



## **ABA Section of Business Law Fall Meeting**

**November 21-- 22, 2008**

**The Ritz-Carlton**

**Washington, DC**

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**Presented by: The Committee on Business Bankruptcy**

**Co-chairs - Hon. Jean K. FitzSimon and Sandra E. Mayerson**

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## **BIBLIOGRAPHY OF RECENT DELAWARE CASES**

### Cases In the Federal Courts

1. *LaSala v. Bordier et Cie*, 2008 WL 638266 (3d Cir. March 11, 2008) (holding that the Securities Litigation Uniform Standards Act did not prevent a trust from bringing claims for aiding and abetting breach of fiduciary duties).
2. *VFB LLC v. Campbell Soup Co.*, 482 F.3d 624 (3d Cir. 2007) (holding that no duty of loyalty was owed by the subsidiary's directors to the subsidiary as against the parent corporation at the time of spin-off).
3. *In re Tower Air, Inc.*, 416 F.3d 229 (3d Cir. 2005) (holding that allegations that directors breached their duty to act in good faith by declining to repair jet engines and instead replacing them with new engines because initial purchase payment was less than the cost of repairs failed to state a cause of action against directors for breach of their fiduciary duties).
4. *The Litig. Trust of MDIP, Inc. v. Rapoport*, 2004 WL 3101575 (D. Del. Nov. 29, 2004) (denying defendants' motion to dismiss finding that the plaintiff alleged sufficient facts to show that the directors knew they were making material decisions without adequate deliberation, and that they did not care that it caused the corporation and its stockholders to suffer loss).
5. *Continuing Creditors' Comm. of Star Telecomm., Inc. v. Edgecomb*, 385 F. Supp. 2d 449 (D. Del. 2004) (directors' sale of stock below merger price did not constitute a breach of the duty of loyalty).
6. *Miller v. McCown DeLeeuw & Co. (In re The Brown Schools)*, 2008 WL 1849790 (Bankr. D. Del. Apr. 24, 2008) (holding that deepening insolvency may be used as a theory of damages when breach of duty of loyalty claims are brought against directors and officers).
7. *Miller v. McDonald (In re World Health Alternatives, Inc.)*, 369 B.R. 805 (Bankr. D. Del. 2007) (denying trustee's request for preliminary injunction preventing disbursement of D&O policy proceeds to shareholders that filed derivative action against debtor on the basis that it was unlikely that the trustee could show that the proceeds were property of the estate).
8. *Miller v. McCown DeLeeuw & Co. (In re The Brown Schools)*, 368 B.R. 394 (Bankr. D. Del. 2007) (finding that the trustee had pleaded sufficient facts with regard to a fraudulent transfer count and a count for aiding and abetting a breach of fiduciary duties against directors in order to withstand a motion to dismiss).
9. *Claybrook v. Morris (In re Scott Acquisition Corp.)*, 344 B.R. 283 (Bankr. D. Del. 2006) (denying defendants' motion to dismiss, finding that a trustee does have standing to seek recovery on behalf of a bankrupt corporation in a breach of fiduciary duty action).

## Cases In Delaware State Courts

10. *Nat'l Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92 (Del. 2007) (holding that a creditor may not assert direct claims for breach of fiduciary duty against directors whether or not the corporation is solvent, insolvent or operating in the “zone of insolvency” and in dicta stating that creditors have standing to assert derivative claims for a breach of fiduciary duty against directors of an insolvent corporation).
11. *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362 (Del. 2006) (describing the duty of loyalty as requiring directors to place the interests of the entity above their own and requiring that actions be taken in good faith).
12. *Nelson v. Emerson*, 2008 WL 1961150 (Del. Ch., May 6, 2008) (rejecting claims that directors breached their fiduciary duties to creditors by having the company file for Chapter 11 and by paying themselves excessive compensation).
13. *Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168 (Del. Ch. 2006), *aff'd sub nom. Trenwick Am. Litigation Trust v. Billet*, 931 A.2d 438 (Del. 2007) (rejecting the notion that there is a viable fiduciary duty claim for deepening insolvency).
14. *Production Resources Group L.L.C. v. NCT Group, Inc.*, 863 A.2d 772 (Del. Ch. 2004) (for an analysis of directors' fiduciary duties and holding that creditors may have standing to pursue certain derivative claims but not due care claims).

## Law Review Articles and Other Publications

15. E. Norman Veasey, *Counseling the Board of Directors of the Company in Distress*, American College of Bankruptcy Conference (March 15, 2008).
16. Corinne Ball et al., *Advising the Board of Directors*, 1646 PLI/Corp 689 (2008).
17. Andrew Gold et al., *The Ins and Outs for Ds and Os: In the Zone: Fiduciary Duties and the Slide Toward Insolvency*, 5 DEPAUL BUS. & COM. L.J. 667 (2007).
18. THE CORPORATE DIRECTORS GUIDEBOOK (5th ed. 2007), *reprinted in* 62 BUS. LAW 1479 (2007).
19. E. Norman Veasey & Christine T. DiGuglielmo, *What Happened in Delaware Corporate Law and Governance From 1992-2004? A Retrospective on Some Key Developments*, 153 U. PA. L. REV. 1399 (2005).

