

Buyouts

GUEST ARTICLE

Protecting Directors From Lawsuits In Tough Times

By Dennis J. White, McDermott Will & Emery LLP

As private equity principals spend more and more time these days helping their distressed portfolio companies craft survival strategies, they are often overlooking their own heightened risk of personal liability as company directors. They shouldn't.

When a company experiences financial difficulties, minority stockholders and creditors will often second-guess the directors and charge them with errors in judgment and/or acting out of self interest. Private equity directors are particularly vulnerable as evidenced by several recent lawsuits.

Directors should not assume they will avoid lawsuits or that the company will fully protect them. Instead, directors need to discharge their duties with proper care and consider taking specific proactive steps to lower their risk profiles.

Step One: Understand Your Fiduciary Duties

If board members observe their fiduciary duties, they will be protected from liability (but not suit) by the so-called business judgment rule. This rule creates a presumption that the directors acted on an informed basis, in good faith, and in the honest belief that their actions were in the company's best interests. The plaintiff must prove otherwise. If the board follows a reasonable process, a court generally will not second-guess its decisions.

First, the board has a duty of care. This is the degree of care that an ordinarily careful and prudent person would use in similar circumstances. The board also has a duty of loyalty. This requires directors to act in good faith in the best interests of the company and to refrain from receiving an improper personal benefit. Self-dealing, diversion of corporate opportunities and favoring of certain stockholders over others are not allowed.



Dennis J. White

If a court is asked to determine whether the directors properly exercised their duties, the board's actions will be reviewed with 20/20 hindsight. The particular facts involved will strongly influence the court's decision. Here are four suggestions to enhance the likelihood that the board's actions will be upheld:

1) Be Well Informed. The board should be fully briefed by management and professionals. The board should ask questions and undertake independent investigation when appropriate. Indifference and lack of oversight can expose directors to liability.

2) Consult Professionals and Advisors. Directors should confer with legal counsel and other third-party advisors and engage their own when appropriate.

3) Process is Paramount. The board should not take at face value what management tells it. The board should actively explore and discuss alternative courses of action. The board should engage in active discussion of all the facts and all the options. The board should be deliberative and avoid a rush to judgment. The board should take adequate time to absorb, discuss and consider all information and recommendations.

4) Ensure the Minutes Reflect the Process. The minutes should substantiate the information-gathering and decision-making process and the time spent in arriving at decisions.

Step Two: Be Sensitive To Conflicts Of Interest

If a director has a personal interest in a matter, he may be found to have breached his duty of loyalty and as a consequence may forfeit business judgment rule protection. Directors from private equity firms that are significant investors in or lenders to a company are susceptible to being so labeled.

Several lawsuits have been filed against private equity directors personally alleging that as directors they breached their duty of loyalty by acting in the best interests of their own firm and its investors, not the company. Without the business judgment rule, directors must demonstrate their actions met the stricter "entire fairness" standard and prove the underlying actions as well as the process were fair.

Directors in sensitive situations should consult their own legal counsel. They should provide full disclosure of any self interest or entanglements and also consider defensive moves such as abstaining, appointing a special committee of independent directors to act, or even resigning from the board. Advance adoption by the board of a policy for handling such matters is often helpful.

Step Three: Learn Special Issues Surrounding Bankruptcy And Sales

Until recently, there was confusion in Delaware (home to half of all public companies) regarding whether directors' fiduciary duties shifted or expanded to include creditors of a company operating in the "zone of insolvency."

The Delaware Supreme Court in the recent *Cheewalla* decision said no and ruled that creditors of a company that is insolvent or in the zone of insolvency cannot bring suit directly for breach of duty against a director. The business judgment rule still operates in the zone of insolvency.

Although the *Cheewalla* decision was welcome, clarifying news, directors did not receive a free pass. The decision applies only to Delaware corporations. The court also noted that "creditors are afforded protection through contract agreements, fraud and fraudulent conveyance law, implied covenants of good faith and fair dealing, bankruptcy law, general commercial law and other sources of creditors rights." In short, creditors may have other claims against the directors.

Finally, the court observed that when a corporation becomes insolvent, the creditors "take the place of shareholders as residual beneficiaries" and "have standing to maintain derivative claims against directors on behalf of the corporation for breaches of fiduciary duty." Unfortunately, there is no bright line test of insolvency. Some courts apply a balance sheet test, others a cash flow test. Also, apart from alleged breaches of fiduciary duties, directors can also be sued for approving actions like cash dividends while a company is insolvent or that render it insolvent, or for approving dispositions of corporate assets for less than fair consideration.

