual insolvency. Creditors need only plead—and later prove—that the corporation was insolvent at the time the suit was filed to have standing. Creditors are not required to show that corporate debtor was irretrievably insolvent to have standing. The balance sheet test is used for determining whether a company is insolvent for the purpose of determining creditor standing.

Unlike stockholders, creditors do not have standing to bring "direct" claims against directors and officers for breach of fiduciary duty. When a corporation is distressed, it may be the one in most need of effective and proactive leadership—as well as the ability to negotiate in good faith with its creditors—goals which would likely be significantly undermined by the prospect of individual liability arising from the pursuit of direct claims by creditors. It is also clear that Delaware law does not allow claims for "deepening insolvency"—claims that directors improperly continued to operate an insolvent corporation or lenders lent to an insolvent corporation, damaging the corporation's stockholders or creditors. The board of an insolvent Delaware corporation remains entitled to exercise its good faith business judgment when determining whether the corporation should continue operating; the decision for the corporation to continue operating when insolvent is not subject to a heightened standard of review by reason of the corporation's insolvency.

The laws of other states should be consulted if the corporation in question is incorporated in a state other than Delaware. Although most states' law is consistent with Delaware corporation law on the issues of creditor standing to bring derivative claims on behalf of an insolvent corporation and the nonexistence of creditor direct claims for breach of fiduciary duty and claims of deepening insolvency, a few are not. A prudent board of a distressed corporation will want to receive an update concerning developments of this still emerging area of law that is specific to their corporation's state of incorporation.

Key Questions

When considering how to meet the duties of care and loyalty duties, key questions that a board member of a distressed corporation might ask include the following:

- ❑ How close to insolvency is the corporation?
- ❑ What has management done to monitor the liquidity and financial position of the corporation?
- ❑ What is the corporation's debt structure and who are the corporation's largest creditors? How reliable are the sources of that information? Do any of the individuals providing it (e.g., management) have a personal interest that I should be aware of?
- ❑ Is the corporation receiving advice on addressing its financial distress (out-of-court restructuring, prepack, reorganization, asset sale in bankruptcy)?
- ❑ Are there potential conflicts of interest between stockholder and creditors? Is controlling stockholder also a creditor?
- ❑ Do the managers have sense of what "runway" exists before insolvency becomes inevitable?
- ❑ Do I or any of my fellow board members have experience with distressed situations? Should we bring in some additional directors with that experience?
- ❑ Have we considered hiring a restructuring firm or chief restructuring officer?
- ❑ What effect would filing for reorganization have on our business operations?

Additional Reading

1. Moringiello, Juliet M., Andrew B. Dawson. *Bankruptcy Overview: Issues Law and Policy,* 7th ed., American Bankruptcy Institute (2016).

2. Hansen, Craig D, et al. *Pre-bankruptcy Planning for Commercial Reorganization*, 2nd ed., American Bankruptcy Institute.

3. Baker, D.J., J. Butler, and M. McDermott, "Corporate Governance of Troubled Companies and the Role of Restructuring Counsel," 63 *Bus. Law* 855–80 (May 2008).

4. Shein, James B., *Reversing the Slide, a Strategic Guide to Turnaround and Corporate Renewal*, Jossey-Bass (2011).

Notes

12 OVERSIGHT OF A DISTRESSED OR INSOLVENT CORPORATION

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As discussed in the previous chapter, distress or insolvency do not change the nature of a director's fiduciary duties, but they do increase the number of constituencies that directors must consider in their decision-making. Although a director's role in governance may be terminated due to the decision to liquidate or because of misconduct, corporate distress or insolvency alone does not change a director's duties to oversee the affairs of the corporation. Even after filing for reorganization, directors retain the authority to manage the affairs of the corporation and their obligation to manage it consistent with their fiduciary duties. There is no obligation on the part of the director to cease the corporation's operations and liquidate. Absent a conflict of interest, director decision making will be reviewed under the business judgment rule, meaning that decisions short of "waste" will not be the source of liability.

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Directors May Remain in Control, or Not

A reorganization under Chapter 11 of the Bankruptcy Code presumes that the debtor's business will continue to operate and that the debtor (and its directors) will remain in possession and control of its assets as a "debtor in possession." Nonetheless, the continuing directors of a reorganizing debtor will likely find that the board's role is circumscribed by the realities of a reorganization proceeding. First, because the debtor's board must submit all nonordinary course business decisions to the bankruptcy court for review and approval, the bankruptcy court supervision is constant. Second, during a reorganization the board typically retains and places heavy reliance upon outside "restructuring professionals," such as chief restructuring officers, bankruptcy lawyers, investment bankers, and others. Third, the debtor's creditors are involved in governance. Debtors will typically agree to conditions in debtor-in-possession (DIP) financing that tightly cabin the discretion of the debtor's management. Creditors also have standing to challenge the debtor's decisions in bankruptcy court.

