Company in Distress?
Directors Needn’t Be.
Mitigating Risks at the Board.

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A company in distress demands special attention from its board of directors to help steer the enterprise into calmer waters. In addition, in such turbulent times, the board and its fiduciary duties are often put to test by disgruntled shareholders and creditors looking to recover their investments or loans. Claudio Rechden and Kalina Miller explain the general legal framework applicable to board members in distressed situations and suggest practical tips for managing and mitigating possible liability risks.

Foreword

The unassailable premise of this paper is that, when a company looks like it is coming off the tracks, the role of the board and the responsibilities of individual directors are transformed in important ways from what they were when the company was nicely chugging along. For instance, shareholders and others expect the board to take a more proactive role than before and to put the company back on a course to financial health and profitability. And these parties usually have the power to hold the directors legally accountable. Failure can result in unpleasant personal and professional consequences for directors.

The authors examine the shift in the relative position of stakeholders when a company enters the penumbra of insolvency. In good times, directors rightly think of the shareholders as the parties to whom their duties to the company (and legal responsibilities) most directly extend. But once the enterprise’s very survival as a going concern comes into question, the profile and legal rights of creditors and other stakeholders take on greater
importance. The board must be able to demonstrate that it is doing everything it can to maximize the enterprise value of the company, and hence the likelihood that the company will meet its obligations to parties with claims (on the cash flow and assets of the company) that come before the residual interest of shareholders. The board must not be seen as having allowed management or controlling shareholders to risk everything in a last-ditch effort to save something of the shareholders’ value.

The core of the paper is a very useful list of some of the most important steps that every director should take when it starts to look like the company is in distress—steps to maximize the board’s effectiveness and value addition in the process of addressing the issues that have brought the company to its current unfortunate state. It also lists other actions (including, importantly, documentation of all material decisions) that each director should take to reduce the chances and consequences of subsequent litigation. The authors rightly emphasize the importance of securing reliable information and good-quality outside advice.

For the board of a company in distress to be effective and to demonstrate that it has satisfied the duty of care, it is necessary to review the existing flow of information between management and the board and to make any changes needed to ensure that people and processes are in place for the board to receive timely and accurate information. Important shifts in the relationship and patterns of interaction between the board and management will be necessary. For one thing, the board may have to partially or completely replace the management team as part of its response to the crisis. But even when the management team stays largely in place, the board cannot be complacent and allow old patterns of communication and board input in strategic decision making to continue unaltered.

If the board is to have the maximum beneficial impact and meet its responsibilities to all stakeholders, it needs to insist on greater accountability and more immediate transparency from management. While a certain degree of tension between management and the board of a company in distress is probably inevitable, this greater focus on accountability and transparency must not result in the board and management seeing each other in a hostile or adversarial light. Indeed, if management does not understand the special position of the board when a company is in distress, the board would do well to share this paper with the C-suite and make sure it has absorbed its messages.

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Introduction

Investors see value in nominating members to the boards of companies they have invested in. Through board members, they can help improve the company’s operations, define corporate strategy, adjust inefficiencies, improve governance, and ultimately increase the expected return on their investment. Independent directors have also become best practice in good corporate governance, with experienced, industry-knowledgeable people serving on one or several boards.

If the company faces likely insolvency, however, things are not business as usual anymore—the board is charged with putting the company back on its feet and setting it back on track. Failure to do so may cause disgruntled shareholders or creditors to assert claims against the board—usually for breach of fiduciary duties—at which point litigation may ensue at a high cost to the board member, perhaps not financial if there is sufficient directors and officers liability (D&O) insurance, but at the very least in terms of time and risk to his or her reputation.

