THE REVIEW OF
BANKING & FINANCIAL SERVICES
A PERIODIC REVIEW OF SPECIAL LEGAL DEVELOPMENTS AFFECTING LENDING AND OTHER FINANCIAL INSTITUTIONS

Vol. 39 No. x xx, 2023

THE ZONE OF SAFETY: HOW TO BE AN ACTIVE AND CONFIDENT DIRECTOR DURING FINANCIAL DISTRESS

In this article the author lays out 11 points for directors in restructuring corporations to consider. If adopted, these can establish boundary lines for what the author calls a "zone of safety" in which directors can be active and engaged for the benefit of the corporation and its stakeholders without fear of liability.

By Andrew G. Dietderich *

A few recent corporate chapter 11 cases have drawn public and Congressional attention to corporate behavior in bankruptcy. And yet, much conventional advice to corporate directors about their fiduciary duties in circumstances of financial distress remains out-of-date. Delaware law and market conventions have both changed significantly over the past years. Today, the rules of the road for directors are clearer than they have been in the past. Directors can continue to be actively involved in the oversight of the corporation during a restructuring, confidently approving even risky transactions, without fear of liability, so long as they are aware of current law and take specific precautions. Indeed, active and engaged directors are the most effective way for a corporation to avoid criticism during a reorganization. This memorandum dispels some old myths about the "Zone of Insolvency" and suggests practical steps to replace it with a modern "Zone of Safety," within which directors can defend and preserve corporate value with confidence.

The topic of director fiduciary duties is perhaps the most important one in restructuring law today. The American system of reorganizing corporations as going concerns depends upon a management, overseen by the board, that is in the best position to decide what to do when a firm cannot pay its debts. This is not intuitive, and other countries take a different approach. Nevertheless, our American restructuring process remains solidly board-centered. When restructuring is done right, the boardroom — not the courtroom — is the first and primary venue where the fate of the corporation is determined. When the various classes of creditors have confidence in the board process, it is easier to find consensus on a restructuring path — even when some creditors initially disagree. When the court has confidence in the board process, the standard of review

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RSCR Publications LLC Published 12 times a year by RSCR Publications LLC. Executive and Editorial Offices, 2628 Broadway, Suite 29A, New York, NY 10025-5055. Subscription rates: $650 per year in U.S., Canada, and Mexico; $695 elsewhere (air mail delivered). A 15% discount is available for qualified academic libraries and full-time teachers. For subscription information and customer service call 609-683-4450; fax 609-683-7291; write Subscriber Services, RSCR Publications, PO Box 585, Kingston NJ 08528; e-mail cri.customer.service@comcast.net; or visit our website at www.rscrpubs.com. General Editor: Michael O. Finkelstein; tel. 212-876-1715; e-mail mofinkelstein@gmail.com. Associate Editor: Sarah Strauss Himmelfarb; tel. 301-294-6233; e-mail sarah.s.himmelfarb@gmail.com. To submit a manuscript for publication contact Ms. Himmelfarb. ISSN: 1051-1741.

is usually more favorable and necessary approvals are easier to obtain. Conversely, when the board does not earn the confidence of stakeholders and, especially, the court, a restructuring plan can lose its way quickly. From a political perspective, if too many restructurings lose their way because too many corporate directors fail to follow best practices, our system of restructuring itself will weaken and change.[1]

THE ZONE OF SAFETY

The good news first. If you are an appropriately informed and involved director during a corporate restructuring today — whether appointed pre-restructuring or specifically in a restructuring context — the law has your back. It was common decades ago for restructuring lawyers to tell the board of directors of a distressed corporation that they had entered the "Zone of Insolvency," a confusing and dangerous place (reminiscent of the Twilight Zone) where normal fiduciary duties to the corporation changed and the risk of director liability increased exponentially. The "Zone of Insolvency" was a place of fear where the safe decision was to commence a prompt chapter 11 filing and turn the keys over to the most influential group of creditors. Taking risks that might increase creditor losses was discouraged, even when the pay-off of a successful rescue strategy was substantial. In other words, for a director, the Zone of Insolvency was a place where his or her ordinary expertise was no longer relevant and the smart director was the one who walked quietly down the path of least resistance.[2]

