DORSEY™
always ahead

2017

What Executives Should Know When Their Company Is on the Brink

A Resource for Officers and Directors

What Executives Should Know When Their Company Is on the Brink

A Resource for Officers and Directors

Stephen O'Neill, Partner, Dorsey & Whitney LLP
Thomas Hwang, Associate, Dorsey & Whitney LLP

Contributing Editors
Jessica McKinlay, Of Counsel, Dorsey & Whitney LLP
Robert Franklin, Of Counsel, Dorsey & Whitney LLP

© Copyright Dorsey & Whitney LLP

TABLE OF CONTENTS

Fiduciary Duties of the Board of Directors 1
- What Is a Director's Fiduciary Duty? 1
- The Business Judgment Rule 1
- To Whom Do Directors Owe Fiduciary Duties? 1
- When Is a Corporation Insolvent? 1
- The Independent Tort of "Deepening Insolvency." 2

Potential Personal Liability of Directors and Officers of an Insolvent Corporation 2
- Unpaid Wages and Compensation Owed to Employees 2
- Failure to Withhold and Pay Over Federal Employee Taxes 2
- Willful Failure to Pay Contribution or Withholding for Unemployment, Workers' Compensation and Disability Taxes/Contributions 2
- Failure to Maintain Workers' Compensation Insurance 2
- Willful Failure to Pay Sales and Use Taxes 2
- Issuance of "Bad" Checks 2
- Unlawful Payment of Dividends 3
- Plan Contributions Under ERISA Plans 3
- Termination of a Single-Employer Plan Under ERISA 3
- CERCLA Responsible Party Liability 3
- Securities Laws 3
- Trade Creditors 3
- Guaranty of Corporation Obligations 3
- Americans With Disabilities Act of 1990 ("ADA") 3
- Perishable Agricultural Commodities Act ("PACA") 4
- Packers and Stockyards Act 4

Practical Measures the Board MAY Consider 4
- Creditor and Shareholder Liabilities 4
- Tax and Insurance Obligations 4
- Employees 5

Business Termination Alternatives 5
- Bankruptcy – Chapter 11 (Reorganization) 5
- Bankruptcy – Chapter 7 (Liquidation) 6
- Formal Dissolution Pursuant to Section 280 Under Delaware Law 7
- Informal Wind Down 7
- Assignment for Benefit of Creditors 7

Additional Issues The Board Should Consider 7
- How Can a Corporation Defend Itself Against Creditor Action? 7
- What Happens to the Corporation's Directors' and Officers' Liability Insurance in Bankruptcy? 8
- For Whose Benefit Is the Corporation's Attorney-Client Privilege? 8
- Scope of Representation by Debtor's Counsel 8
- Special Counsel 8

Fiduciary Duties of the Board of Directors

What Is a Director's Fiduciary Duty?

Directors of a corporation must act in the best interests of the corporation and its shareholders. The laws of the state of incorporation determine the duties owed by the directors. Directors owe duties of obedience, care and loyalty to the corporation. The duty of obedience prohibits activities outside of the bylaws, articles of incorporation and applicable law. The duty of care incorporates the business judgment rule and requires directors to act as prudent business people under similar circumstances, to be informed upon reasonable inquiry, to consider alternative solutions and to act in good faith. The duty of loyalty requires directors to protect the interests of the corporation and prohibits self-dealing and usurping corporate opportunities.

The Business Judgment Rule

The discretionary decisions of directors in the day-to-day management of a corporation are protected by the business judgment rule. This rule protects directors if they act on an informed basis, in good faith and in the honest belief that the decision or action taken is in the best interest of the corporation. There is a rebuttable presumption that actions of directors (but not officers in some states) fall within the business judgment rule.

To Whom Do Directors Owe Fiduciary Duties?

Directors of a corporation owe fiduciary duties to the corporate enterprise, but the constituents of the corporation will evolve depending on the financial state of the corporation.