## THE DELAWARE ZONE

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### Introduction

As parties seek new ways to bring deep pockets into an insolvency, "deepening insolvency" and "zone of insolvency" have become the tort *du jour*. What these catchphrases mean is still open to interpretation. As the law in this area continues to develop, recent decisions emanating from the Delaware courts, which many other courts look to for guidance on issues of corporate governance, have helped clarify some open questions. However, many other issues remain undecided and not every state or federal court follows Delaware in every respect. Therefore, the zone of insolvency remains a trap for the unwary fiduciary. That being said, there are some steps that can be taken before a crisis occurs, that will protect directors and officers when and if potential claims arise down the road. Being aware of the issues and seeking expert guidance are the best safeguards a fiduciary can have in these shifting sands.

### Fiduciary Duties Defined

Under Delaware law<sup>1</sup>, directors and officers owe duties of due care and loyalty. *See, e.g., Minn. Invco of RSA # 7, Inc. v. Midwest Wireless Holdings LLC*, 903 A.2d 786, 797 (Del. Ch. 2006); *Metro Communication Corp. BVI v. Advanced Mobilecomm Technologies, Inc.*, 854 A.2d 121, 156-157 (Del. Ch. 2004). This is true whether the entity is a corporation, a limited liability company, or a limited liability partnership.

The duty of care requires that directors exercise a requisite degree of care in the process of making decisions and in performing other aspects of their directorial responsibilities. *See* Franklin Balotti & Jesse Finkelstein, **Delaware Law of Corporations & Business Organizations** § 4.34 (3d ed. 2007). The standard for establishing a breach of the duty of due care under Delaware law is gross negligence. *See, e.g., Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), *rev'd on other grounds, Brehm v. Eisner*, 746 A.2d 244 (Del. 2000).

In the classic sense, the duty of loyalty requires a director to refrain from self-dealing and from misusing corporate funds or assets for personal gain. *Bell Atlantic Corp. v. Bolger*, 2 F.3d 1304, 1316 (3d Cir. 1993); *Lewis v. Austen*, 1999 WL 378125 (Del. Ch. 1999); *Solash v. Telex Corp.*, 1988 WL 3587 (Del. Ch. 1988). In recent years, courts have explained the duty of loyalty more broadly, as requiring a director or officer to place the interests of the entity

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<sup>1</sup> The law of the state in which an entity is formed usually controls issues of corporate governance and particularly will govern the scope of any duties owed to that entity by its officers and directors. *See, e.g., The Glidden Co. v. Jandernoa*, 5 F. Supp.2d 541, 554 (W.D. Mich. 1998). A large proportion of U.S. companies are incorporated in Delaware, and many other states will look to Delaware law for guidance on these issues. For this reason, we will focus on Delaware law but point out where differences still exist.

above those of any individual director, officer or controlling shareholder and also as requiring that any actions be undertaken in the good faith belief that they are in the best interests of the entity. *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 370 (Del. 2006). “A failure to act in good faith may be shown . . . where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.” *In re Walt Disney Company Derivative Litig., v. Eisner*, 906 A.2d 27, 67- 68 (Del. 2006).

When evaluating whether a particular action or omission constitutes a breach of either the duty of care or loyalty, Delaware law affords to the managers of a corporation 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.” *Walt Disney*, 906 A.2d at 52 (citation omitted). The business judgment rule protects good faith decisions of a board of directors if the decisions “can be attributed to any rational business purpose.” *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971). “[C]ompliance with a director’s duty of care can never appropriately be judicially determined by reference to *the content of the board decision* that leads to a corporate loss, apart from consideration of the good faith *or* rationality of the process employed. That is, whether a judge or jury considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through ‘stupid’ to ‘egregious’ or ‘irrational’, provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in a *good faith* effort to advance corporate interests.” *In re Caremark Intern. Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996) (emphasis in original). As such, it is the decision making process, not the outcome of the decision, that will be examined to determine whether there is liability.

### **To Whom are Fiduciary Duties Owed?**

The next question is, to whom do officers and directors owe their fiduciary duties? In other words, who has standing to challenge the propriety of a director's or officer's actions, and does this change as an entity moves from solvency to insolvency? While much has been written and there is much confusion about this issue, the Delaware Courts have made it clear that in the first instance, directors and officers owe their fiduciary duty directly to the *entity* they serve and to the *shareholders* of such entity. See, e.g., *Production Resources Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772, 792 (Del. Ch. 2004); *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007) (“The directors of Delaware corporations have ‘the legal responsibility to manage the business of a corporation for the benefit of its shareholder owners.’”). This makes sense, because it is the entity that suffers direct harm in the event of a breach of the duty of care or loyalty. So too, when an entity is solvent, the direct harm resulting from a director or officer’s breach of fiduciary duty causes indirect harm to the entity’s residual risk bearers – *i.e.*, its shareholders – typically by causing the value of the entity to drop. For this reason, in addition to the company itself, courts routinely hold that the shareholders of a solvent corporation potentially have standing to pursue claims for breach of fiduciary duty *derivatively* on behalf of the entity, assuming all other requirements of a

derivative action are met.<sup>2</sup> Any damages resulting from such a suit would be payable to the entity, however, for the benefit of all shareholders and not directly to the individual shareholder who brings the suit.

