Emerging Concerns on ‘Independent’ Bankruptcy Directors,

ZONE OF INSOLVENCY & DIP/STALKING HORSE SALES

BY JEFFREY R. MANNING SR., CTP, MANAGING DIRECTOR,
COHNREZNICK CAPITAL MARKETS SECURITIES LLC

THE ROLE OF TURNAROUND PROFESSIONALS

This article reviews issues emerging on the "independent" bankruptcy director, explores recent zone of insolvency trends, and outlines contemporary developments around the DIP/stalking horse.

Independent Bankruptcy Directors

Professor Jared A. Ellias of Harvard Law School has spearheaded recent research on the emergence of independent bankruptcy directors.[1] Over the past few years, a troubling development in bankruptcy practice appears to be making headway, circumventing and undermining the normal Bankruptcy Court review of certain critical issues by corralling litigation risks or granting broad releases to senior management and private equity sponsors.

Sophisticated companies, nearly always under private equity sponsor control, are adapting a strategy to realign prepetition boards of directors by appointing "independent" bankruptcy experts to guide boards on key bankruptcy decisions. While at first blush bringing in this specialized expertise makes sense, the integrity of the restructuring process may be undermined if these bankruptcy directors wrest control from creditors by self-dealing and corralling other potential and legitimate litigation claims against shareholders. By steering these issues into corporate jurisdictions outside of the U.S. Bankruptcy Courts, using the business judgement rule, these bankruptcy directors potentially tilt the playing field in favor of equity stakeholders against the strict priority rules of Chapter 11.

Bankruptcy Courts and the Office of the U.S. Trustee Office (UST) need to carefully examine and potentially push back against this shift.

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In addition to demonstrating "disinterestedness" and "independence" under the code—and the latter may be difficult to ascertain with certitude—these bankruptcy directors need to provide evidence of qualifications.[2] Ellias further argues that the high bar should include consensus from additional major parties in the Chapter 11—senior lenders, official committees, and other key players—before decisions and actions by these bankruptcy directors deserve currency in bankruptcy.

One troubling but revealing statistic from the first empirical study was that unsecured creditors recover on average 20% less when the company appoints a bankruptcy director, and that was before the risks of setting aside widespread releases and other litigation.

While these directors claim to be "neutral experts" who act to maximize value for the benefit of all creditors, evidence suggests that they may suffer from an understandable structural bias because they often receive their appointments from a small community of private equity sponsors and law firms. Many of these professionals are repeat candidates. In one case, a bankruptcy director had been appointed in over 50 cases. Securing future directorships likely requires pleasing core clientele, potentially at the expense of creditors and other stakeholders. Professional "independent" bankruptcy directors may not be so impartial and instead may be influenced by "which side their bread is buttered."

Bankruptcy Courts and the UST should be guided to regard bankruptcy directors as independent only if an overwhelming majority of creditors—whose claims are at risk—support their appointment, making these directors accountable to all sides of the bankruptcy dispute.[3]

Developments in Zone of Insolvency Principles

Holding bankruptcy directors strictly accountable to the principles of the zone of insolvency is one way to protect the integrity of bankruptcy, at least as the zone adds acute tests to the business judgement rule.

It was once well established that an insolvent corporation owed fiduciary duties not only to the corporation and its shareholders but also to the corporation's creditors as well. That was as clear as that yellow line that marks the line to gain for a first down on Monday Night Football. However, over the past decades that line has blurred. Under widely accepted theory and practice, some courts have held the fiduciary duties of directors and officers expand to include other creditors and stakeholders when the corporation is merely approaching insolvency and may be approaching a financially troubled situation.

The Delaware Chancery Court was initially cool to the concept of the zone of insolvency, which was perhaps not surprising given the importance of corporate organization in the state of Delaware. However, while the Delaware Chancery Court may have been guarded, many U.S. Bankruptcy Court jurisdictions recognized, embraced, and took guidance from the principles of the zone of insolvency, albeit on a court-by-court basis. Judges generally made their preferences clear.