1. **Solvent Corporation:** Directors owe fiduciary duties to the corporation, the constituents of which are its shareholders but not its creditors.
2. **Insolvent Corporation:** Upon insolvency, the directors continue to owe a duty to maximize value of a business enterprise; however, the constituency on whose behalf the directors must act are all residual interest holders, which now includes creditors.
3. **Delaware Law (Corporations Organized in Delaware):** Under Delaware law, when a corporation is insolvent, its creditors become residual beneficiaries or risk bearers and, therefore, may bring derivative, not direct, claims against directors as the principal constituents injured by breach of their fiduciary duties to the corporation.
4. **Multiple Constituents:** In the gray area between solvency and insolvency, directors may have obligations to multiple constituencies with divergent interests. In this gray "zone of insolvency," some courts have held that directors must consider the interests of both stockholders and creditors in making corporate decisions (that is, all constituents must be treated fairly). However, the trend, including in Delaware and California, is that there is no change – directors still must exercise their business judgment in the interests of the corporation as a whole.

When Is a Corporation Insolvent?

A corporation is insolvent when:

1. **Equitable Insolvency Test**: The corporation cannot meet its debts as they mature.
2. **Balance Sheet Test**: The fair market value of the corporation's assets is less than the corporation's liabilities. This test involves a modified balance-sheet test - GAAP does NOT control. Balance sheet assets and liabilities must be adjusted to reflect "fair

valuation." The case law provides that the fair value of property is determined by estimating what the debtor's assets would realize if sold in a prudent manner in current market conditions and not necessarily at a fire sale.
3. **Insufficient Capital Test**: This type of insolvency is often alleged to have occurred because of a simple transaction or a series of related transactions. The classic example is an over-leveraged leveraged buyout.

Directors must also consider contingent liabilities and other circumstances which, even if not reflected on the balance sheet, may reduce the net worth of the enterprise. The Bankruptcy Code's definition of "insolvent" refers to "debts," which includes any "liability on a claim." A "claim" is broadly defined to include contingent and unliquidated (dollar value yet to be determined) obligations that might not appear on a balance sheet.

The Independent Tort of "Deepening Insolvency"

Some courts have acknowledged a claim by the corporation against its directors, officers, lenders and/or professionals for "deepening insolvency" which may arise when such individuals contribute to the corporation's failure to timely dissolve in a manner to maximize value, in lieu of staying in operation with spurious debt. However, the current trend is not to recognize deepening insolvency as an independent tort but, in some instances, to merely apply it in the measure of damages.

Potential Personal Liability of Directors and Officers of an Insolvent Corporation

Directors and officers of an insolvent corporation may be personally liable for many specific actions:

1. **Unpaid Wages and Compensation Owed to Employees**. The risk of personal liability for directors and officers is greatest if they continue to allow employees to work after the point when such directors and officers know that the corporation does not have sufficient funds to pay the employees' accrued wages. In such a situation, the employees will be deemed to have relied on the employer's false representation that the employer can pay wages, and the directors and officers could be found liable for fraud or intentional misrepresentation.
2. **Failure to Withhold and Pay Federal Employee Taxes**. An employer must withhold from an employee's wages income and social security taxes and then pay over the withheld taxes (known as "trust fund taxes") based on a deposit schedule. The Internal Revenue Code imposes a penalty equal to the tax on the responsible persons -- those persons with a duty to collect and pay the trust fund taxes -- who willfully fail to collect such tax or to truthfully account and pay over such tax. A responsible person can include corporate officers, board members, controllers and others who sign checks or have authority to cause the spending of business funds.
3. **Willful Failure to Pay Contribution or Withholding for Unemployment, Workers' Compensation and Disability Taxes/Contributions.** Various states impose personal liability for failing to pay contribution or withholdings for unemployment, workers' compensation or disability taxes.
4. **Failure to Maintain Workers' Compensation Insurance.** Various states impose personal liability for failure to maintain workers' compensation insurance.
5. **Willful Failure to Pay Sales and Use Taxes.** Various states impose personal liability on individuals responsible for filing tax returns, or who control or supervise a person filing tax returns, for the willful failure to pay sales and use taxes.
6. **Issuance of "Bad" Checks.** Officers and directors can be liable in various states for willfully and knowingly issuing a check where there is insufficient cash or credit to pay the check.

and knowingly issuing a check where there is insufficient cash or credit to pay the check.

