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Risks for Transactions and Directors in Financially Distressed Businesses (United States)

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A Practice Note addressing the legal and practical considerations in the United States for a director of a company that is in financial distress and may subsequently commence Chapter 11 insolvency proceedings. This Note also explores certain types of claims that may be brought against directors as well as claims to challenge transactions approved by those directors.

When a company is in financial distress its directors need advice on fulfilling their duties to the company and should consider the status of transactions in which the company is currently engaged. Once the company enters insolvency proceedings, the pre-insolvency decisions of the directors will likely be scrutinized by various parties attempting to achieve the greatest return for the company's creditors.

This Note addresses:

- The duties that directors owe to certain types of US companies, whether or not insolvent. Importantly, these duties do not change fundamentally when a company is facing financial distress.
- Likely investigations by certain stakeholders of the pre-insolvency actions of directors.
- The potential for claims against directors, and the protections available to them against these claims.
- The powers of a court to unwind certain prepetition transactions to maximize recover for the company's creditors.

The law of the state where the company is organized, not federal law, generally governs the duties of directors of US companies. Accordingly, the principal focus of this Note is on fiduciary duties under the laws of Delaware, where a majority of the largest 500 US corporations are incorporated. (See Delaware Division of Corporations).

Directors' Duties

Directors of a US corporation must at all times exercise a duty of care and a duty of loyalty (see *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 745 (Del. Ch. 2005)). These state law duties are creatures of judicially created common law.

Duty of Care

To satisfy the duty of care, directors must "use that amount of care which ordinarily careful and prudent [people] would use in similar circumstances, and consider all material information reasonably available in making business decisions" (*O'Toole v. McTaggart (In re Trinsum Grp., Inc.*), 466 B.R. 596, 609 (Bankr. S.D.N.Y. 2012) (internal citation omitted)). Courts generally evaluate whether directors satisfied the duty of care by applying a gross negligence standard. That is, courts will determine whether a director's conduct in a particular situation where a breach of the duty of care is alleged was "reckless indifference or actions that are without the bounds of reason" (*In re Match Grp., Inc. Derivative Litig.*, 2022 WL 3970159, at *24 (Del. Ch. Sep. 1, 2022) (internal citation omitted); see *RBC Cap. Mkts., LLC v. Jervis*, 129 A.3d 816, 854 (Del. 2015) (finding a failure to satisfy the duty of care where a separation process "was structured and timed in a manner that impeded interested bidders from presenting potentially higher value alternatives")).

Examples of how directors comport with their duty of care include:

- Reviewing documents applicable to relevant decisions.
- Engaging in robust discussions (where directors discuss the risks, benefits, and costs of decisions).
- Informing themselves, before making a business decision, of all material information reasonably available to them and acting with requisite care

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(see *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000)).

Good faith and reasonable reliance on expert professionals may support a finding that directors have fulfilled their duty of care (see *Cinerama, Inc. v. Technicolor*, 663 A.2d 1134, 1142 (Del. Ch. 1994) (finding that a "board's reliance upon experienced counsel" indicated "good faith and the overall fairness of the process" and that "reasonable reliance upon expert counsel is a pertinent factor in evaluating whether [c]orporate directors have met a standard of fairness in their dealings with respect to corporate powers")). Conversely, a complaint based on a breach of the duty of care could survive a motion to dismiss where the plaintiff alleges that directors approved a major transaction with no diligence or professional advisor input (see, for example, *Trenwick Am. Litig. Tr. v. Ernst & Young, L.L.P.*, 906 A.2d 168, 194 (Del. Ch. 2006) (explaining that a failure to retain advisors may, in certain instances, be evidence of gross negligence)).

