Independent Directors of Distressed Companies: Considerations for Appointment to the Governing Board

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The proliferation of investments in small, family-owned and mid-cap companies by private equity funds has led to changes in corporate governance provisions in the acquired companies' organizational documents. Some private equity funds team up with existing management and take a minority position in the acquired company, while others will make an investment only if they can acquire controlling interest or 100 percent ownership of a company. In cases where a fund acquires a controlling interest in a company, it will often populate the company's governing body with the fund's principals or employees and the company's chief executive. The fund may also seek to add outside directors with industry expertise to help govern the company. Where a private equity fund acquires a non-controlling interest, it will often seek to protect its investment by having consent and/or veto rights for certain significant transactions – for instance, the incurrence of debt, issuance of additional equity, and acquisition or disposition of assets. Thus, the organizational documents of a company may contain provisions restricting certain activities without the requisite consent of certain directors or equity holders.

Regardless of how or by whom directors are appointed to the governing body of a company, they owe fiduciary duties to the company pursuant to applicable state law. When a company becomes insolvent, the fiduciary duties owed by directors may expand to include not only the interests of the company's shareholders, but also the interest of all other parties that have a stake in the financial affairs of the company, including its creditors.

A lender to a distressed company must evaluate the make-up, abilities and motives of existing members of the governing board and consider whether the existing directors will fulfill their fiduciary duties to the company and its constituents or if the directors will be beholden to the sponsor that appointed them. The lender will also need to assess its rights under the relevant credit documents, including any ability to replace the governing board, and determine if the rights afforded to equity investors under the company's organizational documents are an impediment to achieving an effective restructuring.

This memorandum will review fiduciary duties of directors, discuss the process by which a lender can change the governing board to replace existing directors appointed by a sponsor with independent directors, and consider some of the characteristics of independent directors and issues related to the appointment of new directors.

Fiduciary Duties

Directors of a company owe a duty of care and duty of loyalty to the company and its shareholders. The duty of care requires directors to provide the same care and concern to their board responsibilities as any prudent and ordinary person would provide under similar circumstances. The duty of loyalty requires that the interests of the company take precedence over any interests of the directors or their affiliates.

Under Delaware corporate law, a company and its shareholders can limit a director's personal liability for monetary damages from a breach of fiduciary duties.[1] However, this limit on personal liability only applies to breaches of the duty of care and does not extend to a breach of the duty of loyalty, or for acts involving bad faith or intentional or knowing violation of law.[2]

When a company becomes insolvent, Delaware courts have held that directors' duties may also expand to include the interests of the company's creditors in addition to shareholders.[3] Although creditors have the ability to negotiate contractual protections for themselves in their loan and security documents, and are also protected by the implied covenant of good faith and fair dealing, fraudulent conveyance law, and federal and state insolvency laws, when a company becomes insolvent the fiduciary duties of directors expands to include the interests of creditors of a company because creditors become the principal constituency injured by any breach of fiduciary duty that diminish the company's value.

Delaware courts have also developed and refined the body of law regarding creditor rights against a company's directors. Traditionally, fiduciary duties began to shift to include creditors when the company was in the "zone of insolvency", and creditors could enforce those rights directly against the directors.[4] More recently, Delaware courts have concluded that the "zone of insolvency" was too ambiguous and it was too difficult to ascertain when a company had crossed into the zone. As a result, Delaware courts have held that creditors only have a derivative right (not a direct right) to bring an action against directors and that the exculpation language in a company's charter documents would also apply to creditors, even though they are not a party to charter documents.

Interestingly, Delaware courts have come to a different, narrower conclusion regarding the rights of creditors with respect to a limited liability company, which is also created under state statute. Delaware limited liability company law provides greater flexibility to its equity holders (its members) and those assigned to manage the company (its managers) in determining the obligations that the managers will owe the company, and permits a complete waiver of all fiduciary duties.[5] In addition, Delaware's limited liability company statutes provide that only a member, or an assignee of a member interest in the limited liability company, can bring a derivative action against the company's managers.[6]

Appointment of Directors

Changes to the governing board of a company can generally be effectuated by a lender through the exercise of its proxy right (usually pursuant to a pledge agreement) to appoint directors. It is also not uncommon in forbearance agreements for there to be a requirement (a milestone) that the company appoint new board members who are satisfactory to a lender. Alternatively, changes to the governing board can be achieved by the consent of the parties that have the right to appoint the board (*e.g*. through an equity holders' resolution) or by the existing equity offering the equity to a lender in a consensual deal (often referred to as a "handing over of the keys").

