Are you in the vicinity of insolvency? Serving more than one master

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You are the CEO and a director of a company which you know might not be able to pay all its debts. You have managed this business for years in the shareholders' interests, maximising profit and extracting it where you can. But now, your company's enterprise value might never be enough to pay all claims against it. While there are few instances where the duties performed by a director and/or officer can be compared to a tug of war, when the corporation is insolvent, or near insolvency, you may find yourself playing the role of the "rope" in a highstakes game.

The tension on the "rope" is created by the fiduciary duties that directors of financially-distressed companies owe to at least two potentially divergent groups. At one end of the "rope" are the shareholders, the customary beneficiaries of fiduciary duties. They may want the troubled company to take more risk to maximise the return on their investment than the company's creditors, who are at the other end of the rope. Typically, creditors are contract parties to whom fiduciary obligations are owed only when the company is insolvent or in the vicinity of insolvency.

The tug is even stronger when the corporation's enterprise value is "right on the edge" of solvency. Shareholders claim their shares have value, while unsecured creditors contend that the "equity" is "under water" and that unsecured creditors are the "equitable owners" of the company. Whose interests do a director take care of first, especially in today's world where the creditors who are crying foul are often really interested in acquiring the enterprise?

Directors must first understand the fiduciary duties owed before they can properly discharge their obligations to both of these groups. Law libraries are full of cases where directors were unaware of their "dual masters" until it was too late. This chapter describes the fiduciary duties owed to shareholders, identifies instances where the directors' fiduciary duties extend beyond the shareholders to include creditors and provides suggestions on how directors may satisfy their obligations to these often divergent interests. This chapter focuses on the Delaware law of corporations. The laws of other states are mostly similar.

Fiduciary duties defined

Directors of a solvent corporation owe fiduciary duties to the corporation and its shareholders, who have entrusted control and management of the corporation to them. The duties consist of:

(i) the duty of care: directors must exercise care that an ordinary, prudent person would exercise in similar circumstances;

(ii) the duty of loyalty: directors must act with a reasonable belief that an action taken is in the best interests of the corporation; and

(iii) the duty of good faith: directors must act in good faith.

Directors are presumed to have acted in good faith, on a fully informed basis, and with the belief that actions were taken in the corporation's best interests. This presumption is embodied in the "business judgment rule". The business judgment rule is a judicial acknowledgment that when the director is acting in good faith, a court is reluctant to supplant its own judgment for a director's managerial prerogatives. In carrying out their fiduciary duties, directors may rely, in good faith, on the corporation's records and on information, opinions, reports or statements presented to the corporation by its officers, employees, professionals, or committees of the board of directors.

Fiduciary duties to creditors

When a corporation is solvent, it protects creditors' interests by complying with contracts (paying trade claims and complying with bond and note indentures and loan agreements) and by maintaining sources of cash to pay tort claims. Directors of solvent corporations do not generally owe fiduciary duties to creditors, unless there are special circumstances such as fraud, insolvency or violation of a statute, since, given the safeguards of contracts and cash, their decisions will not affect the creditors' claims. When a corporation approaches insolvency, however, directors owe fiduciary duties to creditors as well as shareholders precisely because the decisions begin to affect creditors.

These duties arise when the corporation is in the vicinity of insolvency, i.e., before the corporation is technically insolvent. Insolvency means either:

(i) balance sheet insolvency (where the corporation's liabilities exceed the reasonable market value of its assets); or

(ii) equitable insolvency (where the corporation is unable to pay its debts as they become due in the ordinary course of business).

The courts have yet to define when a corporation is in the vicinity of insolvency, but the managers of an enterprise usually know this.

When the enterprise is in the vicinity of insolvency, fiduciary duties do not shift from being owed to shareholders to being owed to creditors. Instead, they expand to include both shareholders' and creditors' interests. The directors must seek to maximise the corporation's long-term, wealthcreating capacity. Thus, the fiduciary duties now owed to creditors are to be balanced with the duties owed to other parties with interests, including shareholders and employees, and the directors' duties to the corporation's creditors cannot be satisfied at the expense of duties owed to shareholders. The directors continue to be entitled to the presumption of the business judgment rule.