Corporate law, such as the Delaware General Corporate Law, incentivizes directors to act prudently by providing statutory protection when they follow proper process. For example, directors will be "fully protected in relying in good faith upon the records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees, or committees of the board of directors, or by any other person as to matters the [director] reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation" (Del. Code Ann. tit. 8, § 141). Directors must select experts "with reasonable care," and cannot actually or effectively delegate all the decision making to these experts (*Brandt v. Hicks, Muse & Co. (In re Healthco Int'l, Inc.)*, 208 B.R. 305 (Bankr. D. Mass. 1997); see *Versata Enters. v. Selectica, Inc.*, 5 A.3d 586, 559-600 (Del. 2010) (finding that directors acted reasonably in relying on the valuation estimates of legal and financial advisors before actuating a poison pill to protect "potentially valuable assets")).

Duty of Loyalty

Separate from the duty of care, the duty of loyalty requires that directors put the corporation's interests first and ahead of their own interests (see *In re Trinsum Grp., Inc.*, 466 B.R. at 610). Implicit in the duty of loyalty is the duty of good faith (see *In re Trinsum Grp., Inc.*, 466 B.R. at 609). This means that a director must "act at all times with an honesty of purpose and in the best interests and welfare of the corporation" (*In re Walt Disney Co. Derivative Litig.*, 907 A.2d at 755). The purpose of the duty of loyalty is to prevent "self-dealing," or transactions that would benefit the director personally, including at the expense of the "corporation or all stockholders generally" (*Xtreme Power Plan Tr. v. Schindler (In re Xtreme Power Inc.)*, 563 B.R. 614, 632 (Bankr. W.D. Tex. 2016); see *Valeant Pharm. Int'l v. Jerney*, 921 A.2d 736 (Del. Ch. 2007) (finding a breach of loyalty where a director received three million dollars in "unfair, self-interested bonuses"); *Notinger v. Costa (In re Robotic Vision Sys.)*, 374 B.R. 36, 51 (Bankr. D.N.H. 2007) (holding that the "Trustee [ ] set forth a plausible claim for breach of [ ] duty of loyalty" where the allegations asserted "self-interest and extraneous considerations and influences [rather than] the corporate merits of any decision")). The purpose of the duty of loyalty is to prevent directors from "wrongfully using assets of [the company]" for their own benefit (*Summit Metals, Inc. v. Gray (In re Summit Metals, Inc.*), 2004 WL 1812700, at *15 (D. Del. Aug. 6, 2004)).

To determine whether a director breached the duty of loyalty, a court often examines the process by which directors approved a transaction (see *Valeant Pharm. Int'l v. Jerney*, 921 A.2d at 735-36). For example, a court might consider whether there was "arm's-length bargaining" in the approval process and whether an interested officer or director exerted improper "domination" over the decision making (see *Valeant Pharm. Int'l v. Jerney*, 921 A.2d at 746-747; *Off. Comm. of Unsecured Creditors of Integrated Health Servs. v. Elkins*, 2004 WL 1949290, at *10 (Del. Ch. Aug. 24, 2004)). A process is likely to be the subject of scrutiny if "a majority of the Board was interested and/or lacked independence" (*Orman v. Cullman*, 794 A.2d 5, 23 (Del. Ch. 2002) (explaining that the determination of "interest and independence" will depend on the unique facts of a case)). Evidence of this includes directors who were "interested" in the sense that they were motivated to pursue a transaction because of personal benefits, and directors "influenced by personal or extraneous considerations" (*In re Trinsum Grp., Inc.*, 466 B.R. at 610).

Eliminating or Limiting Liability

Some states permit limited liability companies (LLCs), limited partnerships (LPs), and corporations to limit or disclaim the duty of care in their governing documents (see, for example, 6 Del. C. § 18-1101; Del. Code Ann. tit. 8, § 102(b)(7)). However, under Delaware corporate law, companies may not eliminate or limit a "director's or officer's duty of loyalty to the corporation or its stockholders," "acts or omissions not in good faith,"

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and "transaction[s] from which the director or officer derived an improper personal benefit" (Del. Code Ann. tit. 8, § 102(b)(7); see also *In re Healthco Int'l, Inc.*, 208 B.R. at 308 (explaining that under Delaware corporate law, corporate documents cannot change the statutory requirement that directors always have a duty of loyalty).)

