Maximizing Value

Considerations for Directors of a Company In Distress

By Michael H. Torkin

The U.S. corporate default rate currently is below historical averages, hovering slightly below pre-crisis levels in 2008. Restructuring professionals, however, are cautioning that a rising interest rate environment, exacerbated by the Fed’s reduction in fiscal stimulus, could lead to a softening of the ongoing robust multiyear credit cycle. In addition, it has been reported that the Department of Treasury’s Office of the Comptroller of the Currency has “suggested” to a number of U.S. institutional lenders that they begin to more closely scrutinize credit standards — focusing on reining in issuances of covenant-light high yield debt as well as tightening leverage ratios. If credit tightens, leveraged companies that have successfully and routinely accessed traditional credit markets could face significant challenges.

Directors of a leveraged company should begin to consider the implications of not being able to access traditional debt markets on appropriate terms. This concern is particularly acute for companies with near-term debt maturities, prior difficulty achieving financial projections, a declining EBITDA forecast and/or debt-for-equity exchanges are routine-ly consummated outside the bankruptcy process to alleviate capital structure issues where there is no near-term liquidity issue.

If your company's near-term projections (12-18 months) are premised on refinancing existing indebtedness, you should consider the risks attendant to refinancing and press management to develop and consider downside scenarios. Management should adequately educate the board on interim liquidity levels (quarterly or semi-annually). The board needs appropriate visibility and room to pivot if a challenging refinancing environment should ensue. Management teams that begin to explore restructuring possibilities and strategic alternatives sufficiently in advance of short-term liquidity concerns are best positioned to navigate away from a value detracting or uncontrolled restructuring process.

Even in the rare circumstance where bankruptcy is almost inevitable, the same holds true. A company that is not liquidity constrained during its bankruptcy proceeding will have greater flexibility and opportunity to restructure using the unique tools afforded by the Bankruptcy Code. On the other hand, if liquidity demands drive decision-making, short-term solutions are implemented (or mandated by aggressive senior lenders) instead of value maximizing longer-term strategic objectives. A board faced with pre-bankruptcy rescue financing options should consider carefully the risks associated with incurring pre-bankruptcy financing, including its implication on the company’s ability to incur additional financing should a bankruptcy filing ultimately be in the best interests of the company.

As a final note on liquidity, a director should expect the unexpected when management’s plan is to refinance (as opposed to repay) debt at maturity. What might appear to be a fourth-quarter refinancing could be accelerated significantly if the company’s auditors become sufficiently concerned with refinancing near term maturities, they may feel precluded from issuing an unqualified audit opinion, which could result in defaults in existing financing documents, and require immediate refinancing of the debt or costly waivers.

Restructuring Expertise

A thoughtfully developed record that evidences the board’s consideration of its restructuring advisers’ advice is a powerful defense should the board ultimately be sued for alleged breaches of fiduciary duty arising from an unexpected liquidity crisis. Seasoned restructuring advisers, including financial advisers, investment bankers and counsel, understand the tempo of the restructuring process, how to work constructively with management, when and how to approach key constituents and importantly, how to develop an effective and robust record of the board’s deliberation and assessment of strategic alternatives. It is emerging best-practice for a director with particular subject matter expertise to review the advis-

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ers’ work more thoroughly than the other directors, if possible.

**Remaining on the Board?**

Some directors question whether to resign from the board before or during the restructuring process. Although time commitments increase dramatically for board members in the period leading up to a restructuring, in most situations, it is advantageous to remain on the board. For example, in a bankruptcy, it is customary for continuing directors (as opposed to directors who resign before or midway through the process) to receive releases and exculpation from the debtor and other parties that consent, usually the principal stakeholders involved in the restructuring.

Once a company is in bankruptcy, the board will continue to meet regularly to work with management and the company’s professionals to develop and implement the company’s restructuring strategy. The board’s input and guidance is important to that process. Although most board members resign once the company emerges from Chapter 11, a number of remaining directors are often elected to the new board.

Many times board members are appointed or sponsored by significant stakeholders, including creditors from a prior restructuring that continue to hold restructured paper or stock. In a potential restructuring situation, it can be important for any director who could be perceived as closely connected to a principal stakeholder to ensure full disclosure to the board of any perceived conflict and potentially to recuse him or herself from matters that directly impact negotiations or recoveries. These circumstances merit careful consideration in advance, and in certain situations a special committee of independent directors will be established, which will engage separate counsel.

