Ethics: Debtor’s Counsel and Management Duties In Multiple-Company Cases

Ethics: Debtor's Counsel and Management Duties in Multiple-Company Cases

ABI - 8th Annual New York City Bankruptcy Conference (May 8, 2006) Presentation Outline
-By-
Matthew A. Cantor

1. Duties of Directors and Officers of Financially Solvent Corporation

(a) When a corporation is solvent, its directors and officers owe the following fiduciary duties to the company and its shareholders.

(i) Duty of Loyalty

(A) The duty of loyalty (i) requires directors and officers to act in good faith and in the honest belief that the action taken is in the best interests of the corporation and (ii) prohibits self-dealing.[1] The duty of loyalty mandates that the best interests of the corporation and its shareholders take precedence over any interest that is possessed by a director, officer, or controlling shareholder, but not shared by shareholders generally.[2]

(ii) Duty of Care

(A) Directors and officers must act in a fully informed and considered manner. Consistent with their duty of care, directors 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 ordinarily prudent person in a like position would use under similar circumstances.[3]

---

1 See, e.g., Radol v. Thomas, 772 F.2d 244, 256 (6th Cir. 1985); Norlin Copr. v. Rooney, Pace, Inc., 744 F.2d 255, 264 (2d Cir. 1984); Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

2 See Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993); Pogostin v. Rice, 480 A.2d 619, 624 (Del. 1984); Litt v. Wycoff, No. 19083-NC, 2003 Del. Ch. LEXIS 23, at *12-13 (Del. Ch. Mar. 28, 2003); see also Richard M. Cieri, et al., Protecting Directors and Officers of Corporations That Are Insolvent or in the Zone or Vicinity of Insolvency: Important Considerations, Practical Solutions, 2 DEPAUL BUS. & COM. L.J. 295, 297-98 (2004).

3 See, e.g., Aronson v. Lewis, 473 A.2d at 812; see also Cede & Co. v. Technicolor, Inc., 634 A.2d at 366-367; see also Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264, 274-75 (2d Cir. 1986) ("Directors may be liable to shareholders for failing to reasonably obtain material information or to make a reasonable inquiry."); Cieri, *supra* note, at 297.

(b) Business Judgment Rule

(i) Decisions made by directors are generally protected by the business judgment rule, which is a judicially created "presumption that in making a business decision, the director of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[4]

(ii) The protection of the business judgment rule will be lost upon a showing of any of the following, and the burden shifts to the director to prove the fairness of the challenged transaction[5]

(A) improper director interest in a transaction (if the transaction is not approved by a majority of disinterested directors)

(B) director self-dealing

(C) lack of good faith

(D) fraud.[6]

(iii) When the presumption of the business judgment rule is successfully rebutted, courts will apply the entire fairness standard when reviewing the challenged transaction.[7]

(A) When applying the entire fairness standard of review, the court independently evaluates the merits of the transaction to determine whether it was both procedurally and substantively fair.[8]

---

4 Brandt v. Hicks Muse & Co. (In re Healthco Int'l, Inc., 208 B.R. 288, 306 (Bankr. D. Mass. 1997)(quoting Aronson, 473 A.2d at 812); see also Norlin Corp., 744 F.2d at 264.

5 See Weinberger v. UOP, Inc., 457 A.2d 701, 711 (Del. 1983) (under "entire fairness" standard of review, directors must establish that the transaction in question was the product of fair dealing and resulted in a fair price).

6 Id.

7 Cede & Co. v. Technicolor, Inc., 634 A.2d at 361. A transaction between a corporation and a controller stockholder will be subject to the entire fairness standard. Weinberger v. UOP, 457 A.2d at 701.

8 Weinberger v. UOP, 457 A.2d at 701. Intrinsic fairness includes fair price and fair dealing. Fair dealing concerns questions of when the transaction was time, how it was initiated, structured, negotiated and disclosed to the directors and how the approvals of stockholders and directors were obtained. Fair price concerns the economic and financial consideration for the transaction, including all relevant factors, such as assets, market value, earnings and future prospects.