Business Judgment Rule

Regarding decision making generally, disinterested directors benefit from the business judgment rule, which "is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company" (*Aronson v. Lewis*, 473 A.2d at 812). This prevents "judicial second-guessing" (*In re LATAM Airlines Grp. S.A.*, 620 B.R. 722, 768 (Bankr. S.D.N.Y. 2020) (internal citation omitted)). In other words, the business judgment rule is rooted in the idea that "corporate directors [should have] the ability to take prudent business risks without the fear of judicial scrutiny if those risks prove incorrect or unwise in hindsight" (*Frost v. Adiletta (In re Teleservices Grp., Inc.)*, 2009 WL 838157, at *10 (Bankr. D.N.J. Jan. 15, 2009)). The business judgment rule therefore protects well-intentioned and diligent directors and officers who are disinterested, and enables them to make decisions without undue risk that these decisions could result in personal legal liability (see *NBN Broad., Inc. v. Sheridan Broad. Networks, Inc.*, 2015 WL 1489902, at *4 (W.D. Pa. Mar. 31, 2015) (internal citation omitted) (quoting the Pennsylvania Supreme Court's policy reasoning behind the business judgment rule)).

The business judgment rule, however, "is a rebuttable presumption" (*Badowski v. Carrao*, 42 Misc. 3d 1215(A), 2014 WL 223390, at *5 (Sup. Ct. N.Y. Cnty. Jan. 13, 2014)). It does not apply when "the business decision confers a non-ratable benefit on a controlling stockholder" (*Frederick Hsu Living Tr. v. Oak Hill Cap. Partners III, L.P.*, 2020 WL 2111476, at *33 (Del. Ch. May 4, 2020)). It also does not apply to transactions between a company and an "interested" director. However, potential conflicts can be managed, among other ways, through the use of special committees of disinterested directors. When directors lose the protection of the business judgment rule, they must satisfy the stricter "entire fairness" standard and "demonstrate that they engaged in a fair process and obtained a fair price" (*In re Eerie Cnty. Emps. Ret. Sys. v. Blitzer (In re Kenneth Cole Prods., Inc., S'holder Litig.)*, 27 N.Y.3d 268, 274 (2016)):

- Fair process considers "initiation, structure, and negotiation" (*In re LATAM Airlines Grp. S.A.*, 620 B.R. at 774 (internal citation omitted)). In other words, "fair process" requires an analysis of the steps the directors took to close a transaction or reach a decision (see *Frederick Hsu Living Tr. v. Oak Hill Cap. Partners III, L.P*, 2020 WL 2111476, at *275).
- Fair price considers "assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock" (*In re LATAM Airlines Grp. S.A.*, 620 B.R. at 790). A court might determine that a price is not fair "if that price is not the best alternative available for the corporation and its stockholders" (*In re Dole Food Co., S'holder Litig.*, 2015 WL 5052214, at *34 (Del. Ch. Aug. 27, 2015)).

Overlapping Directorships

It has become common practice for large corporate enterprises comprised of dozens, and sometimes hundreds, of distinct legal entities to have overlapping individuals as officers or directors of multiple entities. If a director sits on more than one board, they owe full, separate fiduciary duties to each entity (see Marshall S. Huebner, A Dangerous Mix: Multiple Board Service and Insolvency, 37-Feb Am. Bankr. Inst. J. 12 (Feb. 2, 2018)). The law recognizes that insolvency is a critical point at which the interests of a parent and its now-insolvent subsidiary may well be at odds (see *Off. Comm. of Unsecured Creditors of TOUSA, Inc. v. Tech. Olympic, S.A. (In re TOUSA, Inc.)*, 437 B.R. 447, 458-459, 461 (Bankr. S.D. Fla. 2010) (internal citation omitted) (quoting the Third Circuit to explain that, in the context of an insolvent subsidiary, there is no longer just an interest in "maximiz[ing] [the] economic value" of the parent but also an interest in "protecting the subsidiary's creditors")).