Insolvency can lead to situations in which the directors are removed from any significant corporate governance role. When a company liquidates under Chapter 7 of the Bankruptcy Code, a trustee is appointed to sell the debtor's assets and use the proceeds to pay the debtor's creditors; there is no job for the directors to perform. Similarly, the appointment of a receiver under state corporation law will typically end the board of director's role in corporate governance. In a Chapter 11 reorganization, the debtor's creditors may seek the appointment of a Chapter 11 trustee to manage the debtor's affairs if there is evidence that the debtor's management has engaged in fraud or other misconduct. The appointment of the Chapter 11 trustee will end the board's role in governance.

Recurring Conflict of Interest Scenarios

When directors remain in control, distress and insolvency can give rise to conflicts of interest that can infect director decision-making and subject a board's decision to attack. Some recurring conflict of interest flashpoints are described in the next sections.

Continued Employment by the Corporation

Continued employment by the corporation can create a conflict of interest. Delaware law presumes that a director does not have a material interest in remaining a director, with limited exceptions. And the receipt of ordinary directors' fees will generally not create a conflict of interest for a director. However, where a director is an employee of the company as well as a director, the director likely has a material interest in the director's continued employment, unless neither the job nor the compensation received is material to the director. Where a director has a material interest in ongoing employment, the director suffers a conflict of interest wherever the director is asked to make a decision potentially affecting the director's employment. The director also suffers a conflict of interest with respect to any transaction in which someone with control over the director's employment, such as a controlling stockholder, has an interest. Such conflicts may easily arise where the corporation is in financial distress, if, for example, the board considers whether to liquidate the corporation or to engage in a merger or other transaction that would foreseeably affect the employment of the director.

Conflicts between Companies within a Corporate Family

When one member of a corporate family is in financial distress the interests of that corporation may differ materially from the interests of other members of the corporate family, which may be stockholders, creditors, or potential acquirers of assets from the financially troubled corporation. A director or officer may face a conflict of interest where the individual serves as a director or officer of multiple entities within the corporate family.

When a wholly-owned subsidiary is solvent, it may be managed exclusively for the benefit of its parent entity. Directors do not breach fiduciary duties when they cause a wholly-owned, solvent, subsidiary to engage in transactions with the subsidiary's parent that are disadvantageous to the subsidiary. Such transactions may include transferring assets to a different subsidiary of the same parent, allowing the parent to use the subsidiary's assets to secure a loan to the parent, or entering into service agreements with the parent or other subsidiaries of the parent that are not set at a market rate.

But, when a wholly-owned corporation becomes insolvent, its dealings with its parent entity may be subject to greater scrutiny. This shift is the result of creditors becoming residual interest holders. At that point, the creditors, not the controlling stockholder, pay the price of any lopsided transactions between the subsidiary and its parent.

Thus, insolvency curtails the freedom that a parent has to engage in transactions with its subsidiaries. As a result, directors of an insolvent subsidiary must scrutinize transaction between the parent and affiliates for fairness to the subsidiary itself. In these situations, it may be prudent to appoint directors to the subsidiaries board that are independent of the parent and for the board of the subsidiary to obtain its own advisors.

Personal Financial Interest in Distressed Company

Directors' ownership of stock of the corporation on whose board they serve is ubiquitous. Outside of bankruptcy, a director's ownership of stock generally does not give rise to a conflict of interest, because generally the stockholders' interests are aligned with the corporation's interests and the beneficiary of the directors' fiduciary duties.

When an insolvent corporation's interests diverge from those of its stockholders, stock ownership may present a conflict of interest for directors. Similarly where a transaction is beneficial or detrimental to various classes of a corporation's equity, a director's financial interest can present a conflict. These types of conflicts may well emerge in times of financial distress despite not existing previously.

Ties to a Controlling Shareholder or Creditor

Perhaps the most common conflict of interest that a director may suffer arises where the director has ties to a creditor of the corporation or to the controlling stockholder of the corporation. In either case, the director's lack of independence from the creditor or controlling stockholder creates a conflict of interest for the director wherever the interests of the creditor or the controlling stockholder differ from those of the corporation.