However, in the seminal 1991 decision of Credit Lyonnais,[4] the Chancery Court recognized the fundamental shift in duties: "[W]here a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers [the shareholders], but owes its duty to the corporate enterprise. [D]irectors [should] recognize that in managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right (both the efficient and fair) course to follow for the corporation may diverge from the choice that the stockholder ... would make if given the opportunity to act." In other words, the duties to creditors may arise even when the corporation is actually solvent but is approaching insolvency.

Although the strict definition of insolvency is often vigorously litigated by talented and experienced professionals, the zone of insolvency may be an even easier determination—to wit, if there is any doubt that a company may not be able to meet future obligations as they come due, it may be in the zone; thus, officers and directors are astute to be guided by zone principles. In short, if one has to ask, it is likely that one is near the zone.

As a general rule, the zone of insolvency provides that officers and directors of the insolvent corporation owe the same duties of loyalty and care to creditors as those that run to shareholders when the corporation is solvent. This rule is doubly pertinent to bankruptcy directors, given their alleged expertise and experience.

Times of financial distress can call for extraordinary diligence and oversight, known as the "duty of obedience." Similarly, there can be a heightened "duty of care" and increased "loyalty" with respect to both financial and operational decisions. Managers are obligated to act in good faith, in a manner reasonably believed to be in the best interests of the enterprise. Since it is the business judgement rule, and not the "good" business judgement rule, officers and directors still have a great deal of discretion but may wish to prudently include third-party consultants and financial advisors to back up major decisions by providing written evidence of how and why a decision was reached.

Any financial transaction—the sale of a division, recapitalization, or spinoff—likely benefits from a fairness opinion issued by a FINRA-licensed investment banker that the board can look to later for protection against fraudulent transaction claims. In the long run, fairness opinions are usually cheap insurance. In general, once near the zone, officers and directors are wise to document, document, document every important decision they make.

While the sparring between Bankruptcy Courts and other courts continues, in the 2006 Gheewalla[5] decision, the Delaware Supreme Court narrowed the zone of insolvency, addressing a nagging question about corporate directors' duties and liabilities to creditors. The court held that "the creditors of a Delaware corporation that is either insolvent or in the zone of insolvency have no right, as a matter of law, to assert direct claims for breach of fiduciary duty against the corporation's directors."

The court explained:

> [D]irectors owe their fiduciary obligations to the corporation and its shareholders. . . . When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners.

However, the Delaware Supreme Court concluded that "the creditors of an insolvent corporation have standing to maintain derivative claims against directors on behalf of the corporation for breaches of fiduciary duties."

Peering into the crystal ball, it is likely that less-than-prudent behavior by insiders in some recent high-profile cases will potentially stress and stretch the breadth and depth of future fiduciary litigation, both outside and especially inside of Bankruptcy Court. An unprecedented near decade of historically low interest rates has driven M&A activities and created thousands of portfolio companies that now face higher interest rates and tighter credit markets. Many directors and senior managers of these companies need to consider zone of insolvency issues as they face challenges, as it is likely that senior lenders and other creditors will focus intently on the zone as a potential source of leverage and recovery.

DIP/Stalking Horse Trends

When Congress drafted Sections 363 and 365 into the Bankruptcy Code, it appeared its short few paragraphs were targeted to sell single assets

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Jeffrey R. Manning, CTP, is a managing director in CohnReznick Capital's Baltimore office and leads the special situations practice. A corporate recovery professional with over 40 years of experience and over 150 transactions completed, his investment banking experience has been across several industries, providing M&A, corporate finance, and strategic advisory services. Manning works with his firm's consultants to bring a full range of restructuring services to clients, including process improvement, financial advisory, interim management, and forensic accounting skills.

outside of the "normal course." Instead, clever lawyers, financial advisors, and investment bankers have materially expanded the use and application of Sections 363 and 365 to market complex going-concern businesses, and this strategy has emerged dominantly over the plans of reorganization more typical in most cases 40 years ago.