7. **Unlawful Payment of Dividends.** Under the Delaware General Corporation Law, in the event of dissolution or insolvency, directors are jointly and severally liable for the willful or negligent unlawful payment of dividends or stock redemptions. Under the Delaware General Corporation Law, payment of dividends is unlawful when the capital of the corporation is less than the aggregate capital represented by the issued and outstanding stock of all classes having a preference upon distributing assets.
8. **Plan Contributions Under ERISA Plans.** ERISA fiduciary liability attaches if (1) the ERISA plan expressly designates a person as a fiduciary (as the plan administrator, plan trustee, or member of an administrative committee); or (2) a manager performs a function that ERISA deems a fiduciary function (such as discretionary authority or control over the administration and management of the plan or plan assets; or the rendering of investment advice for a fee or other compensation). If a person is determined to have a fiduciary duty, then personal liability attaches and the fiduciary is personally liable to make good the losses to the plan.
9. **Termination of a Single-Employer Plan Under ERISA.** Under ERISA, joint and several liability is imposed on members of a "controlled group" of a corporation that is a contributing sponsor of a single-employer retirement plan upon termination of the plan in certain circumstances. This liability is usually a concern in the large corporate setting where there are large pension and retirement plans.
10. **CERCLA Responsible Party Liability.** This federal statute authorizes the EPA to investigate and clean up hazardous waste sites and to recoup clean-up costs from potentially responsible parties. The definition of potentially responsible parties is broad and may include officers and directors.
11. **Securities Laws.** Directors and officers must be mindful of the federal and state laws enforced by different governmental regulatory agencies, besides rules such as listing requirements of exchanges like the New York Stock Exchange and regulations of organizations like the Financial Industry Regulatory Authority. Directors and officers can incur personal liability under securities laws for selling their stock in the corporation prior to public disclosure of the corporation's problems. Stock offerings by the corporation without adequate disclosures can also result in personal liability for the officers and directors.
12. **Trade Creditors.** There is no liability of officers and directors for unpaid debt incurred by a corporation, unless the creditor has obtained a guaranty. However, it is possible for a disgruntled creditor to make a claim on a fraud or an intentional misrepresentation theory, in which case the creditor must prove:
    a. a knowing or intentional misstatement;
    b. the misstatement is material;
    c. the creditor reasonably relies on the misstatement; and
    d. the creditor is damaged.
    e. In addition, a creditor may seek to make a claim based on a deepening insolvency theory (if available in the applicable jurisdiction).
13. **Guaranty of Corporation Obligations.** An officer or director may be personally liable for a corporate debt if he or she has guaranteed the debt. An officer or director is presumed to be aware of whether he or she has guaranteed a debt. Officers are advised to review all documents they may have signed (such as all equipment and property leases) to make certain that no such guaranty was included. Officers and directors should determine if the corporation has any credit card balances and whether employees are personally liable for the charges.
14. **Americans with Disabilities Act of 1990 ("ADA").** Courts are split regarding the extension

only where the individual is acting in an official capacity. In the Ninth Circuit, some courts have explicitly stated that the ADA does not impose individual liability on employees.

15. **Perishable Agricultural Commodities Act ("PACA").** PACA provides that proceeds from the sale of any perishable agricultural commodity, and intermediate products and proceeds from their sale, will be held in trust for the benefit of an unpaid supplier. Individual shareholders, officers, or directors may be held personally liable under PACA.
16. **Packers and Stockyards Act.** Similar to PACA, this federal statute imposes trust protections on proceeds received from the sale of poultry and livestock and products derived therefrom. Individuals may be liable for a violation of any of its provisions.

