



FAMILY OFFICE EXCHANGE NEWSLETTER

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CONSIDERATIONS FOR FAMILY OFFICE DIRECTORS OF DISTRESSED CORPORATIONS

BACKGROUND

Many leading economists agree we are in the midst of the worst global financial crisis since the great depression. Prior to the credit crisis, well managed companies enjoyed ready access to debt or equity capital. Today, many of these well-managed companies find themselves in financial distress due to excessive leverage in their capital structure or a lack by their existing creditors to refinance their credit facility. Often, as their debt matures, these companies may find it difficult to access the debt markets to refinance existing indebtedness.

In the past few years, many companies were financed with “covenant light” loans, which did not contain many of the typical maintenance covenants that historically provided early warning signals to independent or non-management directors. Because of the absence of external red flags, the day of reckoning for these companies is delayed. In these delayed situations, companies are often in a more critical cash position with fewer strategic alternatives available when the crisis hits home.

In the current global economic crisis, a business’s decline can be precipitous. Nothing was more unexpected than the rapid demise of Lehman Brothers. Often in these situations, management can suffer denial, unpreparedness for change and resoluteness that it can resolve its own problems.

When deals go bad, litigation often follows – especially in tough financial times. With the benefit of 20-20 hindsight, disgruntled shareholders, and even creditors, often search for deep pockets to recover their losses. The enhanced litigation risk for distressed companies is further elevated by enhanced and shifting fiduciary duties that apply to corporate fiduciaries. As prudent trustees of generational wealth, many officers of family offices serve on Boards of Directors for companies in which they have made equity investments, or on the Boards of Directors of family owned businesses. As the only likely remaining “deep-pocket,” agents of family offices should exercise particular care navigating the troubled waters surrounding the distressed company and should be particularly aware of potential landmines.

Board inaction is a frequent scenario for a breach of fiduciary duty of care claim. As a business or sector stumbles, the earlier an advisor, joint venture partner or investor can provide additional support and guidance to the declining business, the greater the probability that the enterprise's intrinsic value can be preserved. Industry survivors stay ahead of the game by recognizing issues before they become problems and turning perceived disadvantages into a competitive edge.

This article is intended to alert Family Office Exchange Members to particular considerations pertaining to, and risks associated with, serving on the Board of Directors of a distressed company (either private and public), in which either such member, or his or her Family Office, holds an investment.¹

SPECIAL FIDUCIARY DUTY CONSIDERATIONS FOR DIRECTORS OF DISTRESSED CORPORATIONS²

BASIC FIDUCIARY DUTIES: DUTY OF CARE AND DUTY OF LOYALTY

Generally, a director's obligation to the corporation is governed by the director's fiduciary duty to act in the corporation's best interest. The two elements are the duty of loyalty and the duty of care.

The duty of care dictates that directors must act in a fully informed and considered manner. They must (i) inform themselves of all material information reasonably available to them prior to making a business decision and (ii) act with the care an ordinary prudent person in like position would use under similar circumstances.³ As such, a board cannot adopt an "ostrich like" approach to material decision making by failing to deliberate or get adequate information regarding key corporate decisions.⁴

The duty of loyalty prohibits self-dealing transactions, excessive compensation, corporate waste, personal use of corporate assets, and the use of corporate funds to perpetrate control or "entrenchment" of existing management.⁵ If a company is in financial distress, management often could place their interest for continued employment ahead of the corporation, which would result in a breach of the duty of loyalty.

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² Unless otherwise noted, this article references Delaware law. Under the "internal affairs" doctrine, the law of the state of incorporation governs the scope of a corporate director's duties. Many judiciaries, however, defer to Delaware decisions in formulation judicial decisions.

³ ARONSON V. LEWIS, 473 A.2d 8-5 (Del 1984).

⁴ IN RE WALT DISNEY CO. DERIV. LITIG., 825 A. 2d 275 (Del. Ch. 2003).

⁵ CEDE & CO. V. TECHNICOLOR, INC., 634 A. 2d 345 (Del. Super. 1993).

