Crucial Steps to be Taken by the Board of Directors of Financially Troubled Companies

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This Practice Note describes key steps to be taken by the board of directors of a company nearing or experiencing financial trouble. This Practice Note prepares a board of directors for impending insolvency, with guidance to protect both the company and the board itself.

Ordinarily, a board of directors' duties can be boiled down to a single sentiment: to thy shareholders be true (see *Prod. Res. Group, LLC v. NCT Group, Inc.*, 863 A.2d 772, 787 (Del. Ch. 2004)). Under normal circumstances, a court typically does not second guess a board's decision making process due to the business judgment rule. (see *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (S. Ct. Del. 1985)). In these non-distressed situations, a board of director's fiduciary duties only run to the company and its shareholders (see *In re Rural Metro Corp. Stockholders Litigation*, 88 A.3d 54, 80 (Del. Ch. 2014)). The board members are only beholden to their shareholders, not their creditors, and must have shareholders' best interests in mind when making all decisions.

For more information on the fiduciary duties of board members for non-distressed companies, see Practice Note, Fiduciary Duties of the Board of Directors (6-382-1267).

However, once a company becomes insolvent (or, in certain states, verges on insolvency), the board of directors' fiduciary duties extend to include the company's creditors (see *RSL Comm'ns PLC v. Bildrici*, 649 F. Supp.2d 184, 205 (S.D.N.Y. 2009)).

For more information on the fiduciary duties of board members for distressed companies, see Practice Note, Fiduciary Duties of Directors of Financially Troubled Corporations (9-384-4955).

FIDUCIARY DUTIES OF DIRECTORS OF SOLVENT COMPANIES

Directors generally owe certain touchstone duties to a solvent company for the benefit of its shareholders. If the duty of loyalty, duty of care, and good faith are observed in making a decision, board members are presumed to have made decisions with the best interests of the company in mind:

- **Duty of loyalty**. Directors are expected to act in the best interests of the company and never elevate their personal interests above the company's. If the interests of the director and the company conflict, those of the company must trump (see *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993)). For more information, see Practice Note, Fiduciary Duties of the Board of Directors: Duty of Loyalty (6-382-1267).
- **Duty of care**. A board of directors must be informed when making a decision for the company and may be held liable if its decision constitutes gross negligence. A director's duty of care is exercised when "there [is a] good faith effort to be informed and exercise judgment" (see *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 968 (Del. Ch. 1996)). For more information, see Practice Note, Fiduciary Duties of the Board of Directors: Duty of Care (6-382-1267).
- **Duty of good faith**. A company's board of directors must discharge its duties in good faith, with honesty of purpose and in the best interest of the corporation (see *In re Rural Metro Corp. Stockholders Litig.*, 88 A.3d 54, 80 (Del. Ch. 2014)).

Some courts have held that the duty of good faith is a subsidiary element of the duty of loyalty rather than a separate fiduciary duty (see *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006) and see Practice Note, Implied Duty of Good Faith and Fair Dealing: Good Faith and Fair Dealing versus Fiduciary Duty in Corporate Law (1-520-7165)).

EVALUATING DIRECTORS' DECISION MAKING

Courts do not seek to substitute their judgment for that of a board of directors unless circumstances absolutely compel it. When evaluating a decision by a board of directors, the court may use one of several standards of review to determine if the board has acted appropriately under the circumstances and whether the board may have breached duties owed to creditors and shareholders.

STANDARDS OF REVIEW

In making standard business decisions, directors are protected by the business judgment rule if they comply with their fiduciary duties. When conflicts of interest and other evidence of a board's lack of

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independence are present, courts may use higher levels of scrutiny in reviewing corporate action. Delaware courts have devised three levels for the evaluation of directors' decisions:

- **The business judgment rule**. This is the default standard of review. The business judgment rule presumes that directors of a corporation make decisions based on information, good faith, and in the best interests of the company.
- **Enhanced scrutiny**. This is the intermediate standard of review. Enhanced scrutiny shifts the burden of persuasion to directors to demonstrate that they were properly motivated and took reasonable action in their decision making relating to legitimate corporate objectives. Enhanced scrutiny applies when the decision-making context can subtly undermine the decisions of even independent and disinterested directors.
- **Entire fairness**. This is the most onerous standard to review directors' decisions. If a party challenging a board's decision overcomes the business judgment rule, the burden shifts to the directors to demonstrate that the challenged act was entirely fair to the corporation and its shareholders. Once entire fairness applies, the defendants must establish that the transaction was fair.

