

News from our Bankruptcy & Restructuring, Mergers & Acquisitions and Public Securities Groups

“Best Practices” for Officers and Directors Navigating the Current Economic Crisis

The fall from grace of Lehman Brothers, the venerable investment bank, was brutally fast. Until June 2008, it had never even reported a quarterly loss as a public company. As recently as March 2008, Lehman Brothers CEO Dick Fuld was awarded a \$22 million bonus for 2007, a generous compensation package that also reflected a year in which the bank's net profit had risen 5% to a record \$4.2 billion.

Nevertheless, Lehman quickly emerged as Wall Street's next victim of the credit and subprime mortgage crises, as real estate loans and other toxic assets increasingly weighed on its balance sheet, especially after the collapse of Bear Stearns in March. Even on the eve of Lehman's collapse Mr. Fuld expressed confidence that the bank would weather the financial maelstrom in which it found itself. “We have a long track record of pulling together when times are tough,” Fuld said on a conference call with analysts on September 10, 2008. “We are on the right track to put these last two quarters behind us.” Only a few days later, Lehman filed for bankruptcy.

Mr. Fuld's stated optimism in the face of Lehman's daunting financial problems is not uncommon. Indeed, often times, senior officers and board members of companies operating in a recession—let alone companies with liquidity or other operating issues—do not appreciate the potential degree of financial or operational “distress” until the occurrence of a watershed event, such as a substantive covenant default under the company's loan facility,

the failure of the company to refinance its existing bank debt or the company's failure to raise additional funds to bridge a shortfall in working capital. In years past, this would mark the beginning of an extended process in which the company and its lenders would work together to restructure its debt during a proscribed forbearance period in order to improve the company's performance and stabilize its operations. However, with the credit markets all but nonexistent, the occurrence of such events now often marks the point of no return, at which bankruptcy becomes both inevitable and imminent. Today, these watershed events can be critical. Unlike in the past, officers and directors cannot simply expect to find liquidity in the credit markets or from their equity investors when there is a need for funding.

Fiduciary duties—the shifting nature

In light of the current economic environment, it is vital for officers and directors of all companies to understand their fiduciary duties and, in particular, the shifting nature of these duties when their company is operating in a distressed context.

In general, directors and officers of a corporation owe the shareholders a duty of care and duty of loyalty. The duty of care requires that management exercise reasonable care in overseeing the activities of the corporation, including becoming fully informed of all material information reasonably available when making decisions. The duty of loyalty requires management to

act in the best interest of the corporation's shareholders and refrain from engaging in self-dealing transactions to the detriment of the corporation and its stockholders. A claim for breach of loyalty may be based on the failure to act in good faith, which could arise where the directors have demonstrated a conscious disregard for their responsibilities.

The actions of directors and officers will typically be subject to the presumptions of the business judgment rule. Absent a showing that the directors and officers have breached their fiduciary duties, the business judgment rule will bar a court from second-guessing actions taken in good faith and with the honest belief that their decisions were in the best interest of the corporation and its shareholders.

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What happens to the duties owed when a company encounters financial or operating difficulties that endanger its ability to pay or refinance maturing debt or otherwise meet its liquidity needs? Once their company becomes distressed, officers and directors need to begin operating under a different set of assumptions in order to reduce their personal exposure to liability, while at the same time protecting the interests of the company. When a company enters the “zone of insolvency,” a concept that will be discussed in more detail below, the directors’ and officers’ fiduciary duties shift from maximizing the return to stockholders to preserving the value of the company’s assets for the benefit of the creditors. Accordingly, if directors and officers of a company in the zone of insolvency do not properly take into account their duties to the company’s creditors, they could potentially face a future suit for breach of fiduciary duty.

In many cases, directors and officers of a troubled company do not appreciate the degree to which the company may be mired within the “zone of insolvency” until they have already made several significant decisions. These decisions may have been made differently had they considered their fiduciary duties to creditors. The following is a primer on the steps management can take to protect itself from claims of breach of such duties while at the same time protecting the interests of the corporation, the creditors and the shareholders.

