

FINANCIAL DISTRESS TRIGGERED BY THE IMPACT OF THE CORONAVIRUS - TIP SHEET FOR FINANCIAL SPONSOR APPOINTED DIRECTORS IN THE US

Uncharted Territory

The economic challenges brought about by the sudden and wide-ranging economic impact of the coronavirus (COVID-19) have resulted in boards facing unprecedented situations and challenges ahead. Directors, irrespective of whether appointed by a financial sponsor or other stakeholder, need to act in accordance with their fiduciary duties, as determined by, among other things, the laws of a corporation's state of incorporation and a corporation's governing documents. This briefing aims to serve as a reminder of what those duties generally entail prior to and during financial distress, and highlight some of the key considerations and steps that can be taken by directors in ensuring that they continue to comply with their fiduciary duties.

Directors' Duties during Financial Distress

In the US, duties owed by directors will differ by the laws of the state of incorporation and the governing documentation. For the purposes of this briefing, we have focused on the position for directors of Delaware corporations to provide illustrative guidance given the prominence among many financial sponsors of businesses organized under Delaware law.

In Delaware, directors ordinarily owe fiduciary duties of care and loyalty to the corporation and its stockholders. However, when a corporation becomes insolvent, the directors' fiduciary duties shift and the directors have a responsibility to direct the affairs of the corporation to maximize value for the benefit of the corporation and its creditors. It is often unclear as to when a corporation is insolvent and that determination often is made in hindsight and after the corporation has in fact become insolvent.

There is no requirement that an insolvent corporation commence bankruptcy proceedings and courts will employ a variety of tests to determine whether a corporation was insolvent including: (1) a liquidity test (i.e., a corporation is unable to pay its debts as they become due in the ordinary course of business), and (2) a balance sheet test (i.e., a corporation's liabilities exceed the reasonable market value of its assets).

Minimizing Risk

Given it is difficult to pinpoint the moment when a corporation actually will be determined to be insolvent, it would be prudent for directors to continue to take actions in the best interests of the corporation to maximize its value for the

relevant stakeholders (whether that value rests with the stockholders or the creditors).

Where the corporation is approaching financial distress, it is advisable for the board to retain outside counsel to advise the directors as to their fiduciary duties. Additionally, the directors should continue to act in good faith and on a fully informed basis so as to retain the protection of the business judgment rule (i.e., judicial deference to business decisions made by a board of directors, provided the directors are disinterested and have acted on an informed basis with the good faith belief that the decisions are in the best interests of the corporation and its stockholders).

PRACTICAL STEPS TO PROTECT THE BOARD

In distressed situations, all directors should consider the best interests of the corporation and all its constituencies. This shift in focus requires special care and attention.

Financial Sponsor Appointed Directors

The approach to the practical steps below will depend on the severity of the financial distress. Here are some practical considerations specific to financial sponsor appointed directors where a company is in acute distress:

1. **Role clarification:** address any potential conflict as between the director and the appointing stockholder. Ensure that confidential information at the board level is not made available to stockholders except as required by law or contract (e.g. by the stockholders' agreement). Under Delaware law, a conflict of interest implicates a director's duty of loyalty. Directors are bound to act in good faith and in the best interests of the corporation and must not place themselves in a position in which their duties to the corporation and its relevant constituencies and their own personal interests conflict.
2. **Independent determinations:** it is important that directors are making their own independent determinations in fulfilling their fiduciary duties. If the director ordinarily takes instructions from their appointing financial sponsor, there is a risk that they could be creating liability (i) for themselves by not acting independently and in the best interests of the corporation or (ii) for the appointing financial sponsor acting as an instrumentality of such appointing financial sponsor.

All Directors

More generally, directors need to consider the following issues when dealing with a distressed company:

1. **Keep proper records:** detailed board minutes are invaluable to demonstrating that directors have complied with their duties. Remote meetings and telephone calls are widely accepted means of making board decisions.
2. **Stay informed:** the duty of care requires a director to act diligently and make informed decisions based on adequate information and a good faith belief that such decisions are in the best interests of the company and its stockholders. In practice, directors should obtain all information reasonably available before taking actions and ensure the corporation's decision making process and records properly reflect consideration of these factors. Exercising appropriate care may include insisting on receiving appropriate information sufficiently in

advance of meetings and any other important information between meetings when it becomes available. Directors should not hesitate to test the information and recommendations being made to them.

3. **Seek independent professional advice:** obtaining expert advice, financial and/or legal (e.g. in respect of available restructuring options), may help to reduce the scale of any losses, minimize the risk of directors' liability, and avoid management being distracted by the consequences of non-compliance. Individual directors may need separate advice.
4. **Monitor financial condition and key contracts:** including financing arrangements. Directors should regularly review financial covenants and termination events. Directors should also consider the ability of the company to meet its current and future obligations as they consider new transactions. Regular financial and operational reporting and timely escalation of issues are essential.
5. **Intragroup arrangements:** directors need to consider companies within a group on an individual basis. Duties are owed to creditors of each individual company.
6. **Regulators:** directors should be mindful in certain regulated businesses of the need to involve regulators in decisions or to keep them informed and consulted.
7. **D&O Insurance:** check the terms of the corporation's D&O insurance to ensure it provides adequate cover for the corporation's directors. While it is customary to have the corporation indemnify its directors against lawsuits or proceedings brought on behalf of the corporation or a third party, in practice this doesn't offer much comfort where the corporation is insolvent. In addition, D&O policies may provide more broad insurance cover in certain circumstances than the relevant corporate indemnity.
8. **Be active:** resignation will not discharge a director's responsibility for any previous conduct. Remaining on the board to drive a successful resolution may be the most effective means of mitigating risk.

Further information

You may find the following resources helpful:

- [Coronavirus: Operational and Regulatory Risk-Off Strategies for SEC-Registered Investment Advisers](#)
- [Coronavirus: Checklist for Financial Services Firms](#)
- [Coronavirus: Key Considerations in Respect of Debt Buybacks and Other Liability Management Transactions](#)
- [Coronavirus: Government Financial Aid to Business - an International Guide](#)
- [Global M&A Toolkit](#)
- [Cross Border Financing Guide](#) (CC Financial Markets Toolkit)

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