**Communication Strategy and Public Disclosure**

If a decision to restructure becomes more certain, it is essential to ensure an appropriate communication and disclosure strategy is in place. Once an adverse disclosure is made or a credible leak occurs, restructuring might become a self-fulfilling prophecy. For all companies, there is a practical business-interfacing concern — trade credit is highly sensitive to adverse disclosure. Additionally, for a reporting issuer, the board, together with counsel, should carefully evaluate the company’s SEC reporting and disclosure posture.

In some cases, a company could be compelled to publicly disclose its intention to begin “exploring strategic alternatives,” which has become a euphemism for an intention to restructure in some contexts. That said, management and the board could be criticized for not creating sufficient market awareness of the company’s potential need to restructure. This “Catch-22” often polarizes board members and management teams and requires deliberate debate and consideration.

**Zone of Insolvency**

In most jurisdictions, a director of a solvent corporation owes fiduciary duties exclusively to the corporation and its shareholders. Under Delaware law, most decisions a director will make are protected by the business judgment rule, other than in the context of related party transactions, the adoption of defensive measures, or the sale of corporate control, each of which are subject to differing and heightened standards. Such standards may include entire fairness, or enhanced reasonableness under Unocal or so-called Revlon duties, respectively. A court should not second-guess a director’s business decision with respect to most matters, and a director should not be found to have breached its fiduciary duty to the corporation or its shareholders for good faith business decisions that prove unsuccessful.

In times of financial distress, most directors begin to consider the implications of a financing restructuring on the nature of his or her fiduciary obligations. Often, activist creditors and their restructuring advisers attempt to intimidate a board by claiming that the corporation is in the “zone of insolvency” and therefore, the board’s duties have shifted to its creditors — Delaware law provides otherwise. Under Delaware law, a director’s duty continues to be to maximize the value of the corporation, as a whole, with duties running to shareholders. The principal change, however, is that once the corporation is insolvent, creditors have standing to sue the board derivatively for breaches of fiduciary duty. In Delaware, it is well settled that creditors cannot sue directors directly. In reality, this legal nuance should prove irrelevant for a board that continues to take steps to maximize value for the corporation. Nonetheless, a broad consideration of all constituents should begin — again with the goal of proving value maximizing measures.

Best practice includes: developing a robust record demonstrating diligent preparation for, and frequent attendance and active involvement at board and committee meetings; making the decision-making process transparent; scrutinizing management projections and assumptions; seeking and considering the advice of outside experts; and canvassing and pursuing strategic alternatives.

For directors of non-Delaware corporations, many of the above concepts (and certainly best practices) should apply, although there are state law variations, especially with respect to the scope and nature of a director’s duties in the zone of insolvency. In addition, the corporate laws of other states may contain constituency provisions that expressly permit a director to consider the implications of a particular decision on constituencies beyond shareholders, such as employees and other creditors. It is important to understand and vet these type of provisions with local counsel.

**Corporate Indemnification and Exculpation and D&O Protection**

Given the complex dynamic faced by financially distressed companies, directors renewing coverage during such period should have their D&O policies carefully reviewed by knowledgeable counsel.

**Indemnification and Exculpation**

A company’s obligation to indemnify its directors is not mandated by Delaware law. However, most Delaware corporation charters include provisions requiring reimbursement and exculpation to the maximum extent permitted by law. Delaware law permits a corporation to indemnify its directors for litigation expenses and judgments in connection with third-party actions, provided the director has acted in good faith and for a purpose that the director reasonably believed to be in the best interest of the corporation. Given that the good faith and best interest qualifications generally are not determined until the litigation has concluded, Delaware law permits the corporation to advance funds pending resolution.

In the context of a bankruptcy case, the company’s ability to reimburse current and former directors changes, and directors may end up with prepetition claims against the company for its failure to cover indemnifiable losses to the extent D&O
insurance coverage is insufficient.