Practical Measures the Board May Consider

To fulfill its fiduciary duties, the Board should, with respect to:

Creditor and Shareholder Liabilities

1. Understand its fiduciary duties owed to the corporation and be cognizant that the body of constituents holding residual interests may evolve because of changes in the corporation's financial status.
2. Investigate and evaluate the primary strategic alternatives to maximize value for all constituents.
3. Obtain, with management's assistance, the information to evaluate alternatives properly.
4. Analyze the tradeoffs implied by each strategic alternative between creditors' interests and shareholders' interests, with an eye towards the community of interests as a whole.
5. Obtain the advice of counsel, including insolvency counsel.
6. Confirm that the record reflects a sufficiently deliberative process and that the Board is aware of its duties to the business enterprise, including shareholders and/or creditors.
7. Thoroughly scrutinize actions implemented to increase shareholders' value but that also put creditors at risk.
8. Refrain from giving preference to one creditor or one class of creditors over another.
9. Closely examine and consider transactions that would constitute a preferential payment.
10. Exercise care in approving transactions that leave a corporation inadequately capitalized even if the corporation is solvent.
11. Scrutinize all insider transactions.
12. Prepare a wind down budget and preserve cash that allows the corporation to wind down or liquidate in an orderly fashion rather than a fire sale.
13. Document specifically fund-raising efforts and alternatives to financings (such as a merger, asset sale or reduction of operations to conserve cash).
14. Assess liabilities, both known and contingent, and the fair value of both tangible assets and intangible assets (for example, technology or supplier/customer relationships).
15. Assess the likelihood of claims regarding breach of fiduciary duties.
16. Confirm that indemnification agreements are in place (but note that unless adequate directors' and officers' insurance policies ("D&O policies") are in place, an insolvent corporation is unlikely to satisfy its indemnity obligations to directors and officers).
17. Review exculpatory provisions in the by-laws.

Tax and Insurance Obligations

1. Confirm that all tax obligations (such as franchise taxes, sales and use taxes, and withholding

obligations) are paid in full.
2. Confirm that all insurance policy premiums are paid, including D&O policy premiums. Also consider logistics and timing of policy renewals.
3. Review all healthcare insurance policies (that is, determine when such policies will terminate and consider COBRA ramifications).

Employees

1. Determine vacation benefits and similar payment obligations owed to employees as a matter of policy (that is, review employment agreements, employee handbook and accrued but unpaid wages).
2. Comply with the federal and state WARN Act, if applicable (that is, give at least 60 days' notice of termination or pay salary and benefits in lieu of any portion of that period for which notice has not been given).
3. Consider additional severance as an incentive for employees to sign separation agreements.
4. Consider adopting a severance plan to limit employee claims.
5. Decide whether to terminate the corporation's 401(k) Plan. Under the Bankruptcy Code, if a corporate debtor is the administrator of an employee benefit plan, the debtor in possession or trustee must fulfill the administrator's obligation to wind up the plan. Failure to either terminate the benefit plan or to successfully wind up the plan could expose directors and officers to additional liability.
6. Refrain from paying bonuses or other unusual payments to executives, directors and shareholders.
7. Make arrangements with the payroll service provider to issue W-2's and file final payroll tax returns once the tax year ends.

Business Termination Alternatives

The following are various business termination alternatives a distressed corporation may consider.

Bankruptcy – Chapter 11 (Reorganization)

If a corporation commences a case under Chapter 11 of the Bankruptcy Code, the corporation continues to control the liquidation of assets and satisfaction of creditor claims. Board approval is required to commence a Chapter 11 case. Shareholder approval is not necessary unless it is required by the company's articles of incorporation or bylaws. Distribution of assets takes place after a plan is confirmed by the Court and approved by creditors. Once a plan is filed, the approval process typically takes 90-120 days. A plan is usually not filed for at least four to six months after the case is filed.

Pros: Under Chapter 11, the corporation (i) may complete a sale of substantially all of its assets, while still continuing operations, maintaining going concern value, and retaining employees; (ii) is more familiar with its assets and creditors, making the process more efficient and potentially providing a higher return on a sale; (iii) can "reject" burdensome and expensive contracts and leases and can assume and transfer valuable contracts and leases; (iv) can cap landlord claims to the greater of one year's rent or 15% of the remaining term not to exceed 3 years; (v) receives the benefit of the automatic stay; and (v) has the option of reorganizing, not only liquidating.