Even if directors recused themselves from decision-making at one of the entities, a court might view continuing to act for entity A as a breach of fiduciary duty to entity B, despite the recusal from the issue as an entity B director (see *In re TOUSA, Inc.*, 437 B.R. at 455 (stressing that recusal is not a "per se" discharge of duties); see also *Weinberger v. Uop*, 457 A.2d 701, 710-711 (Del. 1983) (stating that there is "no 'safe harbor,'" including recusal)). The same may be true even if directors recused themselves at both boards (see 37-Feb Am. Bankr. Inst. J. 12). Therefore, where a conflict develops between two entities, even if part of a single enterprise, the safest course for a director is to resign from one, and possibly both, boards. For this and other reasons outlined earlier in the article, directors may consider structuring companies in the form of entities that provide greater protection from liability, such as LLCs (see 37 Am. Bankr. Inst. J. 12).

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Finally, directors should ensure that there is insurance coverage in place that provides maximum protection (see 37 Am. Bankr. Inst. J. 12 and D&O Insurance).

Directors' Duties During the Pre-Insolvency Period

The discussion in this section is based on the law in Delaware.

Unlike in many other jurisdictions, the duties of a director of a US company do not generally change when the company is in the "zone of insolvency" or in fact becomes insolvent. Rather, directors continue to owe duties to the corporation itself, but "creditors take the place of the shareholders as the residual beneficiaries of any increase in value" (*N. Am. Cath. Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007)). Directors are expected to "pursue value maximizing strategies" whether the company is solvent, nearing insolvency, or insolvent (see *Trenwick Am. Litig. Tr. v. Ernst & Young, L.L.P.*, 906 A.2d at 175). Insolvency does not create a duty for a director "to shut down the insolvent firm and marshal its assets for distribution to creditors, although they may make a business judgment that this is indeed the best route to maximize the firm's value" (*Quadrant Structured Prods. Co., Ltd. v. Vertin*, 115 A.3d 535, 546-547 (Del. Ch. 2015)). Moreover, there is no cause of action for "deepening insolvency" under Delaware law (see *Trenwick Am. Litig. Tr. v. Ernst & Young, L.L.P.*, 906 A.2d at 174 (explaining that "under Delaware law, 'deepening insolvency' is no more of a cause of action when a firm is insolvent than a cause of action for 'shallowing profitability' would be when a firm is solvent. Existing equitable causes of action for breach of fiduciary duty, and existing legal causes of action for fraud, fraudulent conveyance, and breach of contract are the appropriate means by which to challenge the actions of boards of insolvent corporations")).

By contrast, in certain jurisdictions outside of the US, the zone of insolvency is a relevant consideration for directors. For example:

- Australia restricts insolvency trading (see Corporations Act 2001 (Cth) s 588GA (Austl.), as amended by Treasury Laws Amendment (2017 Enterprise Incentives No. 2) Act 201).
- Some jurisdictions impose a bankruptcy filing requirement when a company is in a "zone of insolvency" (see UNCITRAL, Legislative Guide on Insolvency Law-Part four, paragraph 7; e.g., Sec. 15a of the Germany Insolvency Code (*Insolvenzordnung - InsO*)). German law, for example, imposes a duty on directors to be aware, at any point in time, of the company's financial position (Sec. 1 para. 1 of the German Corporate Stabilization and Restructuring Act (*Unternehmensstabilisierungs- und restrukturierungsgesetz – StaRUG), Sec. 43 of the German Limited Liability Companies Act (Gesetz über die Gesellschaften mit beschränkter Haftung – GmbHG)*).

The policy rationale for requiring directors in certain jurisdictions to proceed with a bankruptcy filing at insolvency has been described as a motivating mechanism for directors to take targeted and swift actions to rehabilitate the company's financial position so that creditors do not continue to suffer losses (see UNCITRAL, Legislative Guide on Insolvency Law—Part four, para. 8). This is in stark contrast to the US model, where "[d]irectors cannot be held liable for continuing to operate an insolvent entity in the good faith belief that they may achieve profitability, even if their decisions ultimately lead to greater losses for creditors" (*Quadrant Structured Prods. Co., Ltd.*, 115 A.3d at 547).