In sum, directors of a distressed company that is still solvent should still exercise their business judgment in good faith on behalf of the corporation, but should also be sensitive to the creditors. How that principle translates into action will depend upon the situation and the various adverse constituencies involved. Directors in such circumstances face difficult choices and will benefit from outside help and advice.

One final note, if the board decides to sell the business, additional duties under *Revlon*, another Delaware decision, are implicated. Under *Revlon*, in any change of control transaction, the directors acting reasonably must seek the transaction offering the best value reasonably available under the circumstances. Whether a board has met its *Revlon* duties is subject to judicial scrutiny without the business judgment rule. The board must prove that it acted reasonably, in an informed manner, and in good faith.

In the recent *Lyondell* case, the Delaware Court of Chancery concluded that the board had done

little to develop a sales strategy or to determine whether a better deal was available. The court suggested such "conscious disregard" of their duties might constitute bad faith and a breach of the duty of loyalty, something for which the board might not be indemnified or insured. If the sale is made during bankruptcy as part of a so-called Section 363 sale or a Chapter 11 plan of reorganization, the board can derive significant comfort since all out of the ordinary course transactions must be approved by the bankruptcy court.

Step Four: Review Your D&O Policy

There is no such thing as a "standard" D&O (Directors and Officers) policy. Policies vary significantly and are subject to modification by endorsement.

A D&O policy may: (a) cover the individual directors and officers (so-called Side A coverage), (b) reimburse the company for indemnification payments it makes, and (c) provide "entity coverages" to the company for its own liabilities (e.g. securities violations).

If company and individual coverages are combined in one policy, the individuals may be unable to obtain advancement of legal defense expenses (which can be sizeable), if prior claims have eroded policy limits or the company files for bankruptcy. It is possible to negotiate for a separate Side A policy that includes coverage only for the directors, or the non-company directors. There are also various provisions, waivers and endorsements that will better protect the individuals.

My advice: Engage an experienced advisor to review the existing D&O policy. Consider purchasing a Side A-only policy.

Step Five: Review, Update Indemnification Provisions

Director indemnification provisions, usually found in the company charter or by-laws, are based on the corporation statute of the company's state of formation. Such statutes are amended regularly. Many companies, however, have not updated their organizational documents for years. The result is that directors may not enjoy indemnification to the fullest extent allowed by law. A company's indemnification provisions should be reviewed and updated regularly.

Step Six: Confirm That Indemnification Rights Are Vested

In *Schoon v. Troy*, the Delaware Court of Chancery recently faced a situation where a company amended its by-laws to strip former directors of their right to advancement of indemnification-related legal defense costs and related expenses.

Subsequent to the by-law amendment, a former director was sued for actions occurring while he was a board member. He contended that his right to advancement of legal fees under the then existing by-laws became vested upon joining the board. He lost.

The court ruled that advancement rights become vested only when a claim is made, not when a person joins a board and not when the alleged underlying acts occur. In light of this decision, consider adopting new by-law provisions providing that (1) the right to indemnification and advancement of fees vests when a director joins the board, and (2) no subsequent amendment that adversely affects a director will be effective without his consent.

Also, consider signing separate agreements with the company that grant directors advancement rights and prohibit retroactive repeal of their rights.

Step Seven: Anticipate Producing Documents In A Lawsuit

If a lawsuit is filed, the plaintiff's lawyers will typically pursue discovery of all relevant communications, documents, memoranda and notes. Very often an email (even if "deleted") can come back to haunt its sender.

In general, all materials must be produced, subject to few exceptions. For example, communications by directors with their own lawyers in connection with litigation are generally protected under the attorney-client privilege. However, do not assume that communications among the board members themselves, even those relating to litigation strategy, are protected.

Once litigation is anticipated, the company should issue a document preservation directive. Destruction or withholding of materials can result in liability or a claim of spoliation with an adverse inference against the company or the directors.

Gather all materials that are potentially responsive to the discovery and review them with counsel to determine what should be produced.

If you face board-related litigation, consult experienced trial counsel. Finally, do not write anything relating to board activities that you would not want to appear in the press or before a judge or jury.

Dennis J. White is a partner in the Boston office of McDermott Will & Emery LLP where his practice focuses on M&A, buyouts, restructurings and corporate governance issues. He is also vice chairman of the global board of the Association for Corporate Growth. He can be reached at dwhite@mwe.com. ❖