None of that is sensible advice today. Corporate law now protects legitimate corporate risk-taking by distressed corporations and their directors. We can confidently say the following for corporations organized in Delaware, or other jurisdictions to the extent they look to Delaware law:

1. There are no "new" fiduciary duties for directors when a corporation is insolvent. The fiduciary duties for directors are the same as they have been since incorporation: the duty of loyalty, the duty of care, and the duty of good faith. The business judgment rule is available to protect directors who follow the rules, regardless of whether the corporation has sufficient liquidity and regardless of whether stockholders or creditors hold the marginal economic interest.

2. Fiduciary duties do not "shift" to creditors. In fact, there are no fiduciary duties of directors directly to creditors at all under (Delaware) corporate law.[3] Of course, boards on the eve of restructuring are still likely to receive correspondence from creditor groups *alleging* a direct duty to creditors, but case law is clear that no such duty exists. Directors owe their fiduciary duties to the corporation.[4] Creditors are creatures of contract and, generally, adverse parties. The corporation can and should take appropriate action to defend itself against creditors,

[1] It has happened before. In the 1930s, outrage about corporate fiduciary misbehavior inspired Congress to pass the Bankruptcy Act of 1938 (the "Chandler Act"), which dismantled the robust private restructuring industry of the early 20th century and replaced it with a bureaucratic system dominated by court-appointed trustees. The "debtor in possession" did not reappear in large corporate cases until the Bankruptcy Act of 1978.

[2] Occasionally, a director would respond to this dismal picture by resigning prior to the restructuring. However, most directors stayed through the restructuring because of a belief among restructuring professionals that directors who resign (flee the

footnote continued from previous column…

sinking ship) are even more likely to become the target of litigation in a subsequent chapter 11 case.

[3] The Delaware Supreme Court confirmed this principle in 2007 in *North American Catholic Educational Programming* v. *Gheewalla*, 930 A.2d 92 (Del. Supr. 2007), and Delaware courts have applied it consistently since.

[4] There is some debate under Delaware law whether directors of a solvent corporation owe fiduciary duties to the corporation alone or also to stockholders, and it is prudent for the board of a solvent (or potentially solvent) corporation to consider the separate interests of stockholders. The nuance is not relevant for our purpose here; under no circumstances do directors have a duty to creditors.

minimizing creditor liens and claims in good faith when doing so helps franchise value or is otherwise consistent with the corporation's business objectives.

3. Of course, creditors are still stakeholders affected by corporate decisions. If the corporation is actually insolvent, creditors with valid claims can become indirect beneficiaries of the director's fiduciary duties to the corporation for the simple reason that they are entitled to the marginal value of the corporation's assets. In certain circumstances, creditors (or an official committee of creditors) may even seek standing to bring a derivative action against directors to enforce the corporation's claims while "standing in the shoes" of the corporation. However, any such claims will succeed or fail based on the interests of the corporation and general principles of corporate law. The directors serve one master in a restructuring: the corporation.

4. The law also recognizes that directors sometimes need to pick winners and losers. This is inevitable and there is no fiduciary duty to make everyone happy. In a restructuring context, creditors and stockholders can have very different views of risk. Directors complying with their fiduciary duties may approve risky ventures that could benefit stockholders if successful, and harm creditors if not. Conversely, the same directors may decline to reach for stockholder value if they believe the risks to the enterprise and its creditors are unwarranted. Regardless of which group is disappointed, the business judgment rule applies and means that a court will not second-guess such directors simply because another business decision would have led to another result.

5. There is no fiduciary duty to file for chapter 11, whether the corporation is insolvent or not. The decision to file for chapter 11 (or to pursue another restructuring option) can be made in the same manner as any other difficult corporate decision: based on the facts and circumstances.