By the same token, courts routinely find that creditors of a solvent corporation do not have standing to bring claims for breach of fiduciary duty. Solvent corporations have sufficient funds to pay their debts in full, and unlike shareholders, creditors are not entitled to any sort of upside. Moreover, creditors have other direct remedies, such as claims for breach of contract or fraud, that presumably can protect their interests. *See Production Resources*, 863 A.2d at 787-790; *Gheewalla*, 930 A.2d at 99.

Once a company is insolvent, its creditors become the principal constituency that bears the risk of damages resulting from a breach of fiduciary duty by directors or officers. Under those circumstances, courts in Delaware have held specifically that creditors, in addition to shareholders, may bring a *derivative* action against directors and officers for breach of fiduciary duty. *Gheewalla*, 930 A.2d at 101-102. Courts in other jurisdictions likewise have held that creditors of insolvent corporations have standing to bring derivative actions for breach of fiduciary duty. *See, e.g., In re VarTec Telecom, Inc.*, 2007 WL 2872283, \*2-3 (Bankr. N.D. Tex. September 24, 2007) (construing Texas law).

### **Zone of Insolvency**

What happens, then, when a company is somewhere between bright line solvency and insolvency? This is often referred to as the “zone of insolvency.” While there are no precise definitions as to when a solvent company enters the zone of insolvency, fiduciaries should assume that they are operating in the zone of insolvency if the failure of a proposed transaction is reasonably likely to cause a company to become insolvent, or if it is reasonably foreseeable that the corporation will have ongoing trouble paying its creditors as a class. *See, e.g. In re Healthco Intern., Inc.*, 208 B.R. 288, 301-302 (Bankr. D. Mass. 1997). Less obvious fact patterns may also be considered within the “zone of insolvency”, so, fiduciaries must constantly assess the facts of their individual entity and seek professional advice, if necessary, to determine whether the entity is in the zone of insolvency. For example, a company may be consistently having covenant defaults but no payment defaults on its senior loan. The lenders are cooperating and have given a waiver every time, so long as they continue to be paid, but future covenant defaults are foreseeable. Upon any default, the lenders could refuse a waiver, which would accelerate the loan and make it due currently, thereby rendering the company insolvent. Is this company in the zone of insolvency? Similarly, a major customer is threatening to pull its business overnight. A technical default under the supply contract, which is immaterial in a practical sense, would give the customer the legal right to do so. The customer has made this threat before to renegotiate pricing terms and never pulled out, but there is little room for pricing negotiations in the contract now. With the customer in place, the company is healthy, but if the customer pulls out overnight, the company would not recover from the blow. Is this company in the “zone of insolvency” while these threats hang over it, or are these simply everyday, foreseeable business risks?

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<sup>2</sup> These requirements may include first making a demand on the board, continuing to hold the shares throughout the litigation, and other matters that are beyond the scope of this article.

Obviously, determining where the zone of insolvency begins can be a slippery slope. As noted above, during the past few years there has been a fair amount of confusion as to the scope and beneficiaries of a corporate fiduciary's duty when the entity he or she serves enters the zone of insolvency. Among other issues, courts have grappled with whether entering the zone of insolvency gives creditors additional rights to assert claims for breach of fiduciary duty, either directly or derivatively, and also whether corporate fiduciaries then must shift their focus to repayment of creditors at the expense of shareholders. *See, e.g., Production Resources*, 863 A.2d at 787-791 (discussing cases). This confusion has even led some federal courts to guess that the state courts would recognize a cause of action or possibly a damages theory for "deepening insolvency", *i.e.* a damages claim that defendants' decision to borrow additional funds when the entity was becoming insolvent (presumably in the hope that such funds would help the entity through a crisis period) caused the entity to become more insolvent and thus less able to pay creditors' claims. *See, e.g., Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340, 349-52 (3d Cir. 2001) (predicting that Pennsylvania might recognize a deepening insolvency cause of action); *Official Comm. of Unsecured Creditors v. Credit Suisse First Boston (In re Exide Technologies, Inc.)*, 299 B.R. 732, 750-52 (Bankr. D. Del. 2003) (predicting that Delaware courts would recognize such a claim).

Recently, however, in a blow to debtors, and in an effort to provide what they call "definitive guidance," the Delaware state courts have confirmed that there is no cause of action for deepening insolvency under Delaware law and that, even 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." *Gheewalla*, 930 A.2d at 101, *Trenwick American Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 202-203 (Del. Ch. 2006) *aff'd.*, 931 A.2d 438 (Del. Supr. 14 Aug 2007). Under the logic of these decisions, corporate fiduciaries are under no obligation to liquidate a company even in the face of insolvency, and directors and officers of Delaware entities do not breach their fiduciary duties merely by trying to effect a strategy that, if it succeeds, will create value for creditors as well as shareholders by putting the company back in the black, even if it turns out that such strategy ultimately fails. As long as the decision making process is proper and undertaken in good faith, the board is permitted to pursue strategies that it believes will maximize the value of the company, and the mere act of incurring additional debt in the face of insolvency, alone, does not establish bad faith or disloyalty. *Trenwick*, 906 A.2d at 174. Under these decisions, a Delaware fiduciary would continue to owe his duty to the enterprise even as it enters the zone of insolvency. That duty would not "shift" as a company drifts deeper or stays longer in the "zone of insolvency" as many commentators had previously posited.