(See *Reis v. Hazelett Strip-Casting Corp.*, 28 A.3d 442, 457 (Del. Ch. 2011).)

THE INSOLVENCY THRESHOLD

Determining when a director's duties shift from just shareholders to shareholders and creditors requires a determination of when a company has passed the threshold from solvency to insolvency. Under Delaware law, insolvency occurs when there is either:

- **Balance sheet insolvency**. When a company's liabilities exceed its assets.
- **Cash flow insolvency**. There is an inability to pay debts as they mature in the ordinary course of business.

(See *Prod. Res. Group, LLC v. NCT Group, Inc.*, 863 A.2d 772, 787 (Del. Ch. 2004).)

Zone of Insolvency

Some jurisdictions recognize a zone of insolvency in which a board of director's fiduciary duties extend to the company's creditors before the company is actually insolvent on a balance sheet or cash flow basis (see *Snyder Elec. Co. v. Fleming*, 305 N.W.2d 863, 869 (Minn. 1981)).

Many jurisdictions have rejected the zone of insolvency theory, instead holding that actual insolvency is required to extend a board's fiduciary duty to a company's creditors (see *RSL Comm'ns PLC v. Bildrici*, 649 F. Supp.2d 184, 206 (S.D.N.Y. 2009)). In these jurisdictions courts have held that a zone of insolvency construct creates conflicting fiduciary duties for directors to satisfy the needs of both shareholders and creditors, before insolvency has even hit. This conflict may expose directors to personal liability for breach of fiduciary duties to creditors (see *Metcoff v. Lebovics*, 51 Conn. Supp. 68, 74-75 (2007)).

For a discussion of directors' responsibilities in the zone of insolvency, see Practice Note, Fiduciary Duties of Directors of Financially Troubled Corporations: Directors' Fiduciary Duties: Corporations in the Zone of Insolvency (9-384-4955).

Direct and Derivative Claims

Some jurisdictions allow creditors of insolvent corporations to bring direct claims against directors for breaches of fiduciary duty (see*, e.g., Technic Engineering, Ltd. v. Basic Envirotech, Inc.,* 53 F.Supp.2d 1007, 1010–12 (N.D.Ill.1999) (applying Illinois law)). Other jurisdictions allow creditors to bring only derivative claims against directors on behalf of the company for a breach of fiduciary duties (see *Quadrant Structured Prods. Co., Ltd. v. Vertin*, 115 A.3d 535, 543-44 (Del. Ch. 2015)). Derivative claims benefit all stakeholders of a company, whereas direct claims merely benefit the individual claimants.

BEFORE CRISIS STRIKES

A fiscal crisis can strike a company without notice and the board has little time to implement procedures and protocols before responding. Advance planning, therefore, is crucial. Certain strategies can help protect board members from incurring liability for breach of fiduciary duty, whether to the company's shareholders or, if the company is insolvent, its creditors. To prepare for a crisis, the board should, at minimum, take the following steps:

- Establish standard protocols (see Develop and Maintain Standard and Systematic Protocols and Procedures).
- Keep sufficient records (see Draft and Regularly Maintain Board Meeting Minutes).
- Properly insure directors and officers (see Regularly Review and Maintain Directors & Officers Insurance Policies).
- Ensure that the board's needs are reviewed and maintained (see Regularly Review the Board's Needs).
- Disclose conflicts (see Require Board Members to Disclose Potential Conflicts).
- Communicate (see Communication Among Board Members is Key).

DEVELOP AND MAINTAIN STANDARD AND SYSTEMATIC PROTOCOLS AND PROCEDURES

A board should predetermine its protocols and procedures for conducting its work. These protocols should be simple to follow and systematically used. For example:

- Regular board meetings should be prescheduled.
- Members of the company's management team and professional advisors should be invited to present relevant information about material matters.
- An executive committee made up of certain company officers and board members should be created to handle day to day tasks and to report to the board on a regular basis.
- A protocol for scheduling and conducting meetings during a potential crisis should be established.

The board's practices and protocols should be codified in the company's bylaws. The protocols should be revisited annually by the board's governance committee or officer designated with that task (such as the board's secretary).

DRAFT AND REGULARLY MAINTAIN BOARD MEETING MINUTES

The board should designate two individuals to keep careful and detailed minutes of every meeting, resolution and vote. These notes

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should be combined and circulated to the board members as minutes. The minutes must include:

- A list of parties attending the meeting, including all non-board members in attendance.
- All votes taken.
- Any matters tabled for future discussion.