6. Finally, and perhaps most importantly as a practical matter, the same corporate governance conventions that protect directors from liability in ordinary transactions apply during a restructuring. There is a rich body of knowledge on director decision-making in M&A and other strategic circumstances, and all of this learning is at the fingertips of directors and their advisors. A restructuring transaction may feel chaotic and accelerated compared to an ordinary corporate transaction, but the governance principles for building a defendable record for the board are the same.

Putting this together, given the developments in the law in this area over the past decade, it is more accurate to speak today of a *Zone of Safety*, than a Zone of Insolvency. Within the Zone of Safety, protected by a solid board process, boards can take appropriate business risks — whether to avoid a chapter 11 filing altogether or to choose a more challenging path through chapter 11 in pursuit of corporate objectives.

ESTABLISHING THE ZONE OF SAFETY

The Zone of Safety does not arise automatically. It requires preparation and a compelling record that the board truly did comply with its fiduciary duties. In particular, a good corporate process must involve a critical mass of directors whom a court will regard as informed, involved, and disinterested. In this respect, U.S. restructuring practice over the past years has a mixed report card. Restructuring professionals know chapter 11 conventions, but sometimes struggle to incorporate best practices from the broader corporate governance community. In addition, there is too often a view that "consensus" at the end of a restructuring will allow the debtor to sweep corporate governance concerns under the rug in the plan of reorganization — a proposition that works only until tested. These dynamics can be especially dangerous for directors of public corporations because many restructuring conventions arise from cases involving not public corporations, but private equity portfolio companies with more limited stakeholder constituencies.

One example of how corporate governance best practices have changed recently relates to failure-to-supervise claims under the *Caremark* doctrine. In *Caremark*, the Delaware Supreme Court held that, on sufficiently egregious facts, a failure by directors to establish reporting and oversight procedures could constitute a breach of the duty of loyalty.[5] For many years, practitioners had a sense that these claims would rarely survive a motion to dismiss. However, in the last three years, Delaware courts have allowed *Caremark* claims to survive a motion to dismiss in five cases where the plaintiffs alleged that the board ignored foreseeable risks, including risks related to food safety (*Marchand*), clinical drug trials (*Clovis*), oil pipeline reliability (*Inter-Marketing*), financial reporting (*Hughes*) and airplane

[5] *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.3d 959, 967 (Del. Ch. 1996).

safety (*Boeing*).[6] The risk of a successful *Caremark* claim is especially salient for directors because it would involve a breach of the duty of loyalty and, therefore, personal liability that is neither indemnifiable nor insurable. Boardroom advice is changing in response to this perceived risk. Corporate governance lawyers now routinely advise boards to identify specific risks material to the business and, where appropriate and necessary, document appropriate reporting and oversight procedures. In a restructuring context, the recent *Caremark* cases may caution against the board "checking out" and delegating decisions to management or professional restructuring directors without the board understanding — and establishing reasonable oversight procedures for — material risks specific to the restructuring context.

Accordingly, drawing from U.S. corporate governance best practices broadly, here are some reminders of best practices for corporate directors during a restructuring — the boundary lines for the Zone of Safety. These practices will be important over the coming years for many directors, especially those faced with challenging transactions, aggressive stakeholders, or potential conflicts of interest.

1. **Involve the Entire Board in Process Discussions.** The entire board should be involved in deliberating and approving the corporate governance procedures by which the board will oversee the restructuring. If the corporation uses a Restructuring Committee, Conflicts Committee, or similar committee to assist in its duty of oversight, the board should determine the charter and constituency of that committee after discussing and weighing available alternatives. The board should seek management and professional advice about these matters but should make its own decision.

2. **Disclose Conflicts to the Board.** The board should pay special attention early in the case to the disclosure to the board of all facts that create actual or potential conflicts of interest involving directors. If a director is to be characterized publicly or in court as "independent" or "disinterested," the board of directors should review the relevant facts and make a determination on the record as to whether or not the board believes the director is appropriate for that role.

