Bankruptcy and the Board

By Michael L. Bernstein and Charles A. Malloy

A company that is insolvent or otherwise facing financial distress is likely to consider bankruptcy along with other alternatives. The decision to file for bankruptcy or to pursue other alternatives rests with the company's directors. A director faced with these decisions must understand where his or her duties lie, and the advantages and disadvantages of bankruptcy, in order to make the best decision. Directors must understand how to minimize the risk of personal liability, because in insolvency situations, creditors may consider lawsuits against directors as a potential source of recovery when it appears that the company will not be able to pay its debts in full.

Directors' Duties to the Corporation and Shareholders

When a corporation is solvent, the directors' fiduciary duties are owed to the company's shareholders in the form of the duty of care and the duty of loyalty. The duty of care requires directors to act prudently in making decisions that affect the company and to ensure that they receive all material information that is available to them before making a business decision. The duty of loyalty focuses on avoiding conflicts of interest, and requires directors to act with the honest belief that actions they direct are in the best interest of the company and to refrain from engaging in transactions to benefit themselves at the company's expense.

To afford directors some protection in the exercise of their duties, courts apply the "business judgment" rule. This rule provides that a director is presumed to have acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interest of the company.

Some courts have held that when a company experiencing financial distress enters a "zone of insolvency," directors must be held to a higher standard, and the business judgment rule gives way to the "entire fairness" standard, whereby the court independently evaluates the merits of the decision to decide whether it was procedurally and substantively fair.

Directors' Duties When a Company is Insolvent or Bankrupt

When a company is insolvent, the directors' duty is to both the shareholder *and* the creditors. In deciding whether the company should file bankruptcy or to pursue some other alternative, directors must be mindful of their duty to maximize value for both creditors and shareholders. If bankruptcy is filed, the directors will continue, during the bankruptcy case, to have a fiduciary duty to creditors.

Because under the bankruptcy laws creditors are generally entitled to be paid in full before shareholders receive anything, creditors and shareholders may be at odds as to what is the best approach to address an insolvency situation The problem is further complicated because there are often divergent views even among creditors. While it is easy to say "the directors have a duty to maximize value," it is more difficult when various stakeholders have very different views as to how to go about maximizing value. For example, a fully secured creditor may see a prompt sale of the company's assets as the best way to "maximize value" since that will get him paid off quickly. However, an out-of-the-money constituency—perhaps subordinated bondholders or shareholders—may see delay or pursuit of a long-shot transaction as the best way to "maximize value." The diverse views of differently situated stakeholders make

Director Summary: If your company faces the prospect of insolvency what does this mean for you as a director, for the various stakeholders of the company, and for the future of the company itself? The authors profile the pros and cons of filing for bankruptcy, including liability and insurance considerations, the significance of expert consultants, and conflict of interest concerns.

insolvency situations particularly challenging for directors.

An Illustration of Divergent Stakeholder Interests

Suppose a company has assets with a current value of \$60 million. It has a secured debt of \$40 million with a blanket lien on all of the company's assets, and unsecured debt of \$70 million. The company is confronted with two options.

Option 1: The company could liquidate its assets for \$60 million. Secured creditors would be paid in full, unsecured creditors would recover about 28 percent of their claims (\$20 million in proceeds remaining after the secured creditor is paid divided by \$70 million in claims), and shareholders would get nothing. In this case, shareholders would rather see the company use its assets to buy lottery tickets; even a remote chance of a recovery is better for them than a fast sale that generates no recovery.

Option 2: The company seeks to implement a long-term plan to restructure its operations and reduce its debts, with the potential to pay unsecured creditors in full and allow shareholders to retain their equity. This approach is fraught with risk and uncertainty. If it works, it is clearly better than liquidation, but if it does not work, the result may be a fire sale that gets the secured creditor 50 percent of its debt with nothing left for anyone else.