As a corollary, the Delaware Supreme Court has held that, under Delaware law, creditors of a corporation that is insolvent or operating in the zone of insolvency cannot assert a direct claim for breach of fiduciary duty against the company's officers and directors. "To recognize a new right for creditors to bring direct fiduciary claims against . . . directors would create a conflict between those directors' duty to maximize the value of the insolvent corporation for the benefit of all those having an interest in it, and the newly recognized direct fiduciary duty to individual creditors." *Gheewalla*, 930 A.2d at 103. Accordingly, while creditors of an

insolvent corporation may bring a derivative action for breach of fiduciary duty, individual creditors of a Delaware entity may not bring a direct claim for breach of fiduciary duty. *Id.*

### **Uncertainty Remains**

While the Delaware decisions were clearly meant to provide guidance, and the inhabitants of corporate board rooms may be tempted to breathe a sigh of relief, assuming Delaware is once again their safe haven, it is not time for champagne just yet. Not every court has or will adopt Delaware's view that directors and officers remain free to take risks that, if successful, will benefit shareholders, but if not, may make an entity even less able to pay its valid creditors. Indeed, even in Delaware the picture is not crystal clear. At least one Federal bankruptcy court, sitting in Delaware and applying Delaware law, refused to grant a motion to dismiss a claim for deepening insolvency despite the issuance of the Chancery Court's opinion in *Trenwick*. See, e.g., *Miller v. McCown De Leeuw & Co., Inc. (In re The Brown Schools)*, 368 B.R. 394 (Bankr. D. Del. 2007) (denying motion to dismiss deepening insolvency claim). Query whether this decision would come out the same since the Delaware Supreme Court affirmation of *Trenwick*.

A recent Pennsylvania bankruptcy decision, while acknowledging *Trenwick*, also noted that the Third Circuit, which is the circuit encompassing Delaware, in *Official Comm. Of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F. 3d 340, (3d Cir. 2001), had predicted that Pennsylvania would recognize a tort for deepening insolvency. In light of that, in the case of *Miller v Marcel Dutil et al., (In re Total Containment, Inc.)*, 2008 WL 682455 (Bankr. E.D. Pa. 5 March 2008), the judge refused to dismiss claims on summary judgment against individual directors based on the tort of deepening insolvency.

Courts applying other states' laws likewise have found that creditors of insolvent entities *do* have standing to bring direct claims for breach of fiduciary duty against directors and officers. See, e.g., *Jetpay Merchant Services, LLC v. Miller*, 2007 WL 2701636, \*7 (N.D. Tex. Sept. 17, 2007) (Colorado law); *Technic Engineering, Ltd. v. Basic Envirotech, Inc.*, 53 F. Supp.2d 1007, 1010-1012 (N.D. Ill. 1999) (Illinois law); *Lopez v. TDI Services, Inc.*, 631 So.2d 679, 688 (La. Ct. App. 1994). Ultimately, the Third Circuit will need to address these issues before directors, officers and lenders can be truly comfortable in Delaware.

Moreover, as noted above, even Delaware courts have found that creditors have standing to pursue derivative claims for breach of fiduciary duty once a company is insolvent, and there is no question that the time within which an entity moves from the zone of insolvency to actual insolvency can occur in an instant -- especially with hindsight. Indeed, the recent free-fall collapse in the market for sub-prime mortgage securities only underscores how fast liquidity can disappear and asset values plummet. Solvency also is certainly an issue that is ripe for expensive litigation involving expert testimony, is subject to being reassessed in hindsight and often cannot be resolved in a motion to dismiss. The aid of expert forensic accountants can be critical to a Board. This area will continue to be ripe for litigation, and it is often prudent to assume that if the zone of insolvency is here, insolvency is just around the corner.

### **Procedural Safeguards**

What can or should a director or officer faced with a financial crisis do?

Certainly, there is no absolute way to prevent litigation from being filed. Indeed, it is almost certain that when the interests of shareholders and creditors compete -- as when a board is faced with the possibility that the failure of its business strategy could mean that creditors are not paid in full, but success means that shareholders are back in the money -- litigation will ensue from one set of interests or another. Competition among creditor groups in a capital structure with putatively secured debt, trade debt and subordinated debt is just as likely to lead to the threat of litigation.