3. **Pay Special Attention to Conflicts Relating to New Director Candidates.** Before appointing new directors who have been recommended by stakeholders (e.g., controlling owners) or restructuring professionals, the board should review and understand all the facts relevant to the relationship between the proposed director, the recommending party, and other stakeholders in the case. Many types of preexisting relationships are not disqualifying, but all relationships should be on the table for discussion, and no potentially material information withheld from the board. This step can be invaluable in the face of potential future challenges to director independence.

4. **Build a Record that the Board Considered Alternatives.** When considering a subcommittee of independent directors in order to address conflict of interest concerns, the board should review a range of options. It is not enough to accept a single approach without deliberation merely because it is conventional or suggested by expert advisors. Over-delegation to a subcommittee and under-delegation are both potential problems during a restructuring. In some situations, the full board is a more appropriate forum for decision-making, even in the face of certain conflicts of interest, so long as the conflicts are disclosed fully and deliberations are conducted appropriately. In other situations, a subcommittee should be delegated the authority to make a recommendation to the full board, but not to take corporate action. In still other situations, a subcommittee should be delegated full power to act for the corporation and the corporation should consider using other elements of "special committee" or "special litigation committee" practice from outside of a restructuring context. Usually, there is no single right answer, other than that the process be determined by the directors after discussion with counsel and deliberation.

5. **Balance Expertise on a Restructuring Committee.** A good Restructuring Committee (regardless of its name) includes more than restructuring expertise. Incumbent directors are often very valuable and engaged members of the board during a challenging restructuring process, and the board should consider including one or more incumbent directors on any relevant subcommittee.

[6] The five cases are *Marchand* v. *Barnhill*, 212 A.3d 805 (Del. 2019), *In re Clovis Oncology Derivative Litigation*, 2019 WL 4850188 (Del. Ch. Oct. 1, 2019), *Inter-Marketing Group USA, Inc.* v. *Armstrong*, C.A. No. 2017-0030-TMR, 2020 WL 756965 (Del. Ch. Jan. 31, 2020), *Hughes* v. *Hu*, C.A. No. 2019-0112-JTL, 2020 WL 1987029 (Del. Ch. Apr. 27, 2020), and *In re The Boeing Company Deriv. Litig*., 2021 WL 4059934 (Del. Ch. Sept. 7, 2021).

We believe there are both process and litigation advantages in doing so. In fact, the testimony of incumbent, generalist directors about the restructuring process — just like the testimony of managers who are not "bankruptcy experts" — can be extraordinarily compelling in bankruptcy court.

6. **Keep a Disciplined Record of Deliberative Material.** Formal board meetings should be convened with appropriate frequency and involve written board minutes and other materials that demonstrate the informational basis for the board's decisions. Whenever possible, the board should make a final decision only at these meetings after appropriate time to review materials. Directors should avoid reaching conclusive decisions about substantive matters outside of the context of a board meeting or basing their decisions on materials that not vetted for review by the board. When the board must act by written consent, the record for the decisions should be documented appropriately and made available to directors before the written consent is signed. Discipline about meetings, consents, and related materials greatly reduces the burdensomeness of discovery requests and any confusion about the information the directors considered before acting.

7. **Be Familiar with the Law.** The board record should be clear that the directors were briefed about their fiduciary duties under corporate law and had time to ask questions of counsel. In addition, the board should understand basic restructuring law, the corporation's duties as "debtor in possession" during a chapter 11 case, and the standard of review of the corporation's actions if challenged in bankruptcy court. In many circumstances, the board's own involvement and view of the reasonableness of a corporate action will be critical evidence in support of a motion in bankruptcy court. The board should understand — before corporate actions are taken — how the board's decision-making will be referred to publicly and used in court.[7]

8. **Incorporate Stakeholder Feedback into the Record.** It can be tempting to ignore angry letters from creditors, or even to respond in kind, during a difficult restructuring. Directors should avoid direct contact with stakeholders, unless authorized by the board or applicable subcommittee. However, the board should review appropriate input from creditors and other stakeholders and consider its relevance. Review and discussion of stakeholder views can be a critical part of the formal record of board proceedings, especially when the corporation ultimately makes a decision with which a complaining stakeholder disagrees. The point is not to convince stakeholders to support the board's decision, but to document that the board had full information in making the decision in the first place and weighed all reasonable dissenting views.