Other Business Dealings with the Distressed Company

Directors and officers will also suffer a conflict of interest with respect to their management of a financially troubled corporation in any other situation in which their interests differ from those of the corporation or its stockholders generally. Thus, for example, where a financially troubled corporation sells assets in an effort to repair its balance sheet, its directors will have a conflict of interest if they are affiliated with the buyer of the corporation's assets.

In a refinancing or recapitalization, it is not unusual for the new capital to come from someone who already has a position in the troubled company's capital structure. This can create conflicts of interest to the extent the new financing impairs the position of the other members of the capital structure.

Key Questions

When considering how to meet the duties of care and loyalty, key questions that a board member of a distressed corporation might ask include the following:

- ❑ How close to insolvency is the corporation?
- ❑ Do the managers have a sense of what "runway" exists before insolvency becomes inevitable?
- ❑ What has management done to monitor the liquidity and financial position of the corporation?
- ❑ What is the corporation's debt structure and who are the corporation's largest creditors? How reliable are the sources of that information? Do any of the individuals providing it (e.g., management) have a personal interest that I should be aware of?
- ❑ Is the corporation receiving advice on addressing its financial distress (out-of-court restructuring, prepack, reorganization, asset sale in bankruptcy)?
- ❑ Are there potential conflicts of interest between stockholder and creditors? Is the controlling stockholder also a creditor?
- ❑ Do I or any of my fellow board members have experience with distressed situations? Should we bring in some additional directors with that experience?
- ❑ Have we considered hiring a restructuring firm or chief restructuring officer?
- ❑ What effect would filing for reorganization have on our business operations?

Additional Reading

1. Hansen, Craig D, et al. *Pre-bankruptcy Planning for Commercial Reorganization*, 2nd ed., American Bankruptcy Institute.

2. Shein, James B. *Reversing the Slide, a Strategic Guide to Turnaround and Corporate Renewal*, Jossey-Bass (2011).

Notes

12.6 FILING FOR BANKRUPTCY

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The Decision to File

The decision whether to file for bankruptcy belongs to the directors of the corporation and that decision (absent a conflict of interest, a breach of the duty of care, or the failure to act in good faith) is protected by the business judgment rule under state corporation law. The directors have broad discretion in making this decision. A corporation has no obligation to file for bankruptcy or liquidate when it becomes insolvent, and a board may opt to pursue strategies outside of bankruptcy in an attempt to maximize the value of the corporation. When a corporation files for bankruptcy, the corporation is placed immediately under the supervision of the bankruptcy court and automatic stay of the bankruptcy court goes into effect immediately to prevent creditor actions against the corporation.

Although the directors of a corporation are in firm control of the decision to file, that decision can be challenged by the corporation's creditors. A board's decision to file for reorganization under Chapter 11 can be challenged under bankruptcy law on the basis

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the bankruptcy petition was not filed in good faith. In assessing a debtor's good faith, courts may consider the totality of facts and circumstances to determine where the bankruptcy petition is abusive and not in good faith. Factors considered include the following:

- *The debtor must be suffering "financial distress."* Insolvency is *not* required. But at a minimum, the debtor must "face such financial difficulty that, if it did not file at that time, it could anticipate the need to file in the future."
- *The Chapter 11 filing must serve a "valid bankruptcy purpose."* The two valid purposes of Chapter 11 that have been recognized by the case law are (i) preserving going concerns, and (ii) maximizing property available to satisfy creditors.
- *The filing cannot have been "merely to obtain a tactical litigation advantage."* Thus, a case that is filed solely for the purpose of obtaining the protection of the automatic stay, with no prospect of rehabilitation of the debtor, may be deemed to have been filed in bad faith.

Although dismissal of a Chapter 11 petition for bad faith is a rare occurrence, a board considering commencing a Chapter 11 proceeding should evaluate critically its goals in seeking Chapter 11 relief and assess the risk that the decision is vulnerable to attack as not in good faith.

Similarly, if a corporation is unwilling to file for bankruptcy, its creditors (provided they meet certain minimums in number and amount claimed) may file an involuntary petition in the bankruptcy court. An involuntary petition functions as a complaint seeking a declaration that the corporation should be put into bankruptcy. The corporation can respond by opposing the involuntary petition, in which litigation ensues over whether the corporation should be placed into bankruptcy. Because of the potential cost of litigation and damages for lender liability, the creditors seldom use the involuntary petition.