That being said, the more reasoned, informed and carefully considered the process by which corporate directors and officers arrive at a business decision, the more likely that such decision will be deemed a proper exercise of business judgment. Directors can and should acknowledge that their enterprise may be in the zone of insolvency. There should be a clear record that they sought clarification as to whom their fiduciary duties are owed in light of the particular facts facing their company and the shifting legal framework. By doing so, they can establish that decisions were undertaken with these duties firmly in mind, even if the decisions later prove wrong. Directors also can and should obtain the advice of outside experts such as lawyers, financial advisors, auditors and restructuring specialists to help them in their decision making and in understanding which constituency, shareholders or creditors, should be their primary focus at any given time. Such advice also should be obtained as early as possible and reevaluated constantly, so that the board is ready if and when a temporary liquidity crisis turns into insolvency. Even if advance planning is not possible, decisions that are made carefully, with the advice of professionals and with a clear understanding of the board's responsibilities at that time, are more likely to be upheld as a valid exercise of business judgment.

In some cases, particularly when the entity's solvency is in question, it may also be appropriate to bring significant creditors or creditor groups into the decision making process, provided that appropriate confidentiality protections can be put in place. This can help to ensure that the parties with a stake in the process have a hand in developing strategy for the business and will have less reason to raise questions or assert claims later. Directors and officers must be careful not to let the special interests of any one creditor influence this process, however.

Corporate fiduciaries also should take steps to ensure that appropriate systems and controls are in place to prevent oversight deficiencies. Such steps make it less likely that the entity will fail to comply with any applicable regulatory obligations, which also could lead to liability down the road. Such systems also should be reviewed regularly, to make sure that they continue to function appropriately. A record should be kept that these issues were considered, and board meetings may increase in number to show the board is dealing with a crisis. Reliance on the advice of experts should be clearly documented. Minor details like ensuring that the board has materials sufficiently in advance of a meeting to render an informed judgment can become critically important details when viewed through the lens of litigation. In the end, the best protection a board has is its own careful, thoughtful processes guided by expert advice.

Finally, Section 102(b)(7) of the Delaware General Corporate Law permits, but does not require, a corporation to include a provision in its articles of incorporation exculpating directors and officers for personal liability for damages arising out of a breach of the duty of due care, but not for damages arising out of a breach of the duty of loyalty. The Delaware Limited

Liability Company law permits even broader exculpations than those permitted in the corporate context. See 6 Del. C. § 18-1101; *Abry Partners V, L.P. v. F&W Acquisition LLC*, 891 A.2d 1032, 1063 (Del. Ch. 2006) (“In the alternative entity context, where it is more likely that sophisticated parties have carefully negotiated the governing agreement, the [Delaware] General Assembly has authorized even broader exculpation [than permitted in the corporate context], to the extent of eliminating fiduciary duties altogether”); *Metro Communication Corp. BVI v. Advanced Mobilecomm Technologies Inc.*, 854 A.2d 121, 157 (Del. Ch. 2004). Delaware, like most states, also permits, but does not require, entities to indemnify and/or advance legal fees to directors and officers who are named as defendants in actions arising out of their service to the entity, and also permit such entities to use corporate funds to acquire insurance to cover such costs in the event of a claim. Directors and officers can protect themselves in advance by making sure, while the business is still healthy, that the charters of the entities on which they serve include Section 102(b)(7) type exculpation clauses. While these clauses may not bar all suits by all claimants, they can serve to protect against some types of claims. Directors and officers likewise should be sure that their indemnity/advancement rights are made mandatory and are backed up with an appropriate level of insurance. Director and officer insurance also should be renewed on a timely basis and the limits of liability should be revisited from time to time to ensure that sufficient coverage is available. If directors leave the board, appropriate "tails" should be purchased, so that no director has an incentive to turn against the others. Again, the guidance of a knowledgeable D&O specialist can be invaluable in this context.

### **Conclusion**

The onset of a financial crisis can give rise to a whole new set of claimants for the attention and, potentially, the fealty, of corporate fiduciaries. Advance planning is helpful, but not always possible. More importantly, the rules determining who may sue and for whom corporate fiduciaries must act at any given time continue to evolve, while companies can move from solvency to insolvency and back very quickly. Directors and officers faced with potential crises should seek advice from experienced advisors so as to keep up to date on the current state of the law, and ensure that their decisions will have the best chance of being protected by the business judgment rule.



**Clifton  
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# **Corporate Governance and Valuation Issues for a Distressed Business**

American Bar Association, Business Law Section

Fall Meeting

Washington, DC

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Presented by:

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# Conducting the Internal Examination

- Resolving allegations of breach of fiduciary duty or fraud from tips, complaints or accounting clues
  - Documentary evidence
  - Interviewing witnesses
  - Writing investigative reports

# Internal Examination Methodology

- Document methodology establishing a uniform, legal process for resolving allegations in a timely manner.
- Predication
  - Totality of circumstances that would lead a reasonable, professionally trained, and prudent individual to believe a breach of fiduciary duty or fraud *has* occurred, *is* occurring, and/or *will* occur
  - Internal examinations must be based on predication.

