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The Landscape Shifts: Duties of and Risks to Directors and Officers of Insolvent Enterprises

Directors and Officers of distressed companies have a unique opportunity to help an enterprise navigate challenges and to facilitate the best available outcome for stakeholders.

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For both distressed companies and their directors and officers ("D&Os"), insolvency is often complex and fraught. D&Os owe ongoing fiduciary duties to the company, and must often make difficult decisions that impact the enterprise and its creditors, shareholders, employees and other stakeholders. There are various reasons to serve as a D&O of a distressed company, many that mirror the reasons people first chose to serve. D&Os of distressed companies have a unique opportunity to help an enterprise navigate challenges and to facilitate the best available outcome for stakeholders. Moreover, despite the noteworthy developments described below, D&Os can still take substantial comfort from the fact that major business decisions in Chapter 11 require bankruptcy court approval after public notice and right to object, and that Chapter 11 plans of reorganization often provide D&Os who "see things through" with *debtor* releases and exculpations, even if third-party releases are not ultimately available.

Those factors have traditionally been viewed as making bankruptcy fairly low risk for D&Os. Several recent developments have, however, shifted the landscape somewhat and altered the risk profile. First, commentators have pointedly criticized so-called "bankruptcy directors" (described below), alleging that they often present incremental conflict issues and are not actually disinterested. Second, courts have recently criticized Chapter 11 D&Os, and demanded that directors take more active and informed roles. Third, courts have recently denied motions for summary judgment and ruled that suits against D&Os, even arising from corporate actions approved by a bankruptcy court, may not be heard by that court. One ruling also raises the spectre of personal liability for D&Os in connection with a company's external communications. Fourth, there has recently been substantial judicial and legislative scrutiny of third-party releases, long used to provide finality to D&Os who see a case through to conclusion. Finally, it is often important for D&Os to seek legal advice from company or board counsel; recent case law suggests that relatively commonplace practices might waive privilege. D&Os of distressed companies should be aware of these developments and take yet further care in exercising their fiduciary duties.

Fiduciary Duties of D&Os of Troubled Companies

Under often-applicable Delaware law, D&Os owe fiduciary duties of loyalty and care. The duty of loyalty obligates D&Os to act in good faith, in the best interests of the corporation, and to refrain from self-dealing or other acts that confer improper personal benefits. The duty of care requires that D&Os inform themselves of material and relevant information reasonably available and act with requisite care. In discharging the duty of care, D&Os typically benefit from the business-judgment rule—a rebuttable presumption that they acted in good faith and in the honest belief that the action was in the corporation's best interests. D&Os will not benefit from the rule where a conflict of interest exists that precluded decisions being made by disinterested D&Os. Those decisions will instead be subject to the far more stringent "entire fairness" standard, which places the burden on the D&Os to prove that the decision was in the company's best interest.

As at healthy enterprises, D&Os of distressed companies are obligated to "pursue value maximizing strategies for the benefit of the corporation." In *Trenwick American Litigation Trust v. Ernst & Young*, 906 A.2d 168, 174 (Del. Ch. 2006), the Delaware Chancery Court confirmed that the business-judgment rule shields D&Os of distressed companies from liability for appropriate, calculated risk-taking aimed at increasing enterprise value. This was reaffirmed in *Quadrant Structured Prods. v. Vertin*, 102 A.3d 155 (Del. Ch. 2014), in which a group of creditors asserted fiduciary duty claims against directors who had shifted to a riskier business strategy, allegedly putting specific stakeholders at greater risk of loss. *Quadrant* held that the board continued to be protected by the business-judgment rule even if their strategy shifted risk from one constituency to another, as long as it did not target one group. Delaware law encourages D&Os to continue to make reasonable decisions they believe are in a company's best interest, even if the entity may be, or is, insolvent, and even if those decisions increase risk for all or only certain stakeholders. *See* Marshall S. Huebner and Darren S. Klein, *The Fiduciary Duties of Directors of Troubled Corporations*, American Bankruptcy Institute Journal, Vol. XXXIV, No. 2 (2015). And further complexities arise if a director serves at multiple entities in a corporate family when one or more of the entities may be or is insolvent. *See* Marshall S. Huebner, *A Dangerous Mix: Multiple Board Service and Insolvency*, American Bankruptcy Institute Journal, Vol. XXXVII, No. 2 (2018).

