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Bank Director Magazine - 4th Quarter 2009

Directing Within the "Zone"

Frank Aquila and Peter Naismith

Poor economic conditions and lack of credit combine to create new challenges for directors.

The subprime mortgage crisis and resulting credit crunch has led to many a sleepless night for corporate directors of companies in almost all sectors. Almost without warning, directors have had to address a range of issues that were unthinkable a mere few years earlier. The boards of Bear Stearns and Wachovia had to approve business combinations under immense time and other pressures. The boards of companies as diverse as General Motors, Lehman Brothers, Six Flags, and Circuit City have had to approve bankruptcy filings. Among those hardest hit has been the financial services sector. Across the globe, major financial institutions have needed to raise billions in fresh capital to patch bloodied balance sheets. Announcements of bank failures have become regular Friday afternoon features and weakened institutions have merged or sold key assets to remain solvent. Given the weak economic environment coupled with ongoing credit constraints, the next few years will likely provide directors with further tests and challenges.

Add to the stress of making time-sensitive, critical business decisions, boards of directors also need to focus on their fiduciary duties and the potential for personal liability. Seventeen years ago the Delaware Chancery Court launched a thousand client alerts by opining in the *Credit Lyonnais* case that "in the vicinity of insolvency, a board of directors is not merely the agent of the [stockholders], but owes its duty to the corporate enterprise." The Court added in a footnote that, in this "zone of insolvency," the efficient and fair course may diverge from the course that the stockholders, or any single group of stakeholders, might take. These comments were seized upon to posit that when a corporation entered this indeterminable zone, the fiduciary duties of directors shifted, from being owed to the corporation and its stockholders to the corporation and its creditors. Many interpreted the *Credit Lyonnais* decision as empowering creditors with the right to assert direct claims against corporate directors.

The concept of direct preinsolvency exposure to creditors was explosive and troubling news for directors. Until then, the prevailing view was that directors' duties shifted from stockholders to creditors only upon actual insolvency. However, in the years that followed, as further cases have provided additional analysis and clarity, directors have been somewhat reassured that the practical impact of the *Credit Lyonnais* decision is in fact minimal.

As the liquidity crisis began to unfold in 2008, courts continued to lend an understanding ear to directors. In the *Bear Stearns* and *Wachovia* cases, the courts recognized the significant financial, governmental, and time pressures faced by boards in negotiating and signing merger transactions in conditions exacerbated by the global financial crisis. The courts expressed a great reluctance to second-guess informed, good faith decisions made by boards to avert bankruptcy amid, as the court in *Wachovia* put it, an "unprecedented financial tsunami."

The cases since *Credit Lyonnais* refusing to recognize theories such as the action for "deepening insolvency," have left Delaware directors feeling a bit more confident of their ability to navigate treacherous financial waters free of judicial second-guessing. Prudent directors should, however, in an abundance of caution, begin to consider creditors' interests as soon as their corporation becomes financially distressed, even though they do not yet owe fiduciary duties to those creditors.

While the business judgment rule and the fundamental protections afforded by corporate law should insulate directors from personal liability in most situations, directors must keep their eyes wide open and would be well advised to follow some basic principles when making decisions while the specter of corporate insolvency looms.

1. *Keep abreast of legal developments*—Regularly refresh your understanding of fiduciary and other statutory duties. Do not simply rely upon what you were told in the past. This is a fact-driven, dynamic area of the law, so courts and legislatures regularly change the rules or give greater clarity to vague concepts. Also, what might be applicable in one situation may not apply to the set of facts you are dealing with.

2. *Take a balanced approach*—In the "zone of insolvency," it is best to avoid unduly favoring the interests of stockholders over creditors. For example, think carefully before approving dividends, share repurchases, or other transactions that return capital to stockholders. Retain qualified counsel to advise on significant transactions. If appropriate, request that the board obtain independent advisers.

3. *Review the corporation's solvency*—Engage actively in understanding the financial statements presented to you. A clear understanding of the corporation's assets and liabilities, working capital and capacity to service debt, and performance against business plans is helpful to understanding the overall financial picture. Question the feasibility of plans and projections, as well as the assumptions that underlie them.