# Internal Investigation Approach

- Analyze available data
- Create a hypothesis
  - “Worst Case” scenario of breach of fiduciary duty or fraud is involved
- Test the hypothesis
  - Creation of “What If” scenarios...eliminate the most likely causes first!
- Refine and amend the hypothesis
  - Based on all facts not meeting scenario – Revise and retest
  - Negative results may ultimately mean that breach of fiduciary duty or fraud is not present or can’t be proven

# Tools Used in Internal Examination



Observation

# Investigation Theory Approach

- Overall Investigative Theory:
  - We tend to get bogged down in the detail

Remember...

Documents do not make cases:  
witnesses make cases....The  
documents make or break the  
witness!!

# Planning the Investigation

- Who will be involved in the investigation?
- What will be the investigation strategy?

# The Investigation Team

- Include only those individuals who:
  - Can legitimately assist in the investigation
  - Have a genuine interest in the outcome of the investigation
- Primary goal is to resolve breach of fiduciary duty or fraud allegations as thoroughly and efficiently as possible

# The Investigation Team

- Certified Fraud Examiners
- Legal Counsel
- Valuation/Solvency Professionals
- Auditors
- Security personnel
- IT and computer forensics experts
- Human resources personnel
- A management representative
- Outside consultants

# Evidence

- Anything perceivable by the five senses
- Any proof that is legally presented at trial to prove a contention and induce a belief in the minds of a jury
  - Testimony of witnesses
  - Records and documents
  - Facts and data
  - Tangible objects

# Obtaining Evidence

- Covert operations
- Pretexting
- Surveillance
- Using informants
- “Dumpster diving”
- Workplace searches
- Subpoenas
- Search warrants
- Voluntary consent

# Covert Operations

- Investigator assumes a fictitious identity
- Requires high degree of planning and skill
  - Objectives
  - Time frames
  - Approvals
- Legal if there is sufficient probable cause that a crime has been committed
- Query: Can it be used in a Civil Proceeding?

# Pretexting

- Obtaining information through falsehood or deception
  - Example: Calling suspect's relative and pretending to be old friend looking for contact information
- Not always legal

# Surveillance

- Secretive and continuous observance of a suspect's activities to:
  - Obtain probable cause for search warrants
  - Develop investigative leads
  - Identify co-conspirators
  - Gather intelligence
  - Locate persons and things relevant to the investigation

# “Dumpster Diving”

- Sifting through suspect’s trash to obtain evidence
- Can be done without search warrant, provided trash has left suspect’s possession
  - No reasonable expectation of privacy

# Workplace Searches

- Workplace Search Considerations:
  - Constitutional Privacy Rights: The Fourth Amendment
    - Principle limitation on investigative searches and surveillance by law enforcement, public employers and other govt. reps.
    - May apply to private companies under certain circumstances
    - Use of Employee Agreements (advance planning) to provide allowance of searches

# Workplace Searches

- Common Law Invasion of Privacy: Intrusion upon Seclusion
  - Applies to Private and Public employees
  - Can apply to physical intrusion, wiretapping, eavesdropping or other surveillance
  - Most frequently raised in workplace searches and includes:
    - Employer made an intentional intrusion
    - Into an area where the employee had a reasonable expectation of privacy (The KEY)
    - And the intrusion would be high offensive or objectionable to a reasonable person
- Employers need to reduce expectation of privacy through policies and make sure through confirmation that employees are aware and understand

# Handling Evidence

- To be admissible in court, evidence must be preserved and handled correctly.
  - Properly identified
  - Chain of custody maintained
  - Proven relevant and material to case
- Obtain original documents when feasible.
- Do not touch originals any more than necessary.
- Maintain a good filing system.

# Chain of Custody

- Record of when item is received or when it leaves the care, custody, or control of the fraud examiner
- Best recorded in memorandum stating:
  - What items were received
  - When they were received
  - From whom they were received
  - Where they are maintained

# Preserving Evidence

- Documents should be marked for later identification; however, never mark on original documents other than unobtrusive initials or tick mark made for identification.
- Do not fold, staple, paper clip, or otherwise change original document.
- Use gloves when handling documentary evidence to avoid leaving fingerprints.

# Organizing Evidence

- Segregate documents either by witness or by transaction.
- Make a “key document” file.
- Establish a database early on in the investigation.
- Create chronology of events.
- Utilize and frequently update to-do lists.
- Use computer software to organize documents and data.

# Sources of Information

- Investigators may need to search for specific information to help in:
  - Locating individuals or verifying their identities
  - Researching assets or financial positions
  - Discovering banking/creditor relationships
  - Identifying business affiliations/associates (especially of directors)

# In-house Sources

- Investigators can learn a great deal from internal documents and information inside the organization.
  - Personnel files
  - Internal phone records and voice mail
  - Computer files and records
  - Physical files and records
  - Timesheets
  - Financial records
  - Prior audit or investigative files
  - Corporate policies and procedures
  - Company and/or Board communications to employees
  - Access codes and user identification codes
  - Security videos

# In-house Sources

- Physically secure all relevant and available internal records:
  - Financial ledgers, reports and records.
  - Contracts, agreements, leases, etc.
  - Human resources – personnel files, policies, procedures.
  - Electronic media – telephone call listings, access control records, network servers, PC's, archived backup tapes, E-mail, voice mail, fax call listings and print buffer storage.
- Isolate areas of concern:
  - Office spaces, filing cabinets and desks.
  - Off-site storage.
  - Computers, computer files and archived back-ups.