Examination of Directors' Pre-Insolvency Actions During Insolvency Proceedings

The default rule in a proceeding for a large corporate enterprise under Chapter 11 of the Bankruptcy Code (Chapter 11) is that the debtor remains in possession. It is rare and a rare and extraordinary remedy for a court to appoint a trustee to manage or wind down the debtor's business. This means the board and management virtually always remain in control and continue to operate the debtor, with court approval needed for actions not in the ordinary course of business. The debtor's directors become fiduciaries to the debtor's estate under federal bankruptcy law and prior limits on fiduciary duties do not continue to apply (see, for example, *In re Houston Reg'l Sports Network, L.P.*, 505 B.R. 482 (Bankr. S.D. Tex. 2014) (explaining that directors have fiduciary duties in the absence of trustee oversight and holding that "the individuals who manage the Estate's affairs—whether 'officers and managing employees' or puppeteers acting through a general partner—must respect the fiduciary sanctity of the operation of a bankruptcy estate")). As a result, the debtor-in-possession, and not a third party, has the primary duty to investigate actions taken during the pre-filing period. In practice, one or more independent directors may be tasked with this investigation. The independent directors may hire separate counsel to assist in reviewing documents, conducting interviews of company employees, and drafting reports to understand

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and analyze potential causes of action and prior transactions, especially those with insiders and affiliates.

Creditors' Committees

In most corporate Chapter 11 cases, the US Trustee, a division of the Department of Justice, appoints an official unsecured creditors' committee (UCC). The UCC may investigate potential claims, including the against parent or former officers or directors (§ 1103(c)(2), Bankruptcy Code). Specifically, a UCC has the statutory power to "investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business, and any other matter relevant to the case or to the formulation of a plan" (§ 1103(c)(2), Bankruptcy Code). Other parties in interest, such as "ad hoc" groups of creditors or equity holders, may also seek discovery in aid of an investigation. Discovery is generally broad in the US, as "any party in interest" can seek court approval for discovery of "any entity" regarding "any matter which may affect the administration of the debtor's estate" (Fed. R. Bankr. P. 2004).

For more information on creditors' committees, see Practice Note, Chapter 11 Creditors' Committees.

Examiners

The Bankruptcy Code also permits a "party in interest or the United States trustee" to request appointment of an examiner to investigate prepetition or postpetition conduct such as "fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the debtor of or by current or former management of the debtor" (§ 1104(c), Bankruptcy Code).

For more information on examiners, see Practice Note, Chapter 11 Examiners.

Potential Claims Against Former Directors

Directors may find themselves the targets of litigation in Chapter 11 cases (see *In re Nine W. LBO Sec. Litig.*, 505 F. Supp. 3d 292 (S.D.N.Y. 2020)). These claims can include not only breach of fiduciary duty claims, but also claims for aiding and abetting a breach of fiduciary duty or for fraud (see, for example, *In re Nine W. LBO Sec. Litig.*, 505 F. Supp. 3d at 316-317; *In re Toys "R" Us, Inc.*, Memorandum Opinion, Case No. 17-34665-KLP (EDVA, 2022) (claims were brought against directors for allegedly misrepresenting and making fraudulent statements to stakeholders regarding the company's financial state)). To establish a successful aiding and abetting claim, a court must find:

- The existence of a fiduciary relationship.
- A breach of the fiduciary's duty.
- Knowing participation in that breach by the defendants.
- Damages proximately caused by the breach.