The rationale for expanding fiduciary duties is that in insolvency, the shareholders' interests are worthless, and the creditors are entitled to any residual interest in the corporation. Thus, the expansion of fiduciary duties is intended to urge directors to choose a course of action that best serves the entire corporate enterprise at a time when shareholders' wishes should not be their only concern. Of course, once equity is hopelessly "out of the money", equity's recovery definitely takes a back seat.

Complying with fiduciary duties in the vicinity of insolvency

Questions remain regarding the fiduciary duties owed to creditors and how directors can properly discharge their duties to creditors while still acting as fiduciaries to shareholders. Perhaps the most significant issues facing directors of insolvent or nearly insolvent corporations are:

When is the company in the vicinity of insolvency?

What are the diverging interests of the constituencies to whom the duty is owed?

How do the directors balance these divergent interests and satisfy the duties owed to all constituencies?

When is the company in the vicinity of insolvency?

While the vicinity of insolvency does not yet have clear boundaries, it appears that fiduciary duties to creditors arise whenever this group is exposed to risk by virtue of a corporation's decision making, i.e., when the directors are "playing with the creditors' money". Courts have found a corporation in the vicinity of insolvency:

immediately following a leveraged buyout, which was commenced while the corporation's financial performance was declining;

immediately following a large corporate transaction that was intended for the sole benefit of the corporation's insiders; and

immediately prior to an action that, if taken, would render the company insolvent, presuming that the director had knowledge that the transaction would render the company insolvent.

Practically speaking, fully-informed directors will generally know when a company's financial performance is deteriorating to the point where a company is approaching insolvency. Of course, circumstances may arise that may place a company in the vicinity of insolvency without forewarning (such as excessive tort exposure). Nonetheless, where the directors are aware of impending insolvency, they should be wary of pursuing any courses of action that might place the corporation's creditors at further risk of loss. Directors should consider not only the possible advantages of the project, but also the potential risks and any negative financial impact on the corporation in the event of its failure or loss. If the cost of a plan's failure cannot be borne by the corporation's current operations and/or its shareholders – the group that invested understanding the risk and hoping (and usually expecting) to be compensated for bearing it – the directors should assess where their obligations lie.

What are the diverging interests of the parties to whom duties are owed?

Once directors recognise that a company is in a financial position that imposes on them fiduciary duties to creditors, they should assess the interests of all constituencies to whom fiduciary duties are owed.

Shareholders' interests are typically more liquid than trade or tort claims and often more liquid than publicly-traded notes. Shares can be transferred on an open market, and are valued on the basis of supply and demand. As a result, shareholders (more so than trade and tort creditors) evaluate corporate actions by the impact the actions may have on the market. Any action that increases the demand for a stock provides a potential benefit to the shareholders, even where that action may be adverse to the corporation's long-term solvency or profitability.

In contrast, most creditors hold claims that are not always traded. They are most interested in being paid. The value of the creditor's "investment" is simply a function of the collectability of the debt. As a result, creditors typically prefer corporate actions which maximise or protect the funds available for payment in full of debts owed.

By way of simplistic illustration, a company might consider contacting customers and offering a discount if customers satisfy their outstanding obligations prior to the end of a fiscal quarter, so that even at a discounted rate of payment, the company may achieve its financial projections. If the company meets its projections, demand for its stock most likely will increase and the value of the shareholders' investment will rise. But while the stockholders might be served best by the collection of the receivables at a discounted rate, the collection of the face-value of a receivable would best protect the creditors. A more common situation, but less easy to "spot", is where the board has the option to sell a company for a price that would keep creditors whole but return little or nothing to shareholders. What should a board do?

How can directors balance these divergent interests and satisfy the duties owed?

Given the potentially divergent interests of a corporation's creditors and shareholders, directors appear to be confronted with the difficult, if not impossible task of satisfying fiduciary duties to both of these constituencies. Yet, the mandate to maximise the long-term wealth-creating capacity seems to offer some guidance in this situation. Directors must balance the competing interests and make decisions that are reasonably anticipated to benefit the corporation as a legal and economic entity.

This balancing act requires the directors to act in a fully-informed manner and take only those actions that will reasonably allow the company to remedy its financial troubles without unnecessarily endangering the company's current enterprise value. In making fully-informed decisions, a director should:

(i) utilise, and rely upon, professional opinion; and

(ii) consider all possible restructuring alternatives, including relief under the United States Bankruptcy Code.