Insolvency situations and bankruptcy cases are usually more complicated than the scenarios described above, but this simplified hypothetical illustrates the difficult questions faced by a director whose duty is to "maximize value."

Advantages and Disadvantages of Bankruptcy

Bankruptcy offers a company the opportunity to restructure debt and operations, and thereby to emerge as a more viable business. The bankruptcy tools that facilitate this include the ability to reject burdensome contracts, to obtain financing on terms that may not be available outside of bankruptcy, to recover certain pre-bankruptcy payments, and to bind dissenting creditors to a restructuring plan. But, there are tradeoffs. One tradeoff is that the company becomes subject to court supervision and creditors have increased input into the company's decisions. Beyond that, bankruptcy is expensive, time consuming, a distraction from the core business mission, a potential cause of anxiety for customers, suppliers, and employees, and a convenient forum for creditors and others who want to commence litigation.

From a director's perspective, bankruptcy can be a mixed bag. On one hand, the board's discretion is limited because most important business decisions must be approved by the bankruptcy court, and nothing gets approved without creditors and other parties having the right to be heard. Bankruptcy also creates a forum for creditors to assert claims, and a common target for such claims is the directors.

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On the other hand, bankruptcy may offer some comfort to a director. In bankruptcy, the board's decisions in reconciling divergent interests will be subject to review and approval by the bankruptcy court. If the court approves a proposed decision or transaction, it may insulate the directors from an attack. It is hard to argue that a decision to sell a major asset, shut down a business line, or engage in some other transaction was a breach of duty when a court has determined that the transaction was in the best interest of the company and its creditors.

Directors' Responsibilities in a Bankruptcy Case

It is often necessary for a company and its directors to modify their pre-bankruptcy practices to comport with the additional oversight and disclosure requirements of bankruptcy, mindful of the fact that creditors and the bankruptcy court will be reviewing directors' decisions.

Responsiveness to Stakeholders

Companies in bankruptcy are expected to be responsive to requests from stakeholders for information, and to consult with stakeholders before making major business decisions. As a general matter the board should encourage management to be responsive to legitimate requests for information from the creditor committee and other major constituencies. The court will expect such responsiveness and it is likely to minimize disputes.

Hiring Experienced Professionals

It has become common for companies in bankruptcy to hire a restructuring advisory firm or sometimes a chief restructuring officer (CRO) before or shortly after filing bankruptcy. These turnaround professionals are familiar with the requirements of bankruptcy law, and will work with the company's current management and directors to develop a restructuring plan.

In addition to a restructuring advisory firm or CRO,

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counsel with significant experience in restructuring and bankruptcy cases is indispensable. Counsel should be brought on board as soon as the company's financial difficulties become evident. The desire for familiar counsel should be balanced against the need to have attorneys with expertise in bankruptcy law and practice and fresh viewpoints representing the company.

Finally, in some cases the board should consider hiring an investment banker experienced with restructuring and bankruptcy. In some cases, the debtor's restructuring advisory firm can play this role. However, if the company is contemplating an M&A transaction or substantial new financing, it will want to make sure to have investment banking capability.

Forming a Restructuring Committee

Directors may also consider forming a special restructuring committee of the board to address the numerous new issues that will come before the board in a bankruptcy. These issues may include evaluating asset sales, plant closings, employee headcount reductions, collective bargaining agreement modifications, management retention issues, debt restructuring or new investment proposals, and the selection of restructuring professionals.

Anticipating Director Liability Issues

Although director liability issues arise both in and out of bankruptcy, it is perhaps not surprising that directors' actions will be subject to greater scrutiny when a company is insolvent or in bankruptcy. It is advisable to anticipate and address potential liability issues prior to the commencement of a bankruptcy case.

D&O Insurance

If a bankruptcy filing appears likely, the board should review the company's D&O liability insurance policy. Among other things, the board should assess the adequacy of the policy and ascertain whether filing bankruptcy will alter the policy's coverage. It may be more difficult to obtain or increase D&O insurance once a company is in bankruptcy, so the board should review these issues prior to filing.