General fiduciary duties of directors

Several jurisdictions worldwide adopt the principle that directors owe fiduciary duties to the company they serve. The two main fiduciary duties of directors are the duty of loyalty and the duty of care. The duty of care sets forth the principle that directors must act prudently or use reasonable care in making decisions at the board. A director is deemed to act with reasonable care if he or she diligently seeks information necessary to make a decision, participates in the decision-making process, and, if necessary, asks for expert advice should it be warranted by the nature of the decision.
The duty of loyalty relates to directors’ duties to be disinterested, avoid conflicts of interest or “self dealing,” and generally act in good faith. To comply with the duty of loyalty, a director is required to disclose any actual or perceived conflict, refrain from acting when that director’s personal interest conflicts with that of the company, disclose all material information when seeking approval of a transaction, exercise proper oversight by implementing reporting or information systems or controls, and take particular care to act in good faith and in the best interests of the company when that director appears on both sides of a transaction.

Directors’ fiduciary duties in distressed companies

A situation of distress in a company may bring uncertainties regarding the reach of directors’ fiduciary duties. While such duties are focused on the best interests of the company and usually create secondary or derivative rights to shareholders relative to directors, stakeholders with higher statutory payment priority—such as creditors and employees—may become the actual residual owners of a corporation in distress (on the assumption that the equity value in the company is or will be wiped out or have negligible value).

The expanded scope of directors’ fiduciary duties may require the board to shift its focus from solely protecting the interests of the company and maximizing profits for shareholders to also—and perhaps primarily—protecting and preserving the company’s assets in order to honor contracts with or maximize recovery of claims for creditors. To satisfy their duties under these changed circumstances, directors must act with the objective to maximize the enterprise value of the company, not favor equity over the debt, and ensure that no decision benefits only a single group or stakeholder (for instance, controlling shareholders over minority shareholders).

What should a director in a distressed company do?

If you are a director in a company in distress, what should you do to mitigate possible liability exposure? In other words, what should you pay attention to, in addition to discharging your primary responsibilities as a board member? As a preliminary matter, you should recognize that the company may be insolvent or is on the brink of insolvency. Signs of financial distress include repeated contractual breaches, cash flow difficulties, failing
supplier relationships, inadequate or delayed reporting, management derelictions or high employee turnover, significant fluctuations in asset valuations, mismanagement, indication of fraud or corruption, incomplete or inadequate financial information, governance issues, and so on.

As a practical matter, if insolvency is raised at the board as an issue or there are discussions or concerns regarding the company’s solvency, you should take immediate action to become fully familiar with the situation and work toward a decision that can avoid or minimize potential liability for you. Making uninformed decisions or not making decisions when they are necessary can raise questions about the adequacy of the board’s proper discharge of its fiduciary duties.

While it is impossible to foresee and prescribe generic solutions for specific cases, below is a list of steps you could take to mitigate liability risks:

**Get to know the applicable legal framework:** In addition to having a full understanding of the company’s situation, you should also become versed in the directorship liability legal framework applicable to distressed situations. You will need to accept your new and possibly changing role and responsibilities and devise a plan to act in strict compliance with that new role. As there are variations from jurisdiction to jurisdiction, you should immediately consult with the board and with the company’s in-house or external counsel for an explanation of the nuances of the applicable legal regime for directors, including the scope of director duties, safe harbors, and the availability and enforceability of exculpatory/indemnity provisions in the company’s charter documents or by operation of law, and whether you may have any statutory obligations that would be triggered by the company’s insolvency, such as the duty to place the company in bankruptcy proceedings if certain requirements are met.

Also check to see whether, in the relevant jurisdiction, there exists the concept known in the United States and elsewhere as the “business judgment rule,” where courts have found that directors who exercised sound and informed judgment were not liable even if things did not go as planned. In addition, you may be liable for the company’s willful failure to pay wages and taxes, and you should monitor the status of such obligations very carefully, as those could trigger criminal charges against you.
If the company does not have counsel (or if its counsel is not trustworthy or competent, in your opinion), you should strongly make the case at the board to have counsel retained immediately; or failing that, you should consider retaining external counsel for yourself. In any case, it should be considered unacceptable for a company in distress not to have counsel to the board and to the company in such situations.