Utilisation of professional opinion

A board of directors may rely on reports and advice generated by retained professionals in discharging its duties on a fully-informed basis. The importance of retained professionals in the decision-making process increases exponentially when a company is in the vicinity of insolvency. All directors should consult with professionals regarding material acquisitions, divestitures, financings, investments, business plans and other projects or transactions, especially those that may render the corporation insolvent, or otherwise place the corporation's creditors at risk of loss. The focus should expand to enhancing the corporate entity and a board of directors should be well advised of the company's enterprise value, how it can be marketed and what impact any given action (or inaction) will have on the various constituents' recoveries. Professionals with experience in restructuring engagements, such as attorneys, financial advisors, investment bankers and/or accountants, can assist directors in determining what alternatives are available to maximise the constituents' recoveries, whether by way of reorganisation or sale.

Role of bankruptcy proceedings

A chapter 11 bankruptcy case may provide the best context in which directors can discharge their fiduciary duties to multiple constituencies. The Bankruptcy Code requires a debtor to seek bankruptcy court approval, with notice to all interested parties, of any act that is outside the debtor's ordinary course of business. This requirement gives creditors, shareholders and other parties in interest an opportunity to challenge the corporate debtor's proposed action. If the action is approved, the action then has the backing of the court. If not approved, there should not be liability for not taking the unapproved activity. These acts include financings, sales of stock or assets, and other material transactions, especially plan confirmation.

A sale of assets in a bankruptcy case is typically by public auction. The process enables the debtor, and thus the directors to:

(i) obtain court approval of the procedures to govern the auction;

(ii) utilise retained professionals to conduct the auction; and

(iii) seek court approval of a purchaser selected as the highest and best bidder.

Creditors and other interested parties, including shareholders, are afforded the opportunity to object at any stage of the sale process and to bring prospective purchasers into the process.

Another method employed by boards to discharge their duties in a bankruptcy case is to allow interested parties to propose alternative restructuring plans for the debtor. Although the Bankruptcy Code provides for a limited exclusivity period during which the debtor is the only party who may propose a plan of reorganisation, if this period expires without extension, is terminated by a bankruptcy court or is modified by the bankruptcy court to permit the debtor to share exclusivity, committees representing unsecured creditors or shareholders (or individual creditors or shareholders) may propose and seek acceptance and confirmation of a plan for a debtor's reorganisation or liquidation.

Another approach that debtors can employ in a bankruptcy case is to "cram-down" a plan of reorganisation on creditors or shareholders. If a debtor solicits accepting votes from one group of impaired creditors – those who are receiving less than a full distribution – the debtor may obtain bankruptcy court approval of a plan even though it has been rejected by other creditors or shareholders so long as no class of claims or interests with a lower priority is receiving any distribution under the plan. The "cram-down" provisions of the Bankruptcy Code are a tremendously powerful tool for a debtor to address the concerns raised by creditors or shareholders, while simultaneously structuring its own reorganisation.

Yet another strategy for the debtor and its directors is to auction the equity in the restructured corporation. This technique is particularly useful when the equity is close to being "in or out of the money". Assuming additional capital is required for continued operations, a board could auction the new equity (to be issued pursuant to a courtapproved plan), allowing old equity and all creditor classes to bid on the enterprise. In such circumstances, a competitive auction under a courtsupervised plan process should be sufficient assurance that the directors are discharging their duties to the enterprise.

Not only does a chapter 11 bankruptcy case ensure that each class of interested parties (to whom the directors of an insolvent company owe a fiduciary duty) are represented, and provide the debtor a forum in which to address the issues raised by the parties, it can help to insulate the board from liability. By providing the opportunity for an active role by all interested players, a chapter 11 bankruptcy case may assist directors in meeting their fiduciary obligations, insulate their post-bankruptcy decisions from claims they breached their fiduciary duties, and, most importantly, allow the directors to manage the enterprise and, if necessary, dispose of it, without undue concern for personal liability.

Summary

Undoubtedly, directors of a financially-troubled corporation have rather rigorous obligations imposed on them, but, these obligations are not impossible to meet. By being fully informed, relying on appropriate professionals, acting in good faith and with care, and in an effort to maximise the value of the corporation as a whole, they can discharge their duties when their company is in the vicinity of insolvency.

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