Cons: Chapter 11 (i) is expensive and legal fees can range from tens of thousands of dollars to several hundreds of thousands of dollars or more, depending on the size and complexity of the case; (ii) requires management/employee time; (iii) requires the corporation to pay ongoing costs (process could take one to two years to complete); and (iv) will likely take at least one year before any claims are paid (including unpaid salaries and wages – when a distribution is made, unpaid salaries and wages will receive priority over other general unsecured creditors only up to $12,850[1] per employee earned in the 180-day period prior to filing).

Bankruptcy – Chapter 7 (Liquidation)

If a corporation commences a case under Chapter 7 of the Bankruptcy Code, a bankruptcy trustee is immediately appointed. Board approval is required to commence a Chapter 7 case. Shareholder approval is not necessary unless it is required by the company's articles of incorporation or bylaws. The meeting of creditors usually takes place within four weeks of filing the case.

Pros: Chapter 7 (i) does not require employees to remain available during the liquidation process; (ii) is typically less expensive than Chapter 11; (iii) limits landlord claims to the greater of one year's rent or 15% of the remaining term not to exceed three years; (iv) can "reject" burdensome and expensive contracts and leases and can assume and transfer valuable contracts and leases; (v) establishes an automatic stay; and (vi) provides the ability to sell assets free and clear of liens, claims and encumbrances.

Cons: Chapter 7 (i) is likely to take at least two years before any claims are paid; (ii) the corporation has no control over the liquidation of assets and satisfaction of creditor claims; (iii) though usually less expensive than Chapter 11, will still be expensive if the matter is complex because trustee and trustee's professionals will need to be paid; (iv) involves only liquidation and not reorganization; and (v) generally has a greater risk than Chapter 11 to involve litigation.

Assignment for Benefit of Creditors

An assignment for the benefit of creditors, commonly referred to as an "ABC," is a state law remedy that provides for the appointment of an entity ("Assignee") to act as a fiduciary for creditors. Thirty-five states allow for some form of an ABC. The decision to undertake an assignment must be approved by both the board and shareholders. The Assignee is similar to a chapter 7 trustee and is responsible for liquidating the assets of the business and distributing proceeds to creditors.

Pros: In an ABC (i) management selects the Assignee; (ii) the Assignee is usually more efficient than a Chapter 7 trustee; (iii) a sale of assets may be consummated expediently since the assignee is not bound by the procedural requirements applicable in a bankruptcy case, the assignee has fewer cases than a Chapter 7 trustee and the assignee typically is more experienced in selling assets; (iv) distributions to creditors will usually take place earlier than in a chapter 11 or chapter 7 case; and (iv) expenses are usually less than a chapter 7 or chapter 11 bankruptcy thus resulting in a higher return to creditors. .

[1]Dollar amounts are adjusted every 3 years.

Cons: In an ABC (i) an upfront retainer will be required; (ii) there is no automatic stay; (iii) there is no statutory cap for landlord claims; (iv) can only provide for a liquidation not a reorganization; (iv) the assignee typically cannot sell free and clear of liens which necessitates the cooperation of secured creditors; and (v) typically, there is no ability to force transfers of leases and contracts without consent of the contract counterparty.

Formal Dissolution Pursuant to Section 280 under Delaware Law

Notice to creditors (60-day notice period) must be provided. At the end of the notice period, if claims exceed assets, creditors are paid on a pro rata basis.

Pros: Formal dissolution pursuant to Section 280: (i) provides protection to officers and directors, but not as much as bankruptcy; (ii) generally takes three to six months, but can take up to three years; (iii) is less expensive than a bankruptcy or an ABC; and (iv) allows the corporation to control the liquidation of assets and payment to creditors.