In fact, a professionally run competitive marketing process under Sections 363 and 365 is an excellent and expedited way to create the pile of cash to be later distributed in a plan by the professionals. Getting several bidders involved with a spirited auction is a terrific way to uncover the "highest and best" alternative (required but never defined by the code). The prevailing bidder benefits from a determination by the court that the assets sold are free and clear of all liens and encumbrances. To make that ruling, the court hopes to have confidence that the process sufficiently exposed the opportunity to a broad market, and the assets are being sold on an arm's length and transparent basis to an entity that can adequately perform under the assumed contracts and obligations.

Likewise, given debtor-in-possession (DIP) trends over the past decades, and especially the increasing emergence of DIP/stalking horse, many debtors face a near-term cash crunch with insufficient liquidity to run an orderly bankruptcy. This reality gives DIP lenders enormous influence, and thus these financings exert significant leverage through the contracts, provisions, and structures increasingly built into DIP loans. Senior creditors use the often-desperate need for cash to direct preferred outcomes at the outset of the case via devices like "restructuring plan support agreements" with strict benchmarks to define the timeline and administration of a case. Often, senior creditors steer the case to protect any claim against the priority of the senior claim, underlying collateral values, or other future litigation issues.

Unfortunately, the DIP/stalking horse can strain the credibility and effectiveness of the Sections 363 and 365 process to maximize the value of the firm for creditors as a whole. The court, UST, and UCC need to take notice to resist and object to these trends.

A recent case in point was the Winc, et.al. Chapter 11.[6] After an apparently ineffective eight-month marketing process of a public company that had reported assets as of September 30, 2022, in excess of $50 million,[7] the company filed a voluntary petition for protection on November 30, 2022. On December 7, the debtors filed several motions, including (i) Approving Bidding Procedures In Connection with the Sale of the Debtors' Assets, and (ii) Authorizing a Sale with a DIP/Stalking Horse at a price of merely $11 million. Compounding the official committee's concerns, the debtors disclosed that the DIP/stalking horse bid was controlled by one of the debtors' founders and former insiders, and as of early December, the ultimate outcome appeared to indicate a real possibility of an administrative insolvency.

Despite the upcoming holidays, the debtors requested a sale hearing by January 17, 2023—a marketing period of less than 35 days and, given the holidays, arguably less than 20 business days. For someone with 40 years of experience in corporate recovery, this kind of process represents a "silly sale" and not a legitimate market test.

A mentor once counseled that three women cannot make a baby in three months. A comprehensive and professional marketing process takes time. Unless there is a clearly defined (and documentable) effective prepetition marketing effort, a market test of less than 60 days to an auction with qualified bidders is rarely appropriate.[8]

Taking nothing away from the clever attorneys, advisors, and bankers coaching the DIP/stalking horse in WINC and other recent cases, for a successful and elegant strategy to buy assets at compelling valuations on an accelerated timeline without facing genuine competition. However, Bankruptcy Courts and the UST should evaluate the prospects of granting the "gold" Sections 363 and 365 finding of assets acquired free and clear all liens and encumbrances, following an arm's length and transparent market test. Courts appreciate that gold standard for its comfort and confidence. J

[1] See further innovative research published by Jared A. Ellias, Ehud Kamar, & Kobi Kastiel, "The Rise of Bankruptcy Directors," European Corporate Governance Institute Working Paper Series of Law, and Forthcoming 95 Southern California Law Review (2022), January 27, 2022.

[2] For example, through certifications, such as the CTP designation.

[3] The CTP designation should be viewed as strong confirmation of expertise and disinterestedness, guided by the tenets of the CTP certification process.

[4] See *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.* [1991 WL 277613 (Del. Ch. 1991]

[5] See *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla,* 2006 WL 2588971 (Del. Ch. Sept. 1, 2006) (Opinion)

[6] See further, *WINC, INC.*, *et al.* in the District of Delaware, (Case No.: 22-11238 (LSS))

[7] Benchmarking against other public comps suggested a valuation in excess of $75 million was possible.

[8] While debtors claim tight cash constraints mean they have to accept the timeline pushed by the DIP/stalking horse, a trained CTP will nearly *always* find a way to extend the runway to give the court adequate satisfaction of a genuine and defendable marketing period. Courts prefer to give a clean Section 363(m) finding.