**Push the board to hire independent insolvency experts:** In addition to local law experts, the board should also retain financial advisors and seek objective advice on the following (as necessary):

a. the company’s current financial situation, including whether the company is solvent and how any contemplated transaction (such as the sale of significant assets, major spinoff of a subsidiary, incurring of additional debt) would affect the company’s financial condition, the impact of a major contemplated transaction on all constituencies (including the company’s creditors), and whether the transaction would be fair to them;

b. options to structure a contemplated transaction or alternatives to a proposed course of action;

c. how each option/alternative would affect the interests of various stakeholders;

d. applicable regulatory obligations (including environmental, securities, and other laws and regulations) and how to handle those obligations (for example, issues of disclosure for public companies become highly sensitive, as the very disclosure of the company’s financial difficulties could harm the potential to maximize the company’s enterprise value and put it into a tailspin to bankruptcy); and

e. risk of director liability for contemplated transactions (for which the board may need to retain independent counsel if the board and the company management have different views regarding certain transactions or the overall turnaround strategy).
Revisit governance and transparency: The board may create separate committees and/or hire a chief restructuring officer to assist with the handling of the distress situation. Management may need to be changed. Review and scrutinize the form and substance of the information-gathering and decision-making processes both at the board and between the board and management. Before implementing any decision, the board must ensure that appropriate information-gathering and decision-making processes are in place and properly recorded. To that end, you should make sure that:

f. you become informed and stay informed—understand critical functions such as financial statement preparation, verify that adequate financial reporting is in place, continue to monitor closely the company’s financial condition, and investigate thoroughly all relevant facts and their consequences as well as all alternatives and options (again, obtaining independent and trustworthy advice is critical);

g. you have (or require) adequate time to evaluate and make decisions, and that tasks/issues are properly identified, such as the need to evaluate the impact of the decision on all stakeholders;

h. there is due deliberation before the board makes a decision, including weighing pros and cons of each decision, giving due consideration to all material facts/information available, and considering alternatives and their impact on all constituencies—and properly recording the deliberations and decisions;

i. decisions are made in good faith, in the honest belief that they are in the best interests of the corporate enterprise (not just the company’s shareholders), the decision maximizes the value of the enterprise, and all decisions are rational (if not, you should clearly state that for the record in the minutes of the board meeting);

j. directors acknowledge, address, and protect the best interest of the corporation’s stakeholders (particularly the creditor body) when approving a transaction (directors may even consider including diverse constituencies in the decision-making process and obtaining the consent of major creditors, if a contemplated transaction would pose substantial risk to corporate assets);

k. directors maintain neutrality in the decision-making process relative to different corporate constituencies and members (for example, directors do not prefer one constituency over another, such as stockholders versus creditors or one creditor over another);
l. directors fully disclose any material aspects of the contemplated transaction and any potential conflict to the corporate body authorized to approve the transaction;

m. directors (including you) abstain and recuse themselves from deliberations and decisions, if there is a conflict of interest;

n. independent directors (if any) participate in making the decision and approve it (directors that have substantial stockholdings or represent major shareholders may be considered “interested” in relation to creditors); and

o. all legal requirements are met (for example, quorum and voting requirements are met, bylaws and other charter/applicable documents are complied with, and so on).

Check the D&O insurance: If the company has a D&O policy, you should verify that premium payments are current, and you should become familiar with the terms and conditions of the policy, including the type of policy, the policy coverage limits, substantive requirements (exclusions such as whether the policy covers creditor claims), procedural requirements (such as notice requirements, deadlines for submission of claims, whether the insured need to provide notice of even potential claims), and any other limitations that may preclude coverage of director liability. If there is no D&O policy in place, you should explore the availability and cost of possible coverage and assess the option of obtaining a director-only policy, which is cheaper and also protects directors from coverage exhaustion after lawsuits against the company and its officers.