A draft of the minutes should be circulated in advance of the following board meeting and approved at that meeting. Once the minutes are approved, they should be signed by the board secretary and maintained in a designated location that is accessible by all board members.

REGULARLY REVIEW AND MAINTAIN DIRECTORS AND OFFICERS INSURANCE POLICIES

The board should regularly review the adequacy of the company's directors and officers liability insurance coverage and policies. As the company grows, the board should revaluate whether existing coverage is sufficient or adjustments are necessary. Any assessment should include a review of coverage exclusions and liability limits. Directors should consider whether drop down insurance may be appropriate.

For an in-depth discussion of directors and officers liability insurance, see Practice Note, Directors and Officers Liability Insurance Policies (2-504-6515).

REGULARLY REVIEW THE BOARD'S NEEDS

The makeup, skills, duties, and needs of a board changes with the company's business. To respond to these changes, the board should periodically determine whether:

- It has sufficient members to adequately address the company's changing needs.
- Directors with special skill sets are needed to assist with new projects.
- A committee, subcommittee, or advisory committee should be created to deal with a new issue. The creation of any committee should be documented in the board's meeting minutes along with the outcome of the committee's work on behalf of the board.

REQUIRE BOARD MEMBERS TO DISCLOSE POTENTIAL CONFLICTS

Disclosing potential conflicts of interest held by individual board members before the board's approval of company transactions or other corporate actions allows the board to assess whether additional steps must be taken to avoid liability, such as:

- Appointment of independent directors.
- Recusal of interested directors.

COMMUNICATION AMONG BOARD MEMBERS IS KEY

Directors must receive adequate information from the board's professionals and advisors. Moreover, they must receive this information with adequate time to consider it. Practically, it is rare (if ever) that a crisis situation lends itself to lengthy discussion and robust contemplation. However, board leadership should provide as much notice as possible of information for board members to consider so they are properly equipped to avoid a crisis. Directors should consider any information with a critical perspective, especially any information provided by advisors or special committees.

THE ONSET OF CRISIS

When a crisis hits, it is crucial that the board take proactive action, such as:

- Retain independent counsel (see Retain Independent Counsel for the Board).
- Form a special committee (see Form a Special Committee).
- Maintain existing protocols (see Maintain Current Practices and Protocols).

RETAIN INDEPENDENT COUNSEL FOR THE BOARD

Counsel retained by the company represents the company and not the individual directors. Accordingly, directors should not rely on the advice of a company's outside counsel. Directors need advice from attorneys retained solely to represent their interests concerning:

- Their fiduciary duties.
- Potential liability.
- Steps that should be taken to minimize risk.

FORM A SPECIAL COMMITTEE

The board should use a special committee to:

- Address potential conflicts between the interests of board members and shareholders.
- Conduct internal investigations.
- Review change of control events and similar situations.

Depending on the situation, the board may consider authorizing the special committee to have the full authority over the board and to make determinations on behalf of the board without requiring a vote of the entire board. If a special committee is given this power, the board's meeting minutes must reflect this decision.

MAINTAIN CURRENT PRACTICES AND PROTOCOLS

The board should not deviate from its established protocols in a time of crisis unless clearly warranted by the circumstances. Even then, action out of the ordinary course should be taken only after consulting both the company's outside counsel and the directors' personal counsel.

PRACTICE POINTERS FOR DIRECTORS

The public often scrutinizes actions taken by directors of companies in the public eye when the company encounters financial trouble. With this scrutiny, directors should look to actively prepare for crisis, even when one may not be on the horizon. As the board of directors monitors and evaluates company risk, it must be mindful to manage this risk and balance it against. Strategies to do so include:

- **Continue engaging in business**. Though instinct may be to stop engaging in business decisions altogether, directors should continue to engage in good faith conduct that is in the best interest of the corporation and its shareholders if these decisions are made

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with input from management and in exercise of the directors' duties of loyalty and care.

- **Value maximization is key**. Working to maximize company value is for the benefit of both shareholders and creditors. Even with apparent liquidity restraints, directors should work with management to drive development and production to increase enterprise value.
- **Insider transactions draw attention**. Potential transactions with insiders should be approached with caution and well documented as arms' length to avoid any indication of impropriety.
- **Regulatory compliance**. Directors should monitor the company and ensure that it complies with tax, environmental, and workplace regulations.

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