2. Fiduciary Duties upon Actual Insolvency or When the Company Enters the Zone of Insolvency

(a) In most jurisdictions, the fiduciary duties of directors and officers change if the corporation becomes insolvent[9] or enters what is called the "zone" or "vicinity" of insolvency.[10] When a company is actually insolvent, the fiduciary duties of directors and officers shift and run primarily (if not exclusively) to the corporation and its creditors.[11]

(i) This shift of duties from the shareholders to the creditors may occur before the corporation files a bankruptcy petition,[12] and continues to apply after the corporation is a debtor in bankruptcy proceedings.[13]

(b) Directors and officers also owe their fiduciary duties to creditors when a company is not yet insolvent, but in the "zone" or "vicinity" of insolvency.[14]

---

9 In general two standards are used to identify actual insolvency: (a) the "balance sheet" test and (b) the "equity" or "cash flow" test. A company is deemed "balance sheet" insolvent when the fair value of its liabilities exceeds the fair value of its assets. See, e.g., In re Koubourlis, 869 F.2d 1319, 1321 (9th Cir. 1989); In re Healthco Int'l, Inc., 208 B.R. at 301. A company is deemed equitably insolvent when it is unable to meet its debts as they come due in the ordinary course of business. See, e.g., MFS/SUN Life Trust-High Yield Series v. Van Dusen Airport Servs. Co., 910 F.Supp. 913, 943 (S.D.N.Y. 1995). In determining a corporation's solvency, a board must consider both tests. It is unclear whether the corporation would have to be found insolvent under both tests in order for fiduciary duties to shift to creditors, or whether the corporation being insolvent under only one test would suffice, but there is some support for the proposition that the fiduciary duties of a corporation's directors and officers shift if the corporation is insolvent under either test. See Pereira v. Cogan, 294 B.R. 449, 520 (S.D.N.Y. 2003) (interpreting Delaware law as stating that a corporation is insolvent if it is insolvent under either the balance sheet test or the cash flow test).

10 Courts have not articulated a clear definition of the "zone of insolvency." However, it is safe to say it describes a state of a company's affairs somewhere short of actual insolvency, but that provides reason to think that the company could be headed toward actual insolvency.

11 See Cieri, *supra* note 2, at 300; see also FDIC v. Sea Pines Co., 692 F.2d 973, 977 (4th Cir. 1982), cert. denied, 461 U.S. 928 (1983) (where board of directors of an insolvent corporation used its assets to secure a loan for the benefit of the parent company, the court held that the parent directly liable to the creditor, the court stated that "when the corporation becomes insolvent, the fiduciary duty of the directors shifts from the stockholders to the creditors."); First Options of Chicago v. Polonitza, No. 88 C 2998, 1990 WL 114740 (N.D. Ill. 1990) (upholding jury verdict that director was liable for breach of fiduciary duties to corporation's creditors by improperly approving the cancellation of loans to director's son, while corporation was insolvent); California Pollution Control Financing Auth. v. Agajanian, 990 F.2d 1256, 1993 WL 120550, at 2 (9th Cir. 1993) (unpublished table decision) ("As a director, [the defendant's] fiduciary duty ran to the corporation and, after insolvency, its creditors"; applying California law).

12 See, e.g., Credit Lyonnais; Geyer v. Ingersoll Publ'ns Co., 621 A.2d 784, 87 (Del. Ch. 1992).

13 See Cieri, *supra* note 2, at 300-01 (citing Unsecured Creditors Comm. of STN Enter., Inc. v. Noyes, 779 F.2d 901,904 (2d Cir. 1985).

(i) Generally, directors and officers of a corporation in the "zone" or "vicinity" of insolvency have an obligation to the "community of interest that sustained the corporation to exercise judgment in an informed, good faith effort to maximize the corporation's long-term wealth creating capacity."[15]

(c) Generally, directors and officers of corporations that are insolvent or in the "zone of insolvency" are subject to the same duties of loyalty and care to creditors as those that run to stockholders when the corporation is solvent.[16]

(i) Courts have held that directors and officers should still be entitled to the protections of the business judgment rule when the corporation is insolvent or in the "zone" or "vicinity" of insolvency.[17]

(ii) Other Courts have held that the business judgment rule does not apply under the theory that the directors and officers become "trustees" for the creditors when the corporation becomes insolvent or enters the "zone of insolvency."[18]

(iii) Due to this uncertainty, in order to minimize their exposure to liability, directors and officers of a corporation that is insolvent or in the "zone of insolvency" should exercise an abundance of caution by assuming that the business judgment rule will not apply, and that they will have to defend their actions under the much more rigorous entire fairness standard.[19]

---

14 See, e.g., Pereira v. Cogan, 294 B.R. 449, 519-20 (S.D.N.Y. 2003).

15 See Credit Lyonnais Bank Nederland, N.V. v. Pathe Comm. Corp., No. 12150, 1991 Del. Ch. LEXIS 215, at *108-109.

16 In re O.P.M. Leasing Services Inc., 28 B.R. 740 (Bankr. S.D.N.Y. 1983)).

17 See In re Hechinger Inv. Co. of Del. 327 B.R. 537, 549 (D.Del.,2005); Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 788 & n. 53 (Del. Ch. 2004) (Because insolvency does not change "the primary object of the directors' duties, which is the firm itself", "the business judgment rule remains important and provides directors with the ability to make a range of good faith, prudent judgments about the risks they should undertake on behalf of troubled firms."); Angelo Gordon & Co., L.P. v. Allied Riser Comm. Corp., 805 A.2d 221, 229 (Del. Ch. 2002) (holding as a "preliminary view" that the business judgment presumption is available in the zone of insolvency).