(see *In re Nine W. LBO Sec. Litig.*, 505 F. Supp. 3d at 315). A court may also hold a director liable for aiding and abetting a breach of fiduciary duty if the director approves a transaction with "actual or constructive knowledge" that a party or parties who will further execute the transaction and assume fiduciary duties will breach these fiduciary duties (see *In re Nine W. LBO Sec. Litig.*, 505 F. Supp. 3d at 315 (permitting a claim for aiding and abetting against directors who approved a transaction that ultimately resulted in other directors breaching their fiduciary duties because the transaction rendered insolvent the company to which they owed fiduciary duties)).

In a bankruptcy case, claims for breaches of fiduciary duty, fraudulent transfer, preference, and various other claims against directors are property of the estate (see Practice Note, Property of the Estate: Overview). Therefore, a creditor generally cannot pursue them directly. As with shareholders of a solvent entity, creditors must seek standing to bring actions against directors, and courts grant standing "only when the trustee or debtor in possession unjustifiably failed to bring suit or abused its discretion in not suing" which is a high burden for a creditor to overcome (see *In re STN Enters.*, 779 F.2d 901, 904 (2d Cir. 1985)). To prove this, a creditor must demonstrate to the court:

- First, that "a colorable claim or claims for relief that on appropriate proof would support a recovery."
- Second, that "an action asserting such claim(s) is likely to benefit the reorganization estate."

(*In re STN Enters.*, 779 F.2d at 905.) A court might find that even though "[t]he claims were colorable" they were "not in the best interest of the [d]ebtors' estate . . . because the possible recovery was outweighed by the litigation costs and risk" (see *Off. Comm. of Unsecured Creditors v. Sabine Oil & Gas Corp. (In re Sabine Oil & Gas Corp.)*, 562 B.R. 211, 221 (S.D.N.Y. 2016)). Many courts will not permit a litigation that benefits "committees and individual creditors" while "result[ing] in a net loss to the entire estate" (*Off. Comm. of Unsecured Creditors of AppliedTheory Corp. v. Halifax Fund, L.P. (In re AppliedTheory Corp.)*, 493 F.3d 82, 86 (2d Cir. 2007)).

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Finally, state and federal law may impose personal liability on directors in situations beyond the fiduciary duty context. For example, federal and state statutes may impose liability on directors for fraud, illegal dividends, or stock repurchases, and in other areas relating to certain health, safety, taxation, and labor matters (see, for example, 30 U.S.C. § 820 (imposing civil penalties and fines on directors and officers for failure to comply with coal mine health and safety laws); 29 U.S.C. § 216 (imposing liability on officers and other employers for unpaid wages); Cal. Code Regs. tit. 18, § 1702.5 (imposing personal liability for unpaid taxes); see also, for example, *Belcufine v. Aloe*, 112 F.3d 633, 634 (3d Cir. 1997) ("Under Pennsylvania law, when a corporation fails to pay wages and benefits that it owes its employees, the corporation's top officers can be held personally liable")).

Protection for Directors

Releases and Exculpations in Connection with Bankruptcy Proceedings

Releases and exculpations in Chapter 11 plans of reorganization often release, resolve, or settle actual or potential claims against officers or directors. For debtor releases, that is, releases for the many claims that the debtor itself owns, a court generally considers whether these releases are "a valid exercise of the [d]ebtors' business judgment" (see *In re Erickson Inc.*, 2017 WL 1091877, at *7 (Bankr. N.D. Tex. Mar. 22, 2017)). This standard is generally met when the debtor releases and exculpations are "not overly broad," namely, when they are "limited to parties who have performed necessary and valuable duties in connection with [the] [b]ankruptcy [c]ase," or reach settlements justified under the applicable bankruptcy rules and caselaw (*In re Alpha Nat. Res., Inc.*, 556 B.R. 249, 260-261 (Bankr. E.D. Va. 2016)).

Voluntary third-party releases (as opposed to debtor releases) (whether opt-in or opt-out) are also often not contested (see, for example, *In re Indianapolis Downs, LLC*, 486 B.R. 286, 306 (Bankr. D. Del. 2013) ("As for those impaired creditors who abstained from voting on the Plan, or who voted to reject the Plan and did not otherwise opt out of the releases, the record reflects these parties were provided detailed instructions on how to opt out, and had the opportunity to do so by marking their ballots. Under these circumstances, the Third Party Releases may be properly characterized as consensual and will be approved.").