A debtor cannot contractually waive its right to file for bankruptcy. An advance agreement to waive the benefits conferred by the bankruptcy laws is wholly void as against public policy and unenforceable. Nonetheless, a corporation's formation or governing documents may contain provisions that place limitations or preconditions on the corporation's ability to file for bankruptcy case. Examples of enforceable governance provisions include requirements that a super-majority of directors or stockholders vote to authorize the bankruptcy filing or that a particular class of equity securities consent to the filing. A governance provision requiring unanimous director approval when a lender has the right to appoint a director, or requiring consent of a series of preferred stock that is owned by the lender, or has the practical effect of giving a lender veto power over the decision to file for bankruptcy, may be vulnerable to attack as disguised advanced waiver.

Choosing between Liquidation and Reorganization

A board that decides a corporation should file for bankruptcy must choose whether to seek liquidation or reorganization. If the corporation's distress reflects a failure in its business operations and there is no viable business to reorganize, liquidation pursuant to Chapter 7 will likely be the best way to maximize the recovery of the corporation's creditors. For the board of an insolvent corporation, the decision to pursue Chapter 7 liquidation is the end of the governance road. It requires the appointment of a Chapter 7 trustee who takes exclusive control of the corporation's assets and the management of its business. Directors and officers of a Chapter 7 debtor typically resign upon the filing of the bankruptcy petition.

But if the corporation's operations are healthy and the source of its distress is a burdensome capital structure, reorganization may be preferable because it may preserve the otherwise viable business's going concern value that would be lost in liquidation. In a Chapter 11 reorganization, the debtor retains control of its assets and business (as a "debtor in possession") and the insolvent corporation's existing directors and management often continue managing the reorganizing corporation's affairs. Because the reorganization process involves numerous and frequent strategic decision, it will require substantial attention from a corporation's directors. For example, a "reorganization" may take the form of a going-concern sale of all or a substantial portion of the corporation's assets, a merger or strategic acquisition, a recapitalization of the business, or a refinancing or restructuring of existing debt. The directors' control of the reorganizing debtor is constrained by the supervision of the bankruptcy court (e.g., the requirement of bankruptcy court approval for transactions outside the ordinary course of business) and potential challenges by an official committee of creditors, which has the right to participate and be heard on most issues in the reorganization.

Given the specialized nature of bankruptcy proceedings and the complexity of a reorganization, it will typically be prudent for a board to engage insolvency professionals (e.g., bankruptcy counsel, financial advisors, turnaround managers, independent board members) to assist in the decision whether to file for bankruptcy and guide the board through the Chapter 11 process. These advisors can also provide significant protection against personal liability for board members who rely in good faith on their advice. The board's resolution authorizing the bankruptcy filing will typically ratify the corporation's prior retention of insolvency professionals and authorize the continued retention of such professionals in the Chapter 11 case. In addition, given the dynamic nature of Chapter 11 proceedings and the need for flexibility on the part of the debtor's management, the resolutions will typically delegate authority to make decisions and act on behalf of the corporation to specific individuals. Even though a board may delegate to advisors, the board may not abdicate its authority, must continue to provide oversight, and will remain ultimately responsible for the management of the corporation during the Chapter 11 case.

Key Questions

When considering whether to file for bankruptcy, key questions that a board member of a distressed corporation might ask include the following:

- ❑ Can the corporation be reorganized outside of bankruptcy?
- ❑ Are there any governance provisions that require the consent of more than a majority of the directors or the consent of certain securities holders before filing for bankruptcy? Are they enforceable?
- ❑ Has the board received sufficient advice from insolvency specialists that it can make an advised and informed decision about whether to file for bankruptcy?
- ❑ Can the corporation successfully reorganize? Are its problems with the viability of its underlying business (for example, technological advances have made the

corporation's product obsolescent) or is it a good business but with the wrong financial structure?

- ❑ Does the board have a clear picture of how the corporation's creditors and other stakeholders will fare?
- ❑ Is there a creditor who might challenge the filing for bankruptcy as not in good faith?
- ❑ Are there a sufficient number of creditors who might file an involuntary petition?
- ❑ Are there any directors with potential conflicts of interest or independence issues participating in the decision to file for bankruptcy?
- ❑ Are the current directors and officers staying with the corporation while it reorganizes?

Additional Reading

1. Hansen, Craig D, et al. *Pre-Bankruptcy Planning for Commercial Reorganization,* 2nd ed., American Bankruptcy Institute.
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