The zone of insolvency—generally

The concept of the “zone of insolvency” was first discussed by the Delaware Chancery Court in the early 1990s when it held that where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers (i.e. equity), but owes its duty to the corporate enterprise itself. As a result, the court held that under these circumstances, a director no longer owes duties

solely to shareholders. Rather, in managing the affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right course to follow for the corporation may diverge from the choice that the shareholders or any single group interested in the corporation would make if given the opportunity to act.

Thus, directors and officers of a corporation operating in the zone of insolvency have an obligation to the community of interests that sustained the corporation, and to exercise judgment in an informed, good faith effort to maximize the corporation’s long-term wealth creating capacity. Accordingly, it is now generally accepted that officers and directors of a company in the zone of insolvency owe fiduciary duties not only to equity holders, but to creditors as well.

Warning signs that a company is within the zone of insolvency

Courts generally apply two tests to determine whether a company is within the zone of insolvency. A company is within the zone of insolvency if it has either (1) a deficiency of assets below liabilities with no reasonable prospect that the business can be successfully continued, or (2) an inability to meet maturing obligations as they become due in the ordinary course of business. Certain jurisdictions apply the “balance sheet” test, others apply the “inability to pay debts” test and still other jurisdictions consider both tests.

Irrespective of these legal approaches, a company may be nearing or in the zone of insolvency if any or all of the following factors are present:

1. **The company has been experiencing repeated losses and has been financing those losses in unhealthy ways.** This is a key warning sign that a company is operating within the zone of insolvency or is already insolvent. The continued financing of a company in distress and the manner in which such financing is accomplished must be carefully

scrutinized by directors. At a subsequent time creditors may allege that such activities constitute a violation of management’s fiduciary duty to creditors.

2. **The entire industry or sector is experiencing a downturn.** The collapse of Bear Stearns in March 2008 and the massive losses realized by other investment banks at that time provided Lehman Brothers with a clear warning sign that the company could be in serious trouble.
3. **The company is unduly emphasizing profits while neglecting the need for positive cash flow.** A company that unduly prioritizes short-term profits over cash flow may already be insolvent, and continued neglect of the need for positive cash flow may soon result in a default under the company’s loan facility.
4. **The company is extending its accounts payable over ever-lengthening time frames.** Although extending payables is a sound strategy for surviving short-term financial problems, a company that continues to extend payables may be simply ignoring its impending insolvency.
5. **The company is relying on irregular accounting techniques.** Irregular accounting techniques could suggest that the company is struggling to maintain its existence.

Remember that litigation is always brought with the benefit of 20/20 hindsight. It is easy to see tomorrow’s lawsuits being predicated upon the “red flags” associated with the current collapse of the credit and financial markets—investors defaulting upon capital call obligations, banks unable or unwilling to extend maturities or refinance maturing debt. In fact today some banks are putting reserves into place under lines of credit based upon “macro-economic” conditions that, in turn, create a liquidity crisis. Claims will be alleged that companies with debt maturing in mid to late 2009 (or even 2010) should have begun

contingency planning to protect asset values and operations well in advance of time periods applicable in the past. The historical perspective of “we will cross that bridge when we get to it” in addressing liquidity needs or other distress of the past may not apply anymore.