9. **Confirm Reasonableness of Reliance on Management.** The board of directors should be appropriately sensitive to any conflicts of interest involving management or advisors during a restructuring. The board is generally entitled to rely on management within areas of its competence, but to obtain the full benefit of such reliance the board should establish a record that it has considered the applicable facts related to any potential conflict of interest. Again, it is a mistake to jump to the conclusion that a conflict of interest necessarily requires the exclusion of an officer from the deliberative process or the creation of a separate line of reporting. What any potential conflict of interest situation requires in the first instance is disclosure, disclosure, disclosure — and then discussion aided by counsel about the procedural options available in response.

10. **Update Insurance, Indemnification, and Exculpation.** Even with perfect corporate governance, lawsuits can still happen. Directors should review with management the corporation's arrangements for Directors and Officers ("D&O") insurance, indemnification, and exculpation, ideally well before restructuring discussions begin in earnest. These protective arrangements may include provisions that deprive directors of the full benefit of the expected protections during a chapter 11 case (that is, when the corporation may require court approval to take corporate action necessary to trigger coverage). In addition, the suggested scope and duration of D&O insurance can change during a restructuring, and coverage enhancements are typically less expensive when purchased in advance. Fortunately, excellent coverage is usually available

[7] Although the directors of a (Delaware) corporation do not have a direct fiduciary duty to creditors, the Bankruptcy Code does impose trustee-like fiduciary duties on the corporation itself during chapter 11 when the corporation acts as a "debtor in possession." A violation of these trustee duties by the corporation may cause the bankruptcy court to deny approval of corporate actions, may be grounds to remove the corporation as "debtor in possession," or may give rise to monetary claims against the corporation.

and the relevant technical concerns are simple to address with timely preparation.

11. **Focus on Compensation at the Outset.** Finally, a word about management compensation. Compensation issues are a common source of negative attention by the press, politicians, employees, creditors, and the United States Trustee.[8] Bankruptcy courts are typically supportive of reasonable and well-justified arrangements when important to preserve franchise value, but courts also can face pressure in approving even the most sensible arrangements given scrutiny from stakeholders and the public. It is essential that the board understand the executive compensation landscape early in the restructuring process and develop a comprehensive compensation plan, as well as related communication materials. On the one hand, adequate compensation is clearly necessary for management to be the strong fiduciary the Bankruptcy Code requires. On the other hand, a board that simply writes checks (or seeks court authorization to do so) without building a solid record based on *both* bankruptcy rules and general executive compensation principles risks disgorgement litigation or other unwarranted criticism that will hurt the executives it intends to protect.

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These 11 points are neither new nor particularly difficult. Directors and their corporate governance advisors need only to remember them and tailor as appropriately to the facts of each case. With directors in the Zone of Safety who are comfortable making hard decisions and taking appropriate risks, the U.S. system of corporate reorganization — whether out-of-court or pursuant to chapter 11 — can continue to be managed by boards rather than creditors or court-appointed officials. In other words, our uniquely American approach to restructuring can continue on its remarkable path of preserving distressed going concerns and creating value for stakeholders. ■

[8] In 2005, a few notorious examples led Congress to amend the Bankruptcy Code by adding special limitations on senior management compensation that debtors must now navigate. Recently, a handful of cases involving large executive retention bonuses paid prior to bankruptcy (to avoid application of the 2005 rules once the bankruptcy commences) have elicited additional calls for reform. Daniel Gill, *Pre-Bankruptcy Pay a New Target for Fairness Advocates* (November 2, 2021, 6:01 AM), https://news.bloomberglaw.com/bankruptcy-law/pre-bankruptcy-executive-pay-a-new-target-for-fairness-advocates.