International Insolvency Institute

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Committee on Corporate and Professional Responsibilities in Bankruptcy

Saving the "Going Concern": Must the Crew Abandon the Ship?

Issue Addressed: What would you like to see in your local law on officers' and directors' obligations to increase the prospects of the rescue/reorganization of multi-national corporate groups?

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A. Overview Of "Business Judgment Rule" Under U.S. Law

The general rule in the United States is that corporate officers and directors may rely upon the "business judgment rule" as a defense to protect themselves from personal liability for decisions made in the course of their management of business entities. Simply stated, the business judgment rule acts as a rebuttable presumption that officers and directors are not personally liable for business decisions made by them within the scope of their duties, so long as the decisions are made on an informed basis, in good faith, and are not motivated by personal self-interest. See, e.g., Production Resources Group v. NCT Group, Inc., 863 A.2d 772 (Del. Ch. 2004); Creditors Committee v. Haverty (In Re Xonics), 99 B.R. 870 (Bankr. N.D. Ill 1989). If these requirements are satisfied, the presumption creates a strong shield protecting the directors and officers from personal liability.

It is generally accepted that the duties of officers and directors shift from shareholders to creditors when a corporation becomes insolvent. See, e.g., Credit Lyonais v. Pathe Communications, 1991 WL 277613 (Del. Ch. 1991); Brandt v. Hicks, Muse & Co., 208 B.R. 228 (Bankr. D. Mass. 1997). The business judgment rule continues to protect the officers and directors in taking strategic and operational risks in an effort to rehabilitate a distressed company. See, e.g., Angelo, Gordon & Co. v. Allied Riser, 805 A.2d 221 (Del. Ch. 2004) Directors and officers may pursue decisions and strategies that they believe have a reasonably good chance of success. Paramount Communications v. Time, Inc. 571 A.2d 1140 (Del. Ch. 1989).

B. <u>Best Practices To Fulfill The Requirements of The Business Judgment Rule</u>

Although the business judgment rule provides a relatively large safe harbor under U.S. law for officers and directors, the challenge is to provide guidelines of "best practices" for officers and directors both to satisfy their duties to the corporation and to create an evidentiary basis for the business judgment defense against personal liability. The objective is to permit officers and directors to confidently manage the rescue or reorganization effort while avoiding claims and litigation entirely or, if litigation is commenced, to invoke a strong defense. Absent the ability of management to take certain risks as part of rescue and reorganization, officers and directors will either resign or take the most conservative approach (i.e., liquidation) to the problems of a distressed company.

Among the most important steps is the retention of independent and capable advisors upon whose advice the officers and directors may rely. These may include turnaround experts, investment bankers, valuation consultants, attorneys and others. Upon recognition of the company's financial distress, the officers and directors are advised to retain specialists who are familiar with the operational aspects and strategic options to rescue a business. These advisors will present the options available to the company, including refinancing, cost cutting, cessation of certain lines of businesses, or the sale of some or all of the company's assets.

The retention of capable and independent advisors satisfies several important prongs of the business judgment rule, including the requirement that the officers and directors act on an informed basis, and that they act with an honest belief that their actions are in the best interest of the company and its stakeholders. If the advice of independent advisors is followed, it is also far less likely that claims can be made that the officers and directors acted to pursue personal self interest or engaged in self dealing. The dual requirements of acting with due care and with disinterestedness are thus supported by reliance on independent advisors. Finally, the right of officers and directors to take reasonable risks while the company is insolvent is bolstered by the fact that capable advisors create a reasonable prospect for success resulting from such risks.

A second major "best practice" relates to insurance and indemnity against claims. The availability of directors and officers insurance or an indemnity fund is increasingly necessary to attract or retain capable managers of distressed companies. These protections are not intended to shield wrongdoing, and in fact uniformly exclude coverage for intentional misconduct or self-dealing.

A third area of concern, and one which may require legislation, is protection by way of exculpatory provisions in corporate charters. Many corporate statutes authorize charter provisions that shield directors and officers from breach of fiduciary duty claims so long as there has been no violation of the director's duty of loyalty. See, e.g., Del. Code Ann., Title 8, Section 102(b). U.S. law, however, is still developing as to the scope and enforcement of exculpatory provisions with respect to creditors and stakeholders other than shareholders.

Thus, under U.S. law, the business judgment rule generally gives managers the confidence to engage in rescue and reorganization activities so long as certain best practices are followed. Claims and litigation cannot be avoided with certainty, but officers and directors who act in an informed manner and in good faith, and who obtain reasonable "best practices" protections in the form of expert advice, insurance and exculpatory charter provisions, may minimize personal risk while pursuing rescue and reorganization efforts for a distressed company.