Keep your own paper trail: Observe corporate formalities and create extensive and accurate records for yourself. The decision-making process must also be well-documented, reflecting all legal and business advice that the directors sought, received, and evaluated. Corporate minutes must accurately reflect what transpired (who was in attendance, what substantive discussions took place, what factors/issues were taken into consideration, and what resolution for the action was adopted). Keep in mind that most if not all of this information may be proprietary and confidential, and that you have a duty of confidentiality to the company, so you should not use such information unless so authorized.
**Be cautious:** Beware of suspect transactions. Transactions that you should scrutinize to avoid personal liability include:

- p. declaration of dividends (directors may be personally liable for willful or negligent conduct in connection with the unlawful payment of dividends);
- q. stock purchases or stock redemptions;
- r. executive compensation increases and bonuses;
- s. consulting arrangements, especially with insiders or related parties;
- t. special awards;
- u. insider transactions such as extending or repaying loans to insiders or affiliates and transactions that benefit insiders or affiliates, including payment of nonbusiness expenses;
- v. conflict-of-interest transactions;
- w. preferential payments;
- x. fraudulent conveyances (transfers of corporate assets for less than reasonable value or based on fraud); and
- y. transactions that are not properly documented or for which approval is sought after the fact.

In cases of actual or suspected fraud, seek immediate advice from counsel, as there may be reporting requirements to authorities for you to avoid or mitigate criminal liability risk. In such cases, it is also important for you to push for the company to hire forensic accountants to inform the board of potential improprieties.
Resignation an option?

Unfortunately, there is no hard-and-fast rule for whether to resign. An informed decision will largely depend on the facts and circumstances and the applicable laws, on a case-by-case basis and with specific advice from counsel. Arguments may exist to justify a resignation, such as the increased risk to you of potential liability in a time of distress, or an actual or perceived conflict of interest if you have been nominated by a shareholder and there are potential disputes between shareholders and/or between shareholders and the company. As a rule of thumb, if you cannot obtain sufficient information to discharge your duties or you cannot influence the decision-making process in the company, the likely conclusion should be your resignation by making a noisy withdrawal that is properly documented—provided, of course, your resignation is permitted under local law (some jurisdictions expressly limit the ability of directors to resign if the corporation is in an insolvency scenario).

Resignation may have legal implications if it is viewed as dereliction of duties on your part when the company is most vulnerable or when your involvement is most needed. Further, resignation could constitute breach of fiduciary duties if it was harmful to the company or not in its best interests. Examples of resignations that may be harmful to the company include situations when it would be difficult or impossible to find a replacement director and voting quorums may be left unmet, jeopardizing altogether the decision-making process in the company. Also, a company in distress often loses or replaces all or part of its management team; thus another issue to consider when evaluating possible resignation of a director is whether the board needs to step in. As an alternative, recognizing that certain situations of distress require a particular set of skills and experience, you may feel that the best option will be to obtain a replacement director who has experience with insolvency and turnarounds.

On the flipside, resignation may have legal implications if it is viewed as dereliction of duties on your part when the company is most vulnerable or when your involvement is most needed. Further, resignation could constitute breach of fiduciary duties if it was harmful to the company or not in its best interests. Examples of resignations that may be harmful to the company include situations when it would be difficult or impossible to find a replacement director and voting quorums may be left unmet, jeopardizing altogether the decision-making process in the company. Also, a company in distress often loses or replaces all or part of its management team; thus another issue to consider when evaluating possible resignation of a director is whether the board needs to step in. As an alternative, recognizing that certain situations of distress require a particular set of skills and experience, you may feel that the best option will be to obtain a replacement director who has experience with insolvency and turnarounds.
Conclusion

This nonexhaustive guidance paper highlights the need for you to engage in case-specific advance investigation and planning to substantially reduce your risk of liability when serving on the board of a company facing financial difficulties. When a company is in distress, the standard of conduct and the fiduciary duties of directors may expand beyond acting in the best interests of the company to also protecting creditor interests, as creditors become the new residual owners of the troubled enterprise. In those circumstances, a thorough investigation and analysis of the company, the applicable local law, and the director’s role, rights, and responsibilities are critical. In all cases, legal counsel must be closely involved from the outset.