

## Avoiding pitfalls in raising capital from insiders

BY JOEL RUBINSTEIN AND MEIR LEWITTES

In today's economic environment, many US public companies whose revenues are significantly depressed are finding it extremely difficult to raise needed capital due to the lack of liquidity in the traditional equities markets and the difficulty in obtaining financing from traditional lending sources. These companies often turn to insiders to raise needed funds in a private PIPE transaction. Whenever a company engages in a transaction with insiders, it runs the risk that the transaction will be challenged as unfair to the company and its other stockholders or its creditors. Careful planning and execution is critical to ensure that the company's directors fulfil their fiduciary du-

ties in connection with an insider transaction. A finding that they breached their fiduciary duties could result not only in personal liability on the part of the directors, but also in the transaction being voided or altered.

### Fiduciary duties

Under Delaware law (which governs many US public companies), officers and directors of a corporation have two primary fiduciary duties: the duty of loyalty, which requires them to act in good faith in the best interests of the corporation and its stockholders, not usurp corporate opportunities or engage in self-dealing; and the duty of care, which requires them to exercise the degree of care an ordinary person in similar circumstances would use and obtain all material information reasonably available before making a decision. If these duties are met, directors' decisions receive the important protection of the 'business judgement rule', under which a court will not substitute its own notions of what is or is not sound business judgement. Absent this protection, directors could have the burden of showing the entire fairness of the transaction at issue.

The directors of a company in financial distress may owe fiduciary duties not only to the company and its stockholders but also to its creditors. Until recently, many practitioners advised that once a company enters the 'zone of insolvency', the directors' duties also were owed to creditors. However, in *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla* (2007), the Delaware Supreme Court ruled that even when in the zone of insolvency, directors do not have to take the interests of creditors into account in making decisions, because creditors negotiated their protections in their credit documentation. Nevertheless, once the company actually is insolvent, directors also must take into account the interests of creditors. The determination of whether a company is techni-

cally insolvent is often difficult to make with precision, so distressed companies bordering on insolvency would be well advised to put the interests of creditors into the mix. In any event, *Gheewalla* held that even when a company is insolvent, creditors do not have a direct right of action against the directors, but only a derivative right on behalf of the company.

### Insider transactions

When considering transactions with insiders, directors of distressed companies must be careful to comply with their fiduciary duties in order to ensure that their actions are afforded the protection of the business judgement rule. Most importantly, decisions approving such transactions must be made by directors independent of the insider. In a recent Delaware Chancery Court decision, *In re Loral Space and Communications* (2008), Chancellor Strine laid out a roadmap for making such decisions.

Loral was a publicly traded company that emerged from bankruptcy in 2005 with MHR Fund Management LLC holding 35.9 percent of Loral's outstanding common stock. Shortly after this emergence, Loral needed capital to address liquidity shortfalls and to fund future growth and expansion. MHR took advantage of this need and made a \$300m investment in convertible preferred stock (with significant control rights) that solidified its controlling position. Two institutional investors then commenced litigation in the Delaware Chancery Court against MHR and Loral's directors, alleging that the investment "was grossly unfair to Loral, and resulted from fiduciary misconduct by the Loral directors". Chancellor Strine ultimately agreed, and entered a remedy converting MHR's convertible preferred into non-voting common stock. Given the nature of the remedy, he did not make any findings about the extent to which the individual directors would be subject to liability if he had awarded

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Loral monetary damages, but he implied that this would have been a distinct possibility at least with respect to the MHR-employed directors. A complete rendition of the facts and reasoning of the decision of the court in that case is beyond the scope of this brief article. Certain significant points, however, are worth noting to highlight the failings of the approval process by Loral's board and the structure of the transaction that was found unfair.

First, Chancellor Strine found that Loral's eight-member board was controlled by MHR because, in addition to the three board members who were employed by MHR, two other board members had affiliations with MHR that rendered them not independent. Because the types of affiliations that Chancellor Strine relied on to negate independence, especially with respect to board member John Harkey, appear more tenuous than those which have disqualified directors in previous Delaware decisions, boards are cautioned to scrutinise all relationships that board members have with the insider to ensure independence. This scrutiny also applies in determining if the financing source is a controlling stockholder even where, as in *Loral*, the stockholder does not hold a majority of common stock.

Second, although the board formed an independent special committee to evaluate the transaction, Chancellor Strine found fault with: (i) the qualifications of its members and

the financial adviser it hired; (ii) the limited mandate it was given; and (iii) the process conducted by the committee and its adviser to review and approve the transaction. Proper constituents of a special committee must have the requisite financial acumen and experience with respect to the particular transaction, and its financial adviser also must have the requisite skills and experience, especially in relation to the advisers on the other side of the table. The committee's mandate should be not only to review the transaction at issue, but also to thoroughly review alternatives that may be in the best interest of the company and its stockholders, which should include not only other financing sources, but also other financing structures, including, depending on the circumstances, the outright sale of the company. And, most importantly, it must follow through on its mandate in a deliberate fashion.

Third, Chancellor Strine placed importance on the fact that MHR was unwilling to backstop a Loral rights offering. In a rights offering, each existing stockholder is offered the right to purchase additional shares of common stock on a pro-rata basis at a specified price, which is typically discounted from the current market price of the common stock. Any stockholder that does not exercise its 'right' to subscribe for the new shares will see his stake in the company diluted. A rights offering will often be 'backstopped' by an existing or new

investor, meaning that the investor agrees to purchase any shares which are not subscribed for by existing stockholders, providing the company with certainty as to the proceeds of the offering. In the Loral situation, this would have given the other Loral stockholders the right to participate in the deal that MHR struck on a pro rata basis along with MHR, with MHR having the ability to increase its position to the extent that other stockholders did not subscribe for their pro rata shares. For this reason, there has been an increased use of rights offerings by US public companies, and this trend is expected to continue. Another advantage of a rights offering is that under New York Stock Exchange and NASDAQ rules, even if shares are sold at a discount to market and constitute 20 percent or more of the company's shares, there is no requirement to obtain stockholder approval as there would be if the transaction were a PIPE for a company listed on those exchanges because a rights offering is a public offering. ■

Joel Rubinstein and Meir Lewittes are partners at McDermott Will & Emery LLP. Mr Rubinstein can be contacted on +1 212 547 5336 or by email: [jrubinstein@mwe.com](mailto:jrubinstein@mwe.com). Mr Lewittes can be contacted on +1 212 547 5351 or by email: [mle Wittes@mwe.com](mailto:mle Wittes@mwe.com)

This article first appeared in FinancierWorldwide's February 2009 Issue.  
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 For further information on FinancierWorldwide and its publications, please contact James Lowe on  
 +44 (0)845 345 0456 or by email: [james.lowe@financierworldwide.com](mailto:james.lowe@financierworldwide.com)