Cons: Formal dissolution pursuant to Section 280: (i) requires continued involvement by someone at the corporation and could require a significant amount of work; (ii) does not have the benefit of the automatic stay that applies in bankruptcy so there is nothing to stop creditors from filing suits; (iii) cannot "cap" a landlord's claim; (iv) requires various corporate filings and actions (i.e., franchise tax clearance, termination of corporate status in various states, filing of income tax returns) which are not required in a bankruptcy; and (v) does not provide the optics of an independent tribunal or administrator managing the process.

Informal Wind Down

The corporation identifies all known liabilities and attempts to settle with each potential creditor. This is a process not governed by statute or common law, but is conducted informally.

Pros: The informal wind down process will likely be shorter and less expensive.

Cons: The informal wind down process (i) requires continued involvement by someone at the corporation and could require a significant amount of work; (ii) increases the risk that claims will be asserted against officers and directors by creditors; (iii) does not preclude creditors from filing suit at any time (no automatic stay), or even filing an involuntary bankruptcy; (iv) cannot "cap" a landlord's claim; and (v) does not provide the optics of an independent tribunal or administrator overseeing and managing the process.

Additional Issues the Board Should Consider

How Can a Corporation Defend Itself Against Creditor Action?

1. Probably the most common action an unsecured creditor can take is to file suit and move for a writ of attachment. This can be done with very little notice to the corporation. The result may be that the attachment lien blocks the corporation's access to its bank accounts and accounts receivable which are vital to its survival. Almost every creditor remedy can be reversed in a bankruptcy case initiated within 90 days of the creditor action, as can the attachment of bank accounts and accounts receivable, but these "cash" assets may be inaccessible to the corporation in the interim.
2. The most obvious way to avoid the consequences of creditor enforcement action is to

commence a bankruptcy case and obtain the benefits of the "automatic stay".

3. In the informal workout context, some debtors grant a security interest to a third party as trustee for all of its creditors preventing the uncooperative creditor from advancing its position with a writ of attachment.
4. "Out of court" workouts can succeed. The keys to a successful "out of court" workout are maintaining open communication with creditors and treating creditors as they would be treated in a bankruptcy.

What Happens to the Corporation's Directors' and Officers' Liability Insurance in Bankruptcy?

1. D&O policies are property of the bankruptcy estate subject to the automatic stay. A split of judicial authority exists regarding whether proceeds of policies are property of the estate. The outcome usually turns on who is the named insured under the policy. There are three basic types of coverage in a typical D&O policy: (1) "Side A" coverage extends to officers and directors directly; (2) "Side B" coverage extends to the corporation, but only if it has indemnified officers and directors; and (3) "Side C" coverage protects the corporation from claims.
2. Where a D&O policy provides only individual liability coverage to officers and directors, the proceeds of the policy are not property of the bankruptcy estate. Where a D&O policy provides entity coverage to the debtor corporation and individual liability coverage to officers and directors, the proceeds of the policy are property of the bankruptcy estate.
3. Courts are split on whether policy proceeds are property of the bankruptcy estate when the policy provides individual liability coverage to officers and directors and indemnity coverage to the debtor.
4. Where the D&O policy covers both the debtor corporation and the officers and directors, and the proceeds cannot cover all defense costs and potential claims, some have suggested that, because allocation of insurance proceeds under insurance law may counter equitable distribution contemplated in bankruptcy, the bankruptcy court apportion the policy proceeds among the policy beneficiaries.

For Whose Benefit Is the Corporation's Attorney-Client Privilege?

The attorney-client privilege belongs to, and benefits the corporation and not the officers and directors. In bankruptcy, a trustee succeeds to the benefit of the privilege and can waive it.

Scope of Representation by Debtor's Counsel

It is important for officers and directors to appreciate that counsel is representing the corporation, and not the officers and directors individually. In the Chapter 11 context, this distinction is further refined because in Chapter 11, counsel for a debtor represents the bankruptcy estate.

Special Counsel

Where applicable, corporate counsel, labor counsel, ERISA counsel and coverage counsel should be consulted to ensure that the corporation complies with all laws and to further discuss any personal risks and exposure to directors and officers.

DORSEY™
always ahead

dorsey.com