A company's equity owners will usually be required by a lender to provide a pledge of their equity in connection with the structuring of an initial loan. The pledge permits the lender to vote such equity after certain events of default. If there are many equity holders or if not all of the equity holders are willing to grant a pledge, the lender may require that an intermediate holding company be inserted between the borrower company and the equity holders, with the intermediate holding company granting a pledge of the borrower's equity.

At the time of the initial loan, the lender will need to review the borrower's organizational documents to ensure that the lender is obtaining appropriate rights to be able to effectuate a change in the governing board. For instance, some investors in the company may have the right to designate certain board members and fill any vacancies that are created by the resignation of those board members. The organizational documents will also need to be reviewed to ascertain whether any equity holder or class of equity holders possess consent or veto rights over certain actions. If such a right exists, then the organizational documents should be amended to terminate such consent or veto rights upon an event of default under the credit documents.

If the existing equity wants to "hand over the keys" to the lender, the lender must consider whether it is prudent for it to be both a lender and an equity holder of the distressed borrower. For instance, will equity ownership affect the independence of the director appointed by the lender or it will affect its senior secured lending position in the capital structure? Accepting the equity could, among other things, give rise to equitable subordination claims in a bankruptcy proceeding, raise issues of liability for environmental remedial costs or underfunded pensions, trigger a change of control provision under the company's contracts, limit or eliminate the ability to use a net operating loss due to the change in control, or terminate the company's director and officer insurance.

Number and Independence of Directors

An important consideration in appointing a director is to make sure that such a director is independent from the lender so that decisions made by the director will be afforded the protections of the business judgment rule (the presumption that decisions were made in the best interest of the company) and the director is shielded from attack and potential liability. As to the independence of the lender appointed directors, there is a presumption that directors are independent, absent a material relationship with the entity making the appointment, and the mere fact that a director was appointed by a controlling shareholder or lender does not by itself taint or undermine the presumption of a director's independence.[7] Naturally, this presumption can be rebutted by facts which show that the person is beholden to or controlled by the appointing entity.

There is no strict definition that courts use to determine independence. Rather, it is a "facts and circumstances" test of whether the director has professional, financial or personal relationships with the entity appointing the director such that the director's decision-making is effectively jeopardized. Although independence does not require the director to have had no prior contact with the appointing entity, it is important to remember that the facts and circumstances will be reviewed in hindsight and thus appearances will matter. For instance, if a lender has appointed the same person in each of its last seven distressed situations, this fact could raise the appearance that such a director lacked independence and is controlled by the lender. If a director is determined not to be independent, then the protection of the business judgment rule could be called into play. Not only is independence important from a liability perspective for the potential director but it can also subject the lender to control liability and equitable subordination claims.

In selecting a potential director, in addition to assessing independence, a lender should also consider industry expertise and distressed experience. Depending on a lender's objectives as well as the strength or experience of existing management, these other considerations may be given different weights. If the lender's goal is to consummate a sale of the company, then industry expertise may be a less important factor. However, if management is viewed as lacking in expertise or experience, industry expertise may be more of a significant factor. If the lender wants to purchase the business through a credit bid in a UCC Article 9 strict foreclosure sale, then independence of the director may be of the upmost importance, as the director will need to make an independent decision that such a sale is in the best interest of all constituents, not just the lender.

Similarly, it would be prudent for a sponsor of a company that is in distress to consider whether it would be appropriate to appoint a third-party independent director to the governing board so as to avoid the potential ramifications of decisions made by directors who may lack independence. A sponsor director's decisions could be viewed (and hence challenged) as being made to protect the sponsor's equity investment rather than in the best interest of the company, especially when the value of the company does not cover the full amount owed to the company's creditors.

The assessment of whether a director appointed by a sponsor should be removed or resign, or whether a lender should appoint new directors, will depend on the objectives of the sponsor and the lender, and the specific facts and circumstances of the situation. The fact that a sponsor is prepared to fund additional capital, or that a lender is prepared to provide a significant period of time for a turnaround, would influence the decisions on whether the directors appointed by the sponsor should stay on or resign, or be removed from the governing board.

If a decision is made to appoint independent directors, finding a qualified person to appoint to a board has become significantly easier as there are professionals (lawyers, financial advisors and investment bankers) that have developed an expertise and a willingness to sit on boards of distressed companies as independent directors.

The number of directors that are required to be on the governing board will be dictated by the company's organizational documents, and the documents may need to be amended if the number of prescribed directors are reduced or enlarged. In addition, best practice is to select an odd number of directors so as to avoid a dead-lock, and it is common to have three directors so that newly appointed independent directors can out vote an incumbent chief executive officer. Obviously, the greater the number of directors, the harder it will be to build consensus, and director compensation costs will be higher.