**D&O Insurance**

Several factors implicate the structure, scope and amount of D&O insurance, including: the amount of the company’s funded debt; whether the company is public or private; and the nature and risk of the company’s assets and business. In the lead up to a restructuring, or in advance of near-term concerns about a company’s ability to refinance or repay its debt, a director should review the structure, breadth and nuances of the company’s D&O coverage. Specifically, the board should review the policy as it relates to issues that arise in a restructuring context. There are three provisions/features that warrant specific consideration: the structure of Side A coverage; the limitations on the insured versus insured exclusion; and the duration of the imbedded tail.

**Scope of Coverage**

Most sophisticated D&O policies provide at least Side A and Side B coverage. Side A coverage insures a director’s losses if the corporation is unwilling or unable to indemnify the director and does not run to the benefit of the corporation. Side A coverage generally is not subject to a significant deductible or self-insured retention. Side B coverage insures the company’s indemnification obligations to its directors, and generally is subject to a significant deductible or self-insured retention. A number of D&O policies also contain Side C coverage, which provides coverage for certain types of claims (generally securities claims) against the entity itself. Side C coverage also is generally subject to a significant deductible or self-insured retention. From a director’s perspective, Side A coverage is critical. In most jurisdictions, access to Side A coverage for indemnifiable losses should be permissible during the bankruptcy case irrespective of the automatic stay. In certain cases, however, bankruptcy courts have concluded that the insurance proceeds were the debtor’s property and therefore, were not available to satisfy directors’ defense costs or liability.

As additional protection to ensure access to Side A coverage in the event of a bankruptcy, a well-structured policy will contain a priority of payments provision. This provision makes it clear that Side A policy payments have priority over Side B or C payments. As further protection, many companies have obtained Side A only policies. Because Side A only policies provide no benefit directly to the corporate entity, neither such policies nor their proceeds should be considered property of the corporate debtor’s estate. Side A only policies can be excess over or primary to policies containing Sides A, B and C coverage. The Side A only excess policies can be written on a “difference in conditions” basis, which requires them to drop down and provide coverage under circumstances where the lower level coverage has (wrongfully or not) failed to pay.

Most D&O policies contain a definition of “Application” that, for public companies, includes SEC filings, including financial statements, dating back over a certain period of time. As a result, there is a risk that a restatement of financials contained in such filings can be a ground not only for denial of coverage, but for rescission of the policies. There also generally are special recession provisions in the D&O policies, which dictate the extent to which knowledge of certain individuals can be imputed to other individuals or to the corporation. Side A only policies, however, are often non-rescindable.

**Insured-Versus-Insured Exclusivity**

Most D&O policies contain an “IvI exclusion,” which, subject to certain exceptions, excludes coverage when the corporation commences an action against its directors. There are often, however, carve-outs to the exclusion for derivative actions that are commenced without the involvement or participation of the insured. Given the new and competing constituencies involved in a Chapter 11 case, directors should review the breadth of the IvI exclusion to determine whether suits commenced on behalf of the debtor by a trustee, a creditors’ committee or a litigation trust would be subject to the exclusion.

**Acquiring Tail Coverage**

Most D&O policies are claims based as opposed to occurrence based. Following a change of control, the policy often terminates as to subsequent acts. Sometimes the policy also provides for termination as to subsequent acts upon a bankruptcy filing. A question often arises as to what the policy provides with respect to a director’s ability to report a claim made after termination of the policy based on conduct taking place before that termination. Many policies have a standard tail, ranging from 30 days to one year or more. In a distressed context, even one year likely is insufficient to adequately protect the board. Depending on the circumstances surrounding the restructuring, a board might insist that the company procure sufficient tail coverage prior to commencing Chapter 11 or prior to closing an out-of-court restructuring that results in a change of control. Once in Chapter 11, the debtor’s ability to pay for tail coverage could be viewed as requiring bankruptcy court approval.

**Conclusion**

As a company embarks on a restructuring initiative, best practice suggests that the board develop a “zone of safety” to ensure it has the appropriate freedom to make the best decisions to maximize corporate value. Understanding personal protections, assembling a team of first-class and independent experts, and beginning as early as possible to ensure a sufficient runway to implement the restructuring are essential. Each situation has its own opportunities and challenges and counsel should be consulted early to highlight and address issues and assist the board when exploring options and developing a record of robust director oversight.

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