REVLON DUTIES IN SALES, BREAK-UPS AND RESTRUCTURINGS

In financial distress situations, a director's fiduciary duties can differ from his duties when making ordinary business decisions. For example, a corporate distress situation may involve a transaction involving the sale of control, the break-up or restructuring of a company. Under these situations a board faces a well defined set of heightened fiduciary obligations. These fiduciary duties grew from the Delaware Supreme Court's decision in *REVLON, INC. v. MACANDREWS & FORBES HOLDINGS, INC.*⁶ In *REVLON*, the court held that, once a board of directors determines that the company is up for sale, the directors are no longer defenders of the corporation, but instead become "auctioneers charged with getting the best price for the stockholders."⁷ The Delaware Supreme Court expressly noted whether the "sale" takes the form of an active auction or a "restructuring," Revlon duties are triggered.

These Revlon duties require directors to obtain the highest value reasonably available for the shareholders and the corporation. In these cases, courts will apply an "enhanced scrutiny" standard. This enhanced scrutiny standard focuses on the directors' process and action, the adequacy of information relied upon by the directors, and the reasonableness of the directors' decision. In *NETSMART*,⁸ a decision noted by legal commentators to be a legal watershed in Delaware, the Delaware Chancery Court imposed a duty requiring the target to show that it pursued both financial and strategic buyers:

[A]n inert, implicit post-signing market check [through a window-shop provision, relying on publicity to elect offers] does not, on this record, suffice as a reliable way to survey interest by strategic players. Rather, to test the market for strategic buyers in a reliable fashion, one would expect a material effort at salesmanship to occur. To conclude that sales efforts are always unnecessary or meaningless would be almost un-American, given the sales-oriented nature of our culture.⁹

As such, the retention of a qualified and experienced financial advisor or investment banker, with experience and expertise to canvass both financial and strategic buyers, is an essential initial step to be pursued by the board. Surrendering control of the process to the qualified investment bank could reduce a potential conflict between management, whose primary objective could be self entrenchment, and the family office director, whose interest is to maximize the value of the family office's investment.

FIDUCIARY DUTIES TO CREDITORS WHEN CORPORATION IS IN THE "ZONE OF INSOLVENCY"

When an organization is solvent, a director's fiduciary duties run to the corporation's shareholders and to the corporation itself, but not to creditors. However, additional concerns arise when it is not clear

⁶ 506 A.2d 173 (Del. 1985) (hereinafter, "REVLON").

⁷ *Id.*

⁸ *IN RE NETSMART TECHNOLOGIES, INC. SHAREHOLDER LITIG.*, Civ. No. 2563-VCS (Del. Ch., March 2007).

⁹ *Id.* at p. 48.

whether the corporation is solvent, the so-called “zone of insolvency.” While courts have not defined the amorphous term “zone of insolvency,” generally, it refers to the situation where an organization’s financial condition deteriorates to the point where it is at risk of becoming insolvent.¹⁰

By the count of others, a majority of jurisdictions, including many federal courts, have held that the fiduciary duties of directors of an insolvent corporation, or one in the zone of insolvency, extend to its creditors.¹¹ However, recently, the Delaware courts rejected this line of cases and made clear that directors’ and officers’ fiduciary duties do not change when the corporation enters the zone of insolvency.¹² It is uncertain if Colorado will follow the recent Delaware decisions.

If a company is incorporated in a state that imposes fiduciary duties to creditors for companies in the “zone of insolvency,” the family office director could face “dueling” fiduciary duties as he would owe fiduciary duties to the family office and to the creditors of Company. As such, it is important for a family office director to explore with his counsel if the company is incorporated in a jurisdiction that follows the Delaware court’s GHEEWALLA line of reasoning (no fiduciary duty to creditors) or imposes a fiduciary duty to creditors. If the latter, consideration should be given to resign from the board or implement other risk reduction strategies.