# Public Information

- Records that a government unit is required by law to keep or those which are necessary for a governmental unit to keep in order to discharge its duties imposed by law
- Different information is kept by different government levels and agencies
- Financial filings with the SEC or other Regulatory Agencies (e.g. Banking Regulators)

# State or Federal Records

- Business filings
  - Corporate registration
  - Fictitious names/DBA
- Uniform commercial code filings
- Employee/labor records
- Workers' compensation information
- Federal and State tax filings
- Professional associations/licensing boards

# Court Records

- Litigation history
- Divorces
- Personal injury suits
- Financial suits
- Bankruptcy records
- Probate records

# Online Searches

- Commercial online services provide convenient access to a wide range of data in a single place.
- Accessing information online is never a full substitute for an actual examination of public records.
- Investigators should not rely on information from public websites without verifying its authenticity and accuracy.

# Report Writing

- Examinations should conclude with a report of the investigation results.
- Usually a formal written report
- Other than technical matters, no opinions of any kind – particularly those regarding guilt or innocence – should be included in report.

# Investigation Report

- Report must be accurate and understandable, and must “speak for itself”
- A good report:
  - Conveys evidence
  - Adds credibility
  - Accomplishes objectives of the investigation
  - Is written with the expected reader(s) of the report in mind

# Investigation Report

- Report should be written as though it will be used in civil or criminal trial.
- State only the facts.
- Do not make errors.
- Include a follow-up section.

# Report Writing – Memorandum of Interview

- Should contain:
  - Date
  - Name of subject reporting
  - Interview was voluntary
  - Witness informed of nature of inquiry
  - How was interview conducted
  - Recorded or not

# Report Format for Interview

- Consider report format that includes:
  - Introduction/scope
  - Background (of issues addressed)
  - Procedures performed
  - Findings (including opinions when appropriate)
  - Other observations (from fieldwork)
  - Recommendations

# Reconciling Reported Financial Value to Value in Bankruptcy

# DISCUSSION

- General Valuation Overview
- Financial Reporting Standards Affecting Value
- Valuation in Restructurings and Bankruptcy
- Financial Reporting vs. Bankruptcy and Reorganization

# Valuation Terminology

# Valuation

- Present value of future stream of earnings/cash flow
- Purpose usually determines the appropriate definition of value (a used car is a useful example)

# Premise of Value

- Going concern
- Assemblage of Assets
  - Disposal in mass
- Orderly Disposition
  - Piecemeal disposition over time
- Forced Liquidation

# Standard of Value

- Fair Market Value
- Investment Value
- Intrinsic or Fundamental Value
- Fair Value
  - Legal context
  - Accounting Context

# Purpose of Appraisal

Requires matching of valuation methods to purpose

# VALUATION DATE

Valuations are as of a point in time

# INTERESTS TO BE APPRAISED

- Assets
- Securities
- Intangibles
- Intellectual property
- Partial interests
- Equity or Invested capital
- Enterprise value (generally same as invested capital)

# DISCOUNT RATE

Converts future amounts to an estimate of present value

# CAPITALIZATION (CAP) RATE

Converts a single period of economic benefit to an estimate of present value

# BUSINESS ENTERPRISE VALUE

Typically equity plus interest-bearing debt so value of equity is business enterprise value minus interest-bearing debt

# Valuation Standards

# VALUATION DATE

Valuations are as of a point in time

# ORGANIZATIONS

- Financial Accounting Standard Board
- Appraisal Foundation
- American Institute of Certified Public Accountants (SSVS1)
- USPAP - Uniform Standards of Professional Appraisal Practice

# ORGANIZATIONS, cont.

- Professional Business Appraisal Organizations
- Internal Revenue Service – Revenue Ruling 59-60 and tax court decisions
- Federal & State Law - Bankruptcy

# GENERAL VALUATION OVERVIEW

## Valuation Methodology

# ASSET APPROACH

- Adjusted balance sheet method
- Asset accumulation method
  - Individual asset revaluation
- Should include intangible assets

# MARKET APPROACH

- Guideline publicly traded company method
- Guideline merged and acquired company method
- Prior transactions
- Direct market data method (IBA)

# INCOME APPROACH

- Discounted future economic income method
- Discounted cash flow
  - Use when past results don't exist or are not indicative of future results
- Capitalized future economic income method
  - Single period capitalization
    - Use when past is a good indicator of future results

# Discounts

# MARKETABILITY DISCOUNTS

- Control
- Minority

# LACK OF CONTROL

- Minority
- 50/50

# Valuation Triggers

# AN ACQUISITION

- FASB 141
  - Business combinations
- IRS 280g, 338
- Deal pricing, fairness opinions, etc.