Growing Scrutiny of Directors

There has of late been an increasing trend among distressed companies to appoint one or more new directors with prior experience (as investors or professionals) in insolvency and restructuring. These so-called "bankruptcy directors" are lauded by proponents, who claim that their experience helps guide companies through Chapter 11 and bolster relationships with key constituencies. These new directors are also often called upon to assess, or take control of, preference, fraudulent transfer, breach of fiduciary duty or other claims against current or former insiders, including private equity sponsors and D&Os.

Despite the current prevalence and potential benefits of bankruptcy directors, scrutiny and criticism is mounting. A recent article questions their quality and independence, and asserts that their appointment may lead to an increase in conflicted transactions. See Jared A. Ellias, et al., *The Rise of Bankruptcy Directors*, 95 Southern Cal. L. Rev. 5 (2022). The authors assert that a small number of "super-repeater directors" serve in many bankruptcy cases, repeatedly installed by a small number of private equity sponsors, law firms and other industry players. This allegedly creates "structural bias" because these directors are incentivized to please their appointers to avoid jeopardizing lucrative future engagements. The authors claim that a coterie of bankruptcy directors shields self-dealing transactions from judicial intervention or settles them too cheaply, resulting in materially lower creditor recoveries and more aggressive forms of self-dealing.

Some lawmakers have echoed these criticisms. In 2021, five U.S. Senators introduced legislation that would vest unsecured creditors with standing to pursue litigation on behalf of the estate, a right vested in the debtor absent a rare court order granting a different party (often the unsecured creditors' committee or UCC) standing. This material change to the Bankruptcy Code (likely appropriate only in a small number of cases) would put the UCC (fiduciaries for only one constituency) in control of material estate assets. In all events, increased academic, legislative and judicial attention to and criticism of bankruptcy directors will lead bankruptcy courts to take a closer look at their disinterestedness, ties to key case parties, decisions and recommendations.

In addition, some courts have questioned—sometimes harshly—the quality of work being done by directors. The judge overseeing the Neiman Marcus bankruptcy sharply criticized a director overseeing a fraudulent transfer investigation as "unprepared, uneducated, and borderline incompetent." Another bankruptcy court exhorted a bankruptcy advisory committee (serving a similar function to a special committee) to "be active" and give "100% of [their] collective skill sets." More recently, a judge suspended an entire board accused of wrongdoing.

Jurisdiction

Another potential change in the risks to D&Os relates to where suits against them arising out of bankruptcy cases will be heard. D&Os have likely drawn comfort from the fact that the bankruptcy court that has presided over the cases, approved transactions outside the ordinary course of business and confirmed the plan, will understand the context of any case-related suits, and be a knowledgeable and potentially more hospitable forum.

Although fiduciary duty claims arising from D&Os' actions in connection with a bankruptcy were generally considered to be within bankruptcy court's jurisdiction, *TRU Creditor Litigation Trust v. Brandon* Civil No. 3:20 cv 311 (DJN) (E.D. Va. 2022) disagrees. The District Court there held that fiduciary duty claims arising out of the bankruptcy could not be adjudicated by the Bankruptcy Court without consent from all parties.

In March 2020, a trust created to pursue litigation claims sued former TRU D&Os, alleging that they breached their fiduciary duties by, among other things, approving the incurrence of debtor-in-possession financing (approved by the bankruptcy court over the objection of various constituencies). The trust filed a motion seeking to withdraw the reference that had authorized the Bankruptcy Court to hear the dispute, insisting that the claims be heard by the District Court. The District Court agreed, holding that the reference must be withdrawn. This was particularly striking given that the Bankruptcy Court had itself approved the contested financing.

The *TRU* decision may limit the ability of bankruptcy courts to hear fiduciary duty and related disputes arising out of bankruptcy proceedings. While this ruling does not make fiduciary duty claims arising out of Chapter 11 cases more viable, it does increase the risk of D&Os having to litigate in a new forum that does not have background or experience with the case or the litigants.