FIDUCIARY DUTIES OWED TO CREDITORS WHEN CORPORATION IS INSOLVENT

When a corporation is *insolvent*, however, its creditors take the place of the shareholders as the residual beneficiaries of any increase in value. Consequently, the creditors of an *insolvent* corporation have standing to maintain derivative claims against directors on behalf of the corporation for breaches of fiduciary duties. The corporation’s insolvency “makes the creditors the principal constituency injured by any fiduciary breaches that diminish the firm’s value.”¹³ Creditors of insolvent corporations may bring derivative claims on behalf of the corporation. The Delaware Supreme Court, however, has not expressly addressed whether creditors of a corporation operating in the “zone of insolvency” have standing to bring a derivative claim for breach of fiduciary duty.

PROACTIVE DIRECTOR ACTIONS IN DISTRESSED PRE BANKRUPTCY SITUATIONS

Given the heightened fiduciary duty considerations, the following lists of proactive steps should be explored by directors or trustees of distressed companies in consultation with outside legal counsel:

- When deals go bad, litigation follows. Anticipate litigation.

¹⁰ See *id.* at 98 (declining to define the zone of insolvency); *PROD. RES. GROUP, L.L.C. v. NCT GROUP, INC.*, 863 A.2d 772, 790 (Del. Ch. 2004) (referring to the zone of insolvency as “some imprecise and hard-to-define vicinity of insolvency”).

¹¹ See *e.g.*, *CREDIT AGRICOLE INDOSUEZ v. ROSSIYSKIY KREDIT BANK*, 94 N.Y.2d 541, 550 (N.Y. 2000).

¹² See *N. AM. CATHOLIC EDUC. PROGRAMMING FOUND., INC. v. GHEEWALLA*, 930 A.2d 92, 99 (Del. 2007).

¹³ *Gheewalla*, 930 A.2d at 102.

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- Given the litigation risk, review with legal counsel to make sure that the company's D&O liability insurance coverage is "state of the art." Particularly, review with counsel the following:
 - Confirm that the D&O insurance policy will not become part of the company's bankruptcy estate. As such the policy should name the individual directors and not the corporation as the direct insured beneficiary/payee.
 - The policy should provide for the advancement of defense costs on an ongoing basis.
 - Since the company's indemnification obligations under its organizational documents may be unavailable, ensure that the policy covers the company's indemnification obligations.

 - A determination of "insolvency" changes everything. Therefore, the board should make an affirmative determination that the company is solvent. Insolvency requires a showing that (i) a company's liabilities exceed its assets and there is no reasonable prospect that the business can be successfully continued, or (ii) the company is unable to satisfy its obligations as they become due in the ordinary course of business.¹⁴ These tests are widely acknowledged to lack a bright line quality and are highly factual. As such, the company's qualified financial advisor should be requested to render a solvency opinion.

 - The board cannot adopt an ostrich like approach. The board should be cognizant of any "red flags," and obtain necessary information and verify inadequate explanations.

 - It is critical that the Board be advised by outside counsel and a qualified financial advisor. In *IN RE RADOR CORP.*,¹⁵ the court in finding that the board complied with their fiduciary obligations noted particularly that the board received, reviewed and discussed a variety of financial projections as well as a range of options with its financial advisor.

 - If management is part of a buyer group or is otherwise "interested" in a transaction, the establishment of an independent committee is of critical importance. The interested management should be screened from deal negotiations. This could lead to potential conflict between management and the outside directors.

 - The special committee should obtain independent financial and legal advice without the influence of any interested person. The special committee, rather than the entire board, should choose its financial and legal advisors. Counsel and advisors that are behooved or selected by management should not be used.

¹⁴ *Prod. Res.*, 63 A.2d at 782.

¹⁵ *IN RE RADOR CORP.*, 353 B.R. 820 (Bankr. D. De. 2006).