# RESTRUCTURING / BANKRUPTCY

- Chapter 11 reorganization plan
- FASB 141
  - Long-lived assets
- FASB 142
  - Goodwill
- Fresh start accounting
- IRS 108, 165, 382, 468B

# Tax Planning

- FASB 123R
  - Options and/or equity allocations
- Reorganizing subs, IRS 355 & 367
- Worthless stock deductions
- Estate & gift planning
- IRS 409a

# LITIGATION

- Shareholder disputes
- Intellectual property disputes
- Buy/sell agreement arbitration

# Financial Reporting Standards Affecting Value

# SFAS No. 157 – Fair Value Measurements

- Scope
  - Establishes a framework for determining a fair value measure
  - Does not address when to apply or measure fair value or require any new FV measurements

# SFAS No. 157 – Fair Value Measurements

- Effective Date
  - Effective for fiscal years beginning after November 15, 2007 (2008 Calendar year)
  - Early adoption is allowed only in the first interim period and only if financial statements are not yet issued

# SFAS No. 157 – Fair Value Measurements

- Reasons for Issuing Statement
  - Separate from FMV “baggage”
  - Different definitions of fair value in GAAP
  - Limited guidance for applying those definitions

# SFAS No. 157 – Fair Value Measurements

- Fair Value Definition
  - “Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.”

# SFAS No. 157 – Fair Value Measurements

## – Key Concepts

- Exit Price
- Market Based
- Principal or Most Advantageous Market
- Nonperformance Risk (including creditworthiness)

# SFAS No. 157 – Fair Value Measurements

- Highest and Best Use
  - A fair value measurement assumes the highest and best use of the asset by market participants which is
    - Physically possible
    - Legally permissible
    - Financially feasible

# SFAS No. 157 – Fair Value Measurements

- Highest and best use can be either (whichever maximizes fair value):
  - In-use – in combination with other assets
  - In-exchange – as a standalone asset
- Highest and best use maximizes the value to market participants based on the use by market participants
  - Intended use is irrelevant

# SFAS No. 157 – Fair Value Measurements

- Concepts Statement No. 7, paragraph 32(a)
  - The entity's managers might intend a different use or settlement than that anticipated by others. For example, they might intend to operate a property as a bowling alley, even though others in the marketplace consider its highest and best use to be a parking lot.

# SFAS No. 157 – Fair Value Measurements

- Fair Value Hierarchy
  - Prioritizes the inputs to valuation techniques used to measure fair value into three broad levels:

# SFAS No. 157 – Fair Value Measurements

- Level 1: Observable inputs that reflect quoted prices for identical assets or liabilities in active markets and assumes the reporting entity can access the markets at the measurement date
  - An active market for the asset or liability is a market in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis
  - A quoted price in an active market provides the most reliable evidence of fair value and shall be used to measure fair value whenever available, with exceptions.

# SFAS No. 157 – Fair Value Measurements

- Level 2: Inputs other than quoted market prices included within level 1 that are observable either directly or indirectly
- Level 3: Unobservable inputs reflect the reporting entity's own assumptions about market participant assumptions used in pricing an asset or liability Lowest level of significant input drives placement in the hierarchy

# SFAS No. 157 – Fair Value Measurements

- The level within the hierarchy drives financial statement disclosures

# Valuation in Restructuring and Bankruptcy

# RESTRUCTURINGS

- Quality and adequacy of information provided by management
- Lack of due diligence by stakeholders
- No formal committees
- Questionable financial projections prepared by management

# DIP FINANCE

- Protection for lenders in DIP financing
  - Value of collateral interests

# FEASIBILITY OF REORGANIZATION PLAN

- Evaluation of projections
- Ability to obtain financing for the plan
- Value perceptions of investors, lenders and marketplace

# Financial Reporting vs. Bankruptcy & Reorganization

# PREFERENCES & FRAUDULENT CONVEYANCES

- Solvency
- Can be a look back

# Solvency

- Can company pay its debts?
- More often look at balance sheet solvency test
  - Assets valued at fair market value
  - Need to include *all* assets, whether booked or not
  - Liabilities not necessarily at fair market value but at settlement value
  - Other issues (e.g)
    - Contingent assets
    - Contingent liabilities
    - Warranty reserves

# Financial Reporting v. Bankruptcy

- Is it represented on the financial statements?
- Should it be?
- How do we value it?

# Financial Reporting v. Bankruptcy

Can company pay its debts as they  
come due?

# Financial Reporting v. Bankruptcy

## Assets

- Tangible vs. intangible
  - Accounts receivable
  - Inventory
  - Machinery & equipment

# Financial Reporting v. Bankruptcy

## Assets

- Patents
- Customer relationships/customer lists
- Distributor relationships
- Trade name/trademarks
- Existing technology
- In process R&D
- Non-compete agreements
- Supplier lists
- Goodwill
- Net Operating Losses

# Financial Reporting v. Bankruptcy

## Liabilities

- Booked vs. contingent
  - Accounts payable
  - Accrued expenses (wages)
  - Warranties
  - Secured debt (acceleration clauses)
  - Deferred taxes (change in ownership)
  - Bonds, preferred stock, options, etc.

# Financial Reporting v. Bankruptcy

- Warranties
- Guarantees-can push company into insolvency if called
- Indemnifications
- Litigation
- Pollutants (real estate)

# Questions

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