18 See e.g., Geren v. Quantum Chem. Corp., No. 95-7454, 1995 U.S. App. LEXIS 39912, at *3 (2d Cir. Dec. 13, 1995) (nothing that "[u]nder New York law, directors of a corporation may become trustees of the creditors when the corporation is insolvent"); Automatic Canteen Co. of Am. v. Wharton, 358 F.2d 587, 590 (2d Cir. 1966); see also Cieri, *supra* note 2, at 304.

19 See id.

3. Duties in Multiple-Company Cases

In cases involving multiple debtors, inter-creditor issues may arise, which require the debtors' fiduciaries to consider the varied interests of each of the constituencies.

(a) Directors and officers of financially distressed corporations must consider the ramifications of their business decisions on all those with an interest in the corporation, this includes decisions which may favor shareholders over creditors, or which favor one creditor over another creditor.

(b) Individual debtors in multi-debtor cases frequently, if not always, have actual or arguable obligations to each other.

(i) Debtors who lent money to a co-debtor, transferred funds or other assets to a co-debtor, provided to or obtained services from a co-debtor, etc. are effectively creditors of another debtor.

(ii) Creditor recoveries in multi-debtor situations will depend on how the debtors resolve these inter-creditor disputes.[20]

(c) Directors and officers of corporations involved in multi-debtor bankruptcy proceedings must recognize the nature and extent of their fiduciary duties. Unfortunately, there is very little case law discussing the fiduciary duties of directors and officers in the context of inter-creditor disputes. However, these issues were recently addressed in <u>In re Adelphia Comm. Corp.</u>[21] (the "Adelphia Decision").

(i) After commencing their bankruptcy cases, Adelphia and certain of its subsidiaries were forced to restate their accounting records due to fraud and widespread mismanagement. This restatement revealed numerous inter-company obligations, which led to disputes amongst the creditors of each of the subsidiaries. The failure to resolve these disputes began to jeopardize a sale of Adelphia's assets. As litigation amongst the creditors continued, the noteholders of Arohova, one of Adelphia's subsidiaries filed a motion seeking an order:

---

20 As the bankruptcy court discussed in the Adelphia Decision (defined below), these disputes can be characterized as "inter-debtor" or "inter-creditor" disputes. However, it makes more sense to characterize them as "inter-creditor" disputes, as it is the creditors of the respective individual debtors who are directly affected by those debtors' asset-liability mix, and who normally negotiate out (or, in some cases, litigate) the controversies that affect their particular recoveries.

21 <u>In re Adelphia Comm. Corp.</u>, 2006 WL 177159 (Bankr. S.D.N.Y. Jan. 23, 2006). The Adelphia Decision contains a summary of inter-debtor disputes in other cases which demonstrates the limited amount of case law on these issues.

- (directing the appointment of a chapter 11 trustee, or, in the alternative, a non-statutory fiduciary for Arahova;

- directing the recusal of directors and officers of Arahova and its operating company subsidiaries;

- disqualifying the Adelphia Debtors' counsel, Willkie Farr & Gallagher ("WF&G"), from representing them in the inter-creditor disputes; and

- terminating exclusivity.

(ii) In the Adelphia Decision, the bankruptcy court denied the motion for appointment of a trustee or non-statutory fiduciary and did not terminate exclusivity.

(iii) The bankruptcy court did direct the recusal of Arahova's officers and directors and disqualified WF&G from representing the Adelphia Debtors in connection with the inter-creditor disputes.

(iv) The Adelphia Decision highlighted a number of key strategies implemented by the Adelphia Debtors in dealing with the inter-creditor issues. The Adelphia Debtors brought the inter-creditor issues and the uncertainties concerning their resolution to the attention of the creditor groups involved at an early stage in the case.[22] The bankruptcy court noted that it was sensible and "hardly a breach of fiduciary duty" for the Adelphia Debtors to use a motion to establish procedures for resolving inter-creditor disputes to tee up these disputes up for judicial determination and to step aside while the affected creditors litigated the issues.

(v) If the Adelphia Debtors had taken sides in a way that injured one or another of the estates to whom they owed their duties of loyalty, that would result in at least the appearance of impropriety, quite possibly the reality of impropriety. The key lesson to be learned from the Adelphia Decision is that directors and officers of debtors involved in inter-creditor disputes should remain impartial in order to avoid breaching their fiduciary duties which are owed to all creditors.

[22] Id. at 10.