Potential Issues for Director Candidates

The sponsor and lender should expect to negotiate with potential directors about their compensation and indemnification. In terms of compensation, unlike a healthy company, a distressed or insolvent company cannot use non-cash compensation, such as options, warrants or actual equity, because such equity has little or no value. In addition, directors of distressed companies will be significantly more active than directors of a healthy company, as the situation is often filled with meetings with management, lenders, other creditors and regulators (if the company is regulated).

The lender (and for that matter, the sponsor) should avoid providing an indemnity to new director candidates because of its potential effect on the directors' independence. The company's charter or organizational document normally contains a broad indemnity for its directors with provisions for advancement of funds for defense costs, provided the directors are not determined to have acted in bad faith, fraudulently or in breach of their fiduciary duties. However, in a distressed situation, the company's cash flow may not be sufficient to either advance defense funds or pay indemnification claims, or a lender may have dominion and control over the company's cash. Moreover, any claims by directors against the company would be unsecured claims that come behind the claims of the company's senior secured lender and other subordinated (but secured) lenders. To the extent a lender is willing to fund amounts to pay for certain actions by a director, such a decision would play directly into the argument that the lender controls the director and thus the director is not independent.

As for director candidates, they will want to know that there is ample insurance to protect them from potential claims. There may be coverage of officers and directors under the company's suite of business insurance, but the director will be concerned whether the limits under existing coverage are sufficient for a distressed company and whether any prior or pending claims have used up a portion or all of the insurance. It is not unusual for directors, as a condition to their appointment, to request a separate policy that covers just the independent directors (called a "side A policy") which covers a director in the event the company cannot satisfy its indemnification obligations. In addition, a director will likely want a "tail policy" to provide coverage for a period (usually 6 years, which is the general statute of limitations period for causes of action for fraud or breach of fiduciary duties) in the event a director is sued after they are no longer on the board. Most insurance policies are a "claims made policy" rather than an "occurrence policy", *i.e.* coverage exists if a claim is made by a director during the policy period, rather than when the act itself took place that is the subject of a claim for liability.

Conclusion

There are many factors that must be considered when appointing directors to a board of a distressed company. A lender needs to understand its available remedies under the underlying credit documents and also make sure that the company's organizational documents permit the appointment of new directors by the lender. The selection of an appropriate person to the governing board will be based upon the particular facts and circumstances of the situation, but selecting someone that is independent is critical to both the lender and the director. It is likely that there will be a significant cash outlay related to the appointment of independent directors, precisely when the company is experiencing cash flow issues, but such outlay may be insignificant given the amount of loans already advanced and the risk of potential liability if appropriate directors are not appointed.

For More Information

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1 8 Del. C. § 102(b)(7).

2 “A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director . . . shall not eliminate or limit the liability of a director: (i) [f]or any breach of the director’s duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit. 8 Del. C. § 102(b)(7).]

3 *See N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007) (“[T]he creditors of an insolvent corporation have standing to maintain derivative claims against directors on behalf of the corporation for breaches of fiduciary duties.”)

4 *See Bovay v. H.M. Byllesby & Co.*, 38 A.2d 808, 813 (Del. 1944) (describing property of an insolvent firm as being “administered in equity as a trust” for creditors); *see also*, *e.g.*, *Federal Deposit Ins. Corp. v. Sea Pines Co.,* 692 F.2d 973,976-77 (4th Cir. 1982) (“[W]hen the corporation becomes insolvent, the fiduciary duty of the directors shifts from the stockholders to the creditors.”)

5 6 Del. C. § 18-1101.

6 6 Del. C. § 18-1002; *see also CML V, LLC v Bax*, 28 A3d 1037 (Del. 2011).

7 *See Edgewater Growth Cap. Partners LP v. H.I.G. Cap., Inc.* 68 A.3d 197, 230 (Del. Ch. 2013) (“[T]he manner in which someone is nominated to the board is not evidence of their lack of independence”); *Aronson v Lewis*, 473 A.2d 805, 816 (Del. 1984) (“[I]t is not enough to charge that a director was nominated by or elected at the behest of those controlling the outcome of a corporate election. That is the usual way a person becomes a corporate director. It is the care, attention and sense of individual responsibility to the performance of one's duties, not the method of election, that generally touches on independence."); *In re MAXXAM, Inc.*, 659 A.2d 760, 773 (Del. Ch. 1995) (“To be considered independent, a director must not be dominated or otherwise controlled by an individual or entity interested in the transaction.”)

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