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- If entrenchment of current management is a concern, independent analysis of a proposed transaction that might affect current management’s tenure (or promise or hints of continued tenure) should be conducted by the outside financial advisor. Management should not be allowed to handle negotiations solo or even participate in the deal if significant possibility exists of management’s self interest in entrenchment or retention by the buyer.¹⁶
 - Documentation of decision making is essential. Commentators have opined that NETSMART is essentially a “failure of documentation” case by noting that you never want a court to say about the board’s decision making process: “From there, things get fuzzy.”¹⁷
 - The special committee or the full board must be actively involved in exploring available strategic alternatives for the corporation.
 - Consider a range of strategic alternatives, including bankruptcy alternatives. It is often prudent for a distressed company to pursue a dual track reorganization strategy that includes an out-of-court sale, joint venture, equity or debt financing, restructuring strategy and a prepackaged chapter 11 plan and disclosure statement (which can be used to effectuate the restructuring should the out-of-court strategy fail).
 - Demonstrate affirmative director action by clearly documenting the board and committee’s use of outside financial advisor and counsel to advise them during their deliberations. Given the financial crisis, dynamic changes in valuation are present:
 - Buyers and sellers find it challenging to value a seller in distress
 - Metrics and multiples are in flux
 - Financial models for healthy companies may not be accurate and as such both going concern and liquidation valuation analysis should be prepared by the outside financial advisor
 - As enterprise value can decline precipitously, directors should act in a timely and deliberate manner.

CONCLUSION

The global financial crisis has presented corporate directors with increasingly challenging and perilous waters to navigate. Shareholders of household brands like Lehman, AIG and Merrill Lynch have learned that their stockholdings have little or no value. Inaction can lead to a rapid decline of enterprise value. In these times, directors of distressed companies could face heightened fiduciary obligations. Inaction

¹⁶ IN RE LEAR CORP. SHAREHOLDER LITIG., 926 A. 2d 94 (Del. Ch. 2007).

¹⁷ NETSMART, slip op. at p. 16.

in these troubled times could unnecessarily expose family office directors to personal liability as well as liability for the family office itself. In distressed situations, it is more important than ever for independent directors to rely upon independent, experienced and qualified financial and legal advisors to help navigate these troubled waters.

ABOUT HOLME ROBERTS & OWEN:

Holme Roberts & Owen LLP is a law firm with more than 250 attorneys in offices in Denver, Boulder, Colorado Springs, London, Los Angeles, Munich, Phoenix, Salt Lake City and San Francisco. With a strong commitment to its legal work and to client service, HRO represents companies of all sizes and industries across the United States and around the world in high profile business transactions and disputes.

Hendrik Jordaan, a partner based in the firm's Denver office, serves as Co-Chair of the firm's Corporate Group. He specializes in advising financial and strategic buyers and sellers in public and private mergers and acquisitions transactions (including distressed M&A). Mr. Jordaan serves as Chair of the American Bar Association Section of Business Law - Distressed Mergers & Acquisitions Task Force of the Committee on Mergers & Acquisitions. He is also the Chair of the M&A Subsection of the Colorado Bar Association's Section of Business Law.

ABOUT JD FORD & COMPANY:

JD Ford & Company is a specialized Investment Bank offering sophisticated solutions to both private and publicly-held companies in a variety of industries, including consumer products, specialty retail, building products, and specialized services throughout the United States. Since the Firm's founding in 1996, JD Ford & Company has consistently provided clients, operating throughout all phases of the business cycle, with a wide variety of professional services, including: Strategic & Financial Advisory Services, M&A Transaction Services, Business Valuation Services, and a wide array of Financing Solutions.

Joe Durnford, Senior Managing Director and CEO of JD Ford & Company, Investment Bankers and its affiliated companies. Mr. Durnford has over twenty years experience in corporate finance and has structured, negotiated and completed in excess of \$1 billion in mergers, acquisitions, divestitures and financing transactions. Mr. Durnford is also the founder and chairman of numerous private companies, and has served as audit and finance committee chairman for publicly listed corporations. Prior to founding JD Ford & Company in 1996, Mr. Durnford was a corporate finance and business consultant at the predecessor firms of Pricewaterhouse Coopers and Deloitte. Mr. Durnford earned a BSBA (Accounting) at the University of Colorado Leeds School of Business, is a Certified Public Accountant, a Certified Valuation Analyst, a Certified Merger & Acquisition Advisor, and holds Series 24, 27, 7 & 63 securities licenses.

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