Breach of fiduciary duty to creditors: some cautionary examples

Under this analytical framework, many decisions by officers and directors of a company operating within the zone of insolvency will be subject to increased scrutiny whereas the same decisions for a healthy company may not. The following actions by a board operating within the zone of insolvency may give rise to a cause of action against the directors:

1. Approving a business plan that is not viable.
2. Refusing to reduce overhead expenses in anticipation of receiving a new round of investment that does not materialize.
3. Taking on additional debt to finance an acquisition or to otherwise expand operations.
4. Collateralizing previously unencumbered assets, especially in an effort to raise cash to meet operational needs in the face of losses.
5. Approving excessive compensation package for senior executives, including severance payments and other benefits. It should be observed that “excessive” may be a far lower threshold today than it was a year ago as senior executives today face pressure to forgo bonuses and other benefits.
6. Untimely acquisition of D&O insurance policies.
7. Untimely resignations from the board of directors. Resigning from the board of a troubled company without providing for appropriate oversight does not alleviate litigation risk.
8. The failure to consider strategic alternatives for the company or the failure to conduct an adequate sale process.

Protecting yourself (and the company) in the zone of insolvency

In light of the potential sources of liability, there are several important steps that directors and officers should consider taking to provide some insulation from breach of fiduciary duty claims that may be brought by creditors should the corporation become insolvent:

1. **Make sure you have adequate insurance in a timely manner.** Due to the staggering liability potential facing directors and officers for breaches of fiduciary duties owed to creditors, some companies are supplementing standard D&O insurance policies with “Side A-only” excess coverage. Side A coverage is paid to directors and officers themselves when the company cannot or will not indemnify them (as opposed to “Side B” and “Side C” coverage, which reimburse the company itself). The key here is the acquisition of the insurance at a time that precedes the company’s entry into the zone of insolvency.
2. **The board’s deliberative process matters.** Do not take actions in a rushed and uninformed manner. Board deliberations are important and will be heavily scrutinized in future litigation. Directors must ensure that they are informed of all material information reasonably available to them.
3. **Document the company’s good faith exercise of its business judgment.** In order to succeed in an action for breach of fiduciary duty, creditors must present evidence that directors breached their fiduciary duties and thus should be stripped of the protection of the business judgment rule. Fully documenting the good faith basis for all board decisions in the minutes and in memoranda helps to establish a defense against this line of attack. Often times the perception of reasonable business judgment is a key component to the judgment itself—always look at the support for the decision itself as well as the deliberation process.
4. **Demand more accountability from management and the company’s advisors.** If the company is encountering significant fluctuations in performance or asset values, you should be fully apprised of the extent to which such changes are effecting the company’s financial statements.
5. **Consult the professionals.** While officers and directors may feel that they understand the needs of their company, there are a myriad of complex issues affecting operational and financial restructurings. Companies are not typically criticized for seeking the guidance of experienced restructuring professionals too soon. These professionals can assist the company in evaluating options and, if necessary, undertaking contingency planning in the event that formal court protection through Chapter 11 is required. More and more companies (e.g., Chrysler, General Motors, General Growth, etc.) are engaging professionals and obtaining advice, in part to avoid criticism that they “fiddled while Rome burned.” Cooley professionals have extensive experience in understanding your business needs as well as a national reputation in company restructuring and asset protection. Cooley professionals have represented corporations and partnerships in complicated Chapter 11 cases, out-of-court restructurings and prepackaged bankruptcies. Importantly, we understand that considering the options may not always be desirable to discuss—let alone

implement. Nonetheless, seeking the right advice, in advance, and planning for these contingencies, is necessary. We can look at the factors affecting your industry, your company and your needs to provide you with tailored guidance.

6. **Avoid insider transactions.** Transactions with insiders may come under special scrutiny, and any actions that benefit directors at the expense of creditors could constitute a breach of fiduciary duty. Conflict of interest issues can be a particular problem to navigate for directors of a portfolio company who are also owners, managers or employees of the fund that owns the portfolio entity.
7. **Consult with creditors.** If a decision would pose a substantial risk to the value of a corporation's assets, it may be prudent to consult with and/or obtain the consent of major creditors before implementing the decision. Cooley restructuring professionals can assist you with developing the right approach for negotiating with key creditors.

If you have questions about this *Alert* or any related matters, please contact one of the attorneys listed above or the Cooley attorney with whom you regularly work. ■