The question of whether "the Bankruptcy Code permit[s] nonconsensual third-party releases of direct claims against non-debtors" has been the subject of litigation, and the Second Circuit is the most recent Circuit to address this question (*Purdue Pharma L.P. v. City of Grand Prairie (In re Purdue Pharma L.P.)*, 2023 WL 3700458, at *2 (2d Cir. May 30, 2023)).

The Second Circuit, which is joined by a majority of circuits, recently reconfirmed that the Bankruptcy Code authorizes non-consensual third-party releases in appropriate cases (see *In re Purdue Pharma L.P.*, 2023 WL 3700458, at *16-17 and Legal Update, In re Purdue Pharma: Second Circuit Holds that Bankruptcy Code Permits Non-Consensual Third-Party Releases, Reversing US District Court for SDNY). Before confirming a plan that contains a nonconsensual third-party release, courts should consider whether:

- There is an identity of interests between the debtors and released third parties, including indemnification relationships.
- Claims against the debtor and non-debtor are factually and legally intertwined, including whether the debtors and the released parties share common defenses, insurance coverage, or levels of culpability.
- The scope of the releases is appropriate.
- The releases are essential to the reorganization.
- The non-debtor contributed substantial assets to the reorganization.
- The impacted class of creditors "overwhelmingly" voted in support of the plan with releases.
- The plan provides for the fair payment of enjoined claims.

(see *In re Purdue Pharma L.P.*, 2023 WL 3700458, at *19-20.)

A minority of circuits have disapproved of nonconsensual third-party releases outside of the mass tort context, but have not yet expressed a view on mass tort bankruptcies (see, for example, *Ad hoc Grp. of Vitro Noteholders v. Vitro S.A.B. de C.V. (In re Vitro S.A.B. de CV)*, 701 F.3d 1031, 1061 (5th Cir. 2012) (citation omitted)).

For more information on third-party releases, see Practice Note, Third-Party Releases in Bankruptcy Plans.

D&O Insurance

Directors can also help protect themselves from potential personal liability by ensuring that the corporate entity has procured appropriate insurance (see 37-Feb Am. Bankr. Inst. J. 12). Side A coverage (direct coverage) best protects directors, under which the insured are exclusively the directors and officers rather than the company itself

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(see Marshall S. Huebner and Benjamin M. Schak, D&O Insurance and Insolvency: Navigating the Intersection, 25 Corp. Governance Advisor, No. 3, at *11 (May/June 2017); § 362, Bankruptcy Code). In addition to Side A coverage, there is:

- Side B coverage (indemnification coverage), which reimburses a company for indemnification payments the company makes to directors on account of claims and related expenses.
- Side C coverage (entity coverage), which is the coverage that protects the company for claims against it.
- Side D coverage (derivative investigation coverage), which covers costs associated with internal investigations that the company initiates in response to a shareholder derivative claim.

(See Practice Note, Insurance Policy Holder Issues in Bankruptcy: Common Types of D&O Insurance.)

Coverage that is shared among the directors and officers and the company may be property of the debtor's estate in a Chapter 11 case (see 25 Corp. Governance Advisor, No. 3, at *11; § 362, Bankruptcy Code and Practice Note, Insurance Policy Holder Issues in Bankruptcy: D&O Insurance as Property of the Estate). As a result, absent a separate or properly structured set of insurance policies or court approval, directors might, absent relief from the automatic stay, be delayed or even be prevented from actually recouping under insurance policies shared with the debtors (see 25 Corp. Governance Advisor, No. 3, at *10; § 362, Bankruptcy Code).

Company Transactions That Can Be Challenged and Unwound if the Company Files for Bankruptcy

Certain corporate transactions, even if they do not lead to personal liability for a director, are subject to avoidance in bankruptcy proceedings.