Personal Liability for Corporation's Debts

Although ordinarily directors are not liable for claims against a corporation, certain circumstances may lead to the assertion of claims against directors. While an exhaustive review of potential director liability is beyond the scope of this article, it is a topic that should be considered by directors when a company is insolvent or contemplating bankruptcy. For instance, failure to pay withholding or "trust fund" taxes collected by the corporation; permitting the use of employee 401k or medical plan contributions for purposes other than the plan; or failure to pay employee wages may result in claims against directors. Directors of a troubled company should be vigilant to assure that these issues are dealt with properly, especially when cash is tight.

Conflicts of Interest

Conflicts of interest involving directors will arise from time to time in bankruptcy and insolvency situations. For example, in a private equity context, a director of the company may also be an employee of the private equity fund that is the major shareholder, or lender, or perhaps both. As a director, he has an obligation to maximize value for all creditors and shareholders; however, in his representative capacity as an officer or employee of a significant stakeholder, he is most interested in the recovery to his own institution. Where there is not enough value to satisfy all obligations, these conflicts can become particularly problematic.

Recusal and Resignation

In the event a conflict of interest arises, directors should seek the advice of counsel and should be prepared to follow the same process that they would follow outside of bankruptcy. This may include disclosure of the conflict of interest and recusal from decision making related to the matter giving rise to the conflict. Where conflicts do exist, the entire fairness standard is applied.

As well, a number of states have statutes that deal with circumstances in which a director has a conflict of interest and state laws should be consulted.

While it is hard to imagine a conflict of interest that would not merit at least disclosure and, potentially, recusal, directors should be circumspect about taking the further step of resigning from the board. Resignation does not shield a director from liability for events that transpired before the director's resignation and, rightly or wrongly, creditors and others may construe resignation as an abdication of responsibility or a sign that the resigning director feels he or she has some culpability for the company's financial distress. Apart from these considerations, a director who is familiar with the company and its business can add significant value and increase the prospects of a successful reorganization by remaining on the board through bankruptcy.

Creating a special committee to investigate or consider matters where one or more director may have a conflict may also be an effective way for the board to continue to fulfill its fiduciary duties without requiring repeated recusals or resignation by a conflicted board member.

Overlapping Boards and Affiliated Companies

A large business may consist of numerous affiliated companies. When such an organization files bankruptcy, each affiliate will file its own bankruptcy case. While the cases may be administered together for efficiency reasons, the assets and liabilities of the companies will not be consolidated unless the legal standards for "substantive consolidation" are satisfied. Thus, even if a group of affiliated businesses operates, for practical purposes, as a single entity, bankruptcy law requires that they be treated as separate entities.

Creditors of each separate entity will have their own interests to protect. This may give rise to conflicts of interest, especially when, as is common, directors serve on the board of more than one of the affiliated companies. Courts have noted that, although there may be good and valid business reasons for directors to serve on the boards of multiple affiliates, these business reasons do not trump a director's fiduciary duty to the stakeholders of each individual company. The existence of intercompany debt or even litigation claims by one debtor against another debtor complicate the situation. Directors sitting on the boards of affiliates with adverse interests may be put in the difficult situation of trying to make decisions that fulfill their fiduciary duties to the stakeholders of both companies. Recusal is an option, but it is not always practical. At the very least, the advice of counsel is necessary in these situations.

Parting Thoughts

The complex set of duties and responsibilities that directors ordinarily face is only magnified when a company becomes insolvent or files bankruptcy. To distill things into a few words of practical advice, in insolvency situations directors should (1) make sure they understand where their duties lie, (2) assure that the company's D&O insurance is adequate and that it is paying any obligations that, if not paid, could give rise to director liability, (3) make sure the board and company are obtaining appropriate advice from professionals with expertise in the restructuring area, and (4) be attuned to the potential for conflicts of interest. ■

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