As discussed in the previous chapter, distress or insolvency do not change the nature of a director’s fiduciary duties, but they do increase the number of constituencies that directors must consider in their decision-making. Although a director’s role in governance may be terminated due to the decision to liquidate or because of misconduct, corporate distress or insolvency alone does not change a director’s duties to oversee the affairs of the corporation. Even after filing for reorganization, directors retain the authority to manage the affairs of the corporation and their obligation to manage it consistent with their fiduciary duties. There is no obligation on the part of the director to cease the corporation’s operations and liquidate. Absent a conflict of interest, director decision making will be reviewed under the business judgment rule, meaning that decisions short of “waste” will not be the source of liability.

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Directors May Remain in Control, or Not

A reorganization under Chapter 11 of the Bankruptcy Code presumes that the debtor’s business will continue to operate and that the debtor (and its directors) will remain in possession and control of its assets as a “debtor in possession.” Nonetheless, the continuing directors of a reorganizing debtor will likely find that the board’s role is circumscribed by the realities of a reorganization proceeding. First, because the debtor’s board must submit all nonordinary course business decisions to the bankruptcy court for review and approval, the bankruptcy court supervision is constant. Second, during a reorganization the board typically retains and places heavy reliance upon outside “restructuring professionals,” such as chief restructuring officers, bankruptcy lawyers, investment bankers, and others. Third, the debtor’s creditors are involved in governance. Debtors will typically agree to conditions in debtor-in-possession (DIP) financing that tightly cabin the discretion of the debtor’s management. Creditors also have standing to challenge the debtor’s decisions in bankruptcy court.

Insolvency can lead to situations in which the directors are removed from any significant corporate governance role. When a company liquidates under Chapter 7 of the Bankruptcy Code, a trustee is appointed to sell the debtor’s assets and use the proceeds to pay the debtor’s creditors; there is no job for the directors to perform. Similarly, the appointment of a receiver under state corporation law will typically end the board of director’s role in corporate governance. In a Chapter 11 reorganization, the debtor’s creditors may seek the appointment of a Chapter 11 trustee to manage the debtor’s affairs if there is evidence that the debtor’s management has engaged in fraud or other misconduct. The appointment of the Chapter 11 trustee will end the board’s role in governance.

Recurring Conflict of Interest Scenarios

When directors remain in control, distress and insolvency can give rise to conflicts of interest that can infect director decision-making and subject a board’s decision to attack. Some recurring conflict of interest flashpoints are described in the next sections.

Continued Employment by the Corporation

Continued employment by the corporation can create a conflict of interest. Delaware law presumes that a director does not have a material interest in remaining a director, with limited exceptions. And the receipt of ordinary directors’ fees will generally not create a conflict of interest for a director. However, where a director is an employee of the company as well as a director, the director likely has a material interest in the director’s continued employment, unless neither the job nor the compensation received is material to the director. Where a director has a material interest in ongoing employment, the director suffers a conflict of interest wherever the director is asked to make a decision potentially affecting the director’s employment. The director also suffers a conflict of interest with respect to any transaction in which someone with control over the director's employment, such as a controlling stockholder, has an interest. Such conflicts may easily arise where the corporation is in financial distress, if, for example, the board considers whether to liquidate the corporation or to engage in a merger or other transaction that would foreseeably affect the employment of the director.
Conflicts between Companies within a Corporate Family

When one member of a corporate family is in financial distress the interests of that corporation may differ materially from the interests of other members of the corporate family, which may be stockholders, creditors, or potential acquirers of assets from the financially troubled corporation. A director or officer may face a conflict of interest where the individual serves as a director or officer of multiple entities within the corporate family.

When a wholly-owned subsidiary is solvent, it may be managed exclusively for the benefit of its parent entity. Directors do not breach fiduciary duties when they cause a wholly-owned, solvent, subsidiary to engage in transactions with the subsidiary's parent that are disadvantageous to the subsidiary. Such transactions may include transferring assets to a different subsidiary of the same parent, allowing the parent to use the subsidiary’s assets to secure a loan to the parent, or entering into service agreements with the parent or other subsidiaries of the parent that are not set at a market rate.

But, when a wholly-owned corporation becomes insolvent, its dealings with its parent entity may be subject to greater scrutiny. This shift is the result of creditors becoming residual interest holders. At that point, the creditors, not the controlling stockholder, pay the price of any lopsided transactions between the subsidiary and its parent.

Thus, insolvency curtails the freedom that a parent has to engage in transactions with its subsidiaries. As a result, directors of an insolvent subsidiary must scrutinize transaction between the parent and affiliates for fairness to the subsidiary itself. In these situations, it may be prudent to appoint directors to the subsidiaries board that are independent of the parent and for the board of the subsidiary to obtain its own advisors.

Personal Financial Interest in Distressed Company

Directors’ ownership of stock of the corporation on whose board they serve is ubiquitous. Outside of bankruptcy, a director’s ownership of stock generally does not give rise to a conflict of interest, because generally the stockholders’ interests are aligned with the corporation’s interests and the beneficiary of the directors’ fiduciary duties.

When an insolvent corporation's interests diverge from those of its stockholders, stock ownership may present a conflict of interest for directors. Similarly where a transaction is beneficial or detrimental to various classes of a corporation’s equity, a director’s financial interest can present a conflict. These types of conflicts may well emerge in times of financial distress despite not existing previously.

Ties to a Controlling Shareholder or Creditor

Perhaps the most common conflict of interest that a director may suffer arises where the director has ties to a creditor of the corporation or to the controlling stockholder of the corporation. In either case, the director’s lack of independence from the creditor or controlling stockholder creates a conflict of interest for the director wherever the interests of the creditor or the controlling stockholder differ from those of the corporation.

Other Business Dealings with the Distressed Company

Directors and officers will also suffer a conflict of interest with respect to their management of a financially troubled corporation in any other situation in which their interests differ from
those of the corporation or its stockholders generally. Thus, for example, where a financially troubled corporation sells assets in an effort to repair its balance sheet, its directors will have a conflict of interest if they are affiliated with the buyer of the corporation’s assets.

In a refinancing or recapitalization, it is not unusual for the new capital to come from someone who already has a position in the troubled company’s capital structure. This can create conflicts of interest to the extent the new financing impairs the position of the other members of the capital structure.

Key Questions

When considering how to meet the duties of care and loyalty, key questions that a board member of a distressed corporation might ask include the following:

- How close to insolvency is the corporation?
- Do the managers have a sense of what “runway” exists before insolvency becomes inevitable?
- What has management done to monitor the liquidity and financial position of the corporation?
- What is the corporation’s debt structure and who are the corporation’s largest creditors? How reliable are the sources of that information? Do any of the individuals providing it (e.g., management) have a personal interest that I should be aware of?
- Is the corporation receiving advice on addressing its financial distress (out-of-court restructuring, prepack, reorganization, asset sale in bankruptcy)?
- Are there potential conflicts of interest between stockholder and creditors? Is the controlling stockholder also a creditor?
- Do I or any of my fellow board members have experience with distressed situations? Should we bring in some additional directors with that experience?
- Have we considered hiring a restructuring firm or chief restructuring officer?
- What effect would filing for reorganization have on our business operations?

Additional Reading