Fraudulent Transfers

Section 544 of the Bankruptcy Code (which incorporates state fraudulent transfer law) and section 548 of the Bankruptcy Code (a separate federal fraudulent transfer statute) govern fraudulent transfers. Fraudulent transfer claims can result in damages for, or the avoidance or unwind of, transactions found actually or constructively fraudulent (§§ 544, 548, Bankruptcy Code). The distinction between actual and constructive fraudulent transfers turns on intent (§ 548, Bankruptcy Code). While actual intent requires an "intent to hinder, delay, or defraud" a creditor, transactions in which the debtor was or was rendered insolvent and "received less than a reasonably equivalent value in exchange for such transfer obligation" can be deemed constructively fraudulent under state or federal law (§ 548(a)(1)(B), Bankruptcy Code).

Section 548 expressly references insiders and states that "transfers to or for the benefit of an insider under an employment contract" may be avoided if, one year before the company files for bankruptcy, the debtor "made such transfer to or for the benefit of an insider, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business" (§ 548, Bankruptcy Code). This transfer can be avoided even if it was made while the debtor was solvent if the debtor "received less than equivalent value in exchange for the transfer or obligation" (§ 548, Bankruptcy Code).

For more information on fraudulent transfers, see Practice Note, Fraudulent Conveyances in Bankruptcy: Overview.

Safe Harbors

There are safe harbors in the Bankruptcy Code that protect certain participants in certain prepetition transactions from fraudulent transfer claims. For example, section 546(e) of the Bankruptcy Code exempts from fraudulent transfer attack transfers in connection with a margin payment, settlement payment, or securities, commodity, or forward contract and involve parties such as "commodity broker[s], forward contract merchant[s], stockbroker[s], financial institution[s], financial participant[s], [and] securities clearing agenc[ies]" (§ 546(e), Bankruptcy Code). Regarding each of these types of transactions and types of participants, plaintiffs may argue that a particular transaction or participants do not fall within the applicable definitions, and therefore, do not fall within any of the safe harbors. For example, one circuit court recently defined "financial institutions" to include a "customer" of a "financial institution," if there is agency (see *Deutsche Bank Tr. Co. Ams. v. Large Private Beneficial Owners (In re Tribune Co. Fraudulent Conveyance Litig.)*, 946 F.3d 66, 78 (2d Cir. 2019)). A recent judicial decision has also held that, under section 546(e), "state law, intentional fraudulent conveyance claims are preempted" (*Holliday v. Credit Suisse Sec. (USA) LLC*, 2021 WL 4150523, at *9 (S.D.N.Y. Sept. 13, 2021)).

For more information on safe harbors, see Practice Note, Bankruptcy Code Avoidance Action Safe Harbors and Guide to Bankruptcy Code Safe Harbors for Financial Contracts: Checklist.

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Preferences

Section 547 of the Bankruptcy Code allows for preferential transfers to be recovered (§ 547, Bankruptcy Code). This section of the Bankruptcy Code prevents a debtor from, in certain circumstances, being able to advantage one creditor over others that are similarly situated.

Directors should be aware that transactions with both insiders and non-insiders close to the time of a bankruptcy filing are at risk of being investigated, challenged, and unwound if:

- Made for or an account of antecedent debt (that is, a debt that existed before the time of the transfer).
- Made while the debtor was insolvent.
- Made within 90 days before the filing of the bankruptcy petition or within one year, if made to an insider.
- Made to or for the benefit of a creditor.
- That enabled the creditor to receive more than it would have received if the case were a case under Chapter 7 of the Bankruptcy Code.

(§ 547(b), Bankruptcy Code).

At the same time, in certain instances, such as where a creditor provides "new value" or the transaction occurs in the "ordinary course of business," there are defenses to potential preference challenges (§ 547(c), Bankruptcy Code).

For more information on preferences, see Practice Note, Preferential Transfers: Overview and Strategies for Lenders and Other Creditors.

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