4. *Maintain records*—Ensure that board minutes record the efforts of you and your fellow directors make to discharge your duties. Your conflict disclosures, your requests for and consideration of information material to significant decisions, such as management recommendations, and your recognition of any insolvency considerations should all be duly and properly memorialized. Recording sensitive board deliberations is a job for experienced counsel – remember inclusion of irrelevant details could be as dangerous as the failure to provide sufficient details.

5. *Insist on full D&O protection*—Insist upon, to the extent possible, charter and bylaw provisions that represents best practice with respect to exculpation, indemnification, and expense advancement (be aware that there are limitations to the utility of these provisions, particularly in bankruptcy). Confirm that your corporation maintains adequate D&O insurance, understand its terms and/or consider purchasing an additional layer of coverage. When appropriate, consider requesting an indemnification agreement to supplement both the charter/bylaws provisions and the D&O insurance coverage. Confirm where insurance proceeds will be received in the event of a bankruptcy. Yes, all of this can be expensive and time consuming, but these are important lines of defense in case of litigation and the potential for personal liability.

6. *Avoid self-dealing*—When it comes to any transaction that could possibly be characterized as self-dealing of any kind, it is always essential to be beyond reproach. When insolvency is a possibility, it is essential that you diligently comply with your obligation to disclose personal interests and avoid participating in decision-making if a conflict might be perceived. Receipt of fairness opinions for certain transactions may also be appropriate. When in doubt obtain professional advice.

7. *Do not resign in haste*—Often a director will seek to resign when a crisis is looming. Not because the director is shirking their duty, but rather because their “day job” requires their full attention and the director believes they may not be able to do justice to both roles. Before resigning your position though, it is essential to give due consideration to how that resignation will be perceived. As a general matter, the law obliges directors to remain in office if their resignation might cause or permit immediate harm to the corporation or its business.

While these seven principles are good “rules of the road” in almost any situation, in the context of the current financial crisis they are essential. Beyond these principles, most directors will want to have a fuller understanding of all aspects of the corporation’s financial picture. Your primary objective should always be to do the best possible job for the corporation and its various constituencies, but in times of crisis, a better understanding of the financial state of affairs will allow you to more fully assist management in their efforts to steer the company clear of financial disasters. A few basic steps can help directors better understand the depth of potential problems:

- Maintain a regular dialogue. Engage in a dialogue with management with respect to the areas of the business that have been most affected. Seek to understand how these will impact budgeted initiatives, future plans, and projections. Assess the impact of declining asset values, “mark-to-market” requirements, and adverse ratings actions. Evaluate the performance of your management team in handling the challenges faced. Review the adequacy of your corporation’s reporting structures—Have you been caught unawares?
- Understand the entire credit picture. Gain a working familiarity with the corporation’s credit facilities, covenants, and compliance history. Keep an eye on any assignment of your loans and caution management to exercise consent rights carefully. Be aware that one lender’s failure to enforce a covenant does not imply the same treatment by the same lender or its assignees in future.
- Take a 360° view. Monitor the financial health of key customers and competitors. Question management as to the impact of customer insolvencies. Consider whether key contracts might be renegotiated in the light of current circumstances. Stay on top of industry trends, as well as the performance and problems of competitors. Remember, competitors approaching insolvency often take seemingly irrational actions that could further erode your company’s revenues and profits.

Although the global economy has significantly improved in recent months, the outlook for the balance of 2009, early 2010, and beyond continues to be somewhat sobering. As the aftershocks continue to be felt, many corporations may well be operating in the “zone,” whether or not they are aware of it.

It is fortunate that most courts recognize the real difficulties that directors face on a daily basis and the importance of having talented individuals willing to serve as corporate directors. While the risk of litigation and the possibility of personal liability may always exist, acting prudently and following a few sensible practices will not only lead to the best available outcome for the corporation, but it should all but eliminate the risk of personal liability for the directors.

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