The *TRU* bankruptcy court's ruling denying summary judgment on claims asserted on behalf of trade vendors alleging fraud, misrepresentation and negligence is also notable. The trust alleged that three management directors misled trade creditors through various communications and press releases about the company's liquidity and its ability to purchase goods on credit, and that non-management directors improperly approved and ratified the communications strategy. The decision highlights the importance of carefully crafted and centralized communications, and underscores that directors should generally refrain from involvement with communications, whether with the press, customers, vendors, employees or other stakeholders.

Third-Party Releases

In recent years, many Chapter 11 reorganization plans have included third-party release provisions releasing identified non-debtors, often including D&Os, from claims related to the debtor that third parties might hold against them. Thirdparty releases—distinct from debtor or estate releases and exculpations that are likewise important but far less controversial—can be a powerful tool in resolving Chapter 11 cases. They encourage financial and other participation by parties necessary to a reorganization, and provide finality to released parties such as D&Os (and encourage them to serve). In appropriate cases, they materially increase the value distributable to creditors.

Courts have, however, recently taken a closer and more skeptical look at these releases. One bankruptcy court recently sharply criticized the overuse of third-party releases, noting that they "are not a merit badge that somebody gets in return for making a positive contribution to a restructuring. They are not a participation trophy, and they are not a gold star for doing a good job." *In re Aegean Marine Petroleum Network, Inc.*, Case No. 18-13374 (MEW) (Bankr. S.D.N.Y. Apr. 8, 2019) [ECF No. 520]. See also *Patterson v. Mahwah Bergen Retail Grp., Inc.*, 636 B.R. 641, 655 (E.D. Va. 2022) (the ubiquity of third-party releases demands even greater scrutiny of their propriety). In a decision currently on appeal, the *Purdue Pharma* District Court went much further, breaking with decades of appellate jurisprudence to find these releases flatly illegal. While the law in this area will continue to develop, one thing is certain—courts are now examining third-party releases far more skeptically, and demanding more detailed factual showings and satisfaction of the tests set forth in appellate law (often requiring extraordinary circumstances) before approving them. Members of Congress also recently introduced legislation to prohibit non-consensual third-party releases. Thus, D&Os should not reflexively assume that reorganization plans will provide them.

Privilege Waiver Concerns

Legal advice given by company or board counsel to D&Os is ordinarily protected from disclosure by the attorney-client privilege and similar doctrines. The situation is, however, more complex when such advice is given to directors who also hold other roles, including being representatives or designees of private equity sponsors. Recent caselaw suggests that, absent due care, a court might determine that individuals to whom legal advice was given were not then-acting as directors, and were instead functioning in another capacity—in which case such communications would not be privileged and could be discovered.

In *Argos Holdings Inc. v. Wilmington, N.A.* ("*Petsmart*"), 18-cv-5773 (DLC), 2019 U.S. Dist. LEXIS 53104 (S.D.N.Y. Mar. 28, 2019), for example, the District Court, applying New York law, declined to extend privilege to certain communications with individuals who were both directors of the company and partners of the private equity firm invested therein, even though counsel represented only the company. In concluding that the individuals were not then-acting as directors, the court found significant that the communications: (1) were not shared with the full board, (2) were addressed to the directors' private equity firm email addresses (not company addresses) and (3) did not caution the directors to maintain confidentiality with respect to others at the private equity firm.

Similarly, directors sometimes invite others from their firms to attend board meetings with them or in their stead. If communications exclusively between company counsel and a director could waive privilege based on a capacity finding, it is highly likely that courts would find that including outside parties in board meetings or on otherwise privileged communications likewise significantly risks a privilege waiver.

As a practical matter, it has become more challenging to preserve privilege given the efficiencies and ubiquity of group emails and teleconferences (and adding the perceived "right people" thereto). The following steps can increase the likelihood of privilege being preserved: (1) ensuring that legal advice is given to the full board rather than to select members, (2) limiting board communications to actual board members and appropriate company personnel and advisors, (3) using company email addresses, (4) instructing board members to maintain the confidence of legal advice within the board and (5) adding confidentiality and privilege legends to privileged communications.

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