BeardGroup

Nineteenth Annual

Distressed Investing 2012

Maximizing Profits in the Distressed Debt Market

Ethics Hour:
Navigating Ethical Challenges and Fiduciary Duties

Helmsley Park Lane Hotel
New York City
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Ethics Hour:
Navigating Ethical Challenges and Fiduciary Duties

Panel Moderator

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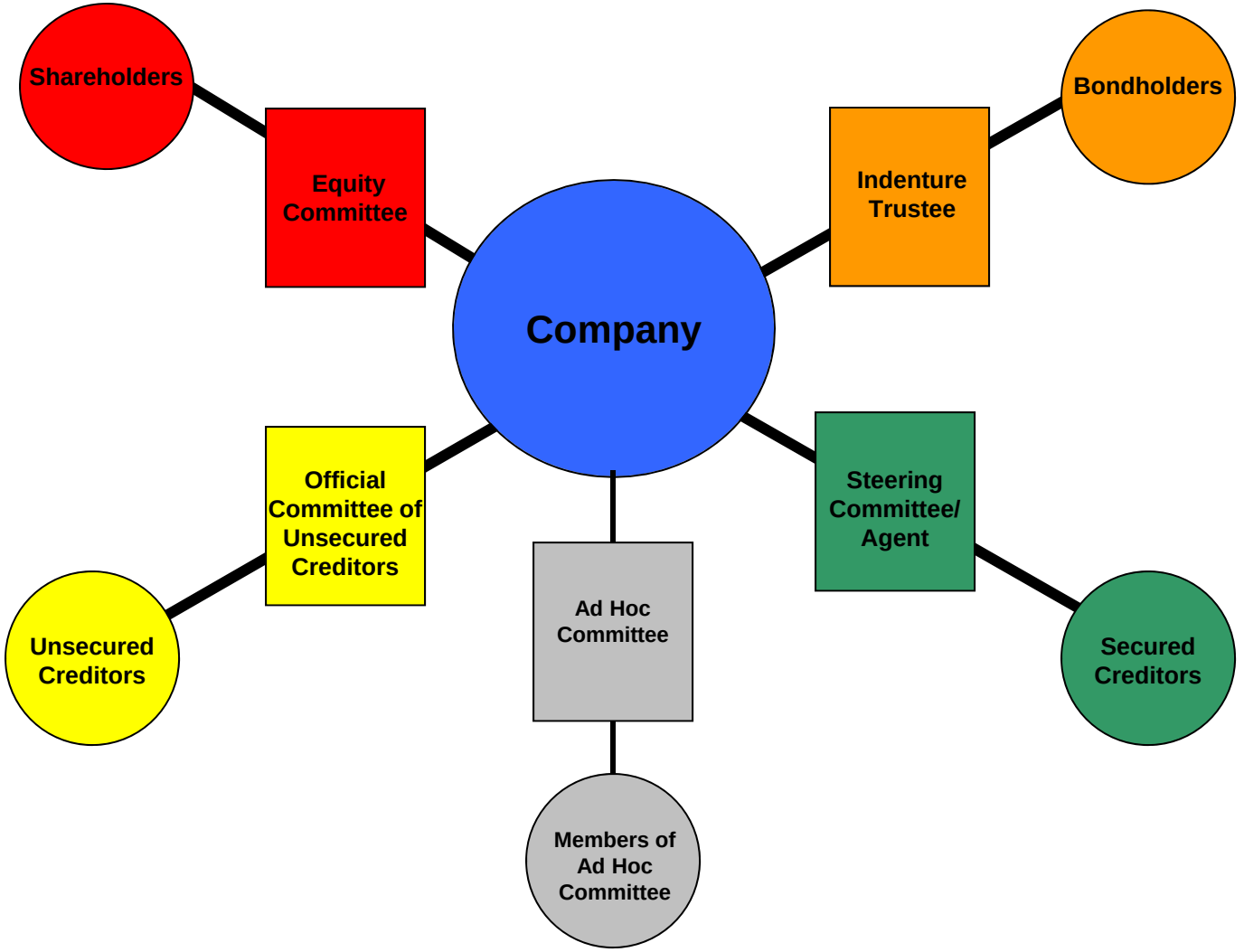
Defining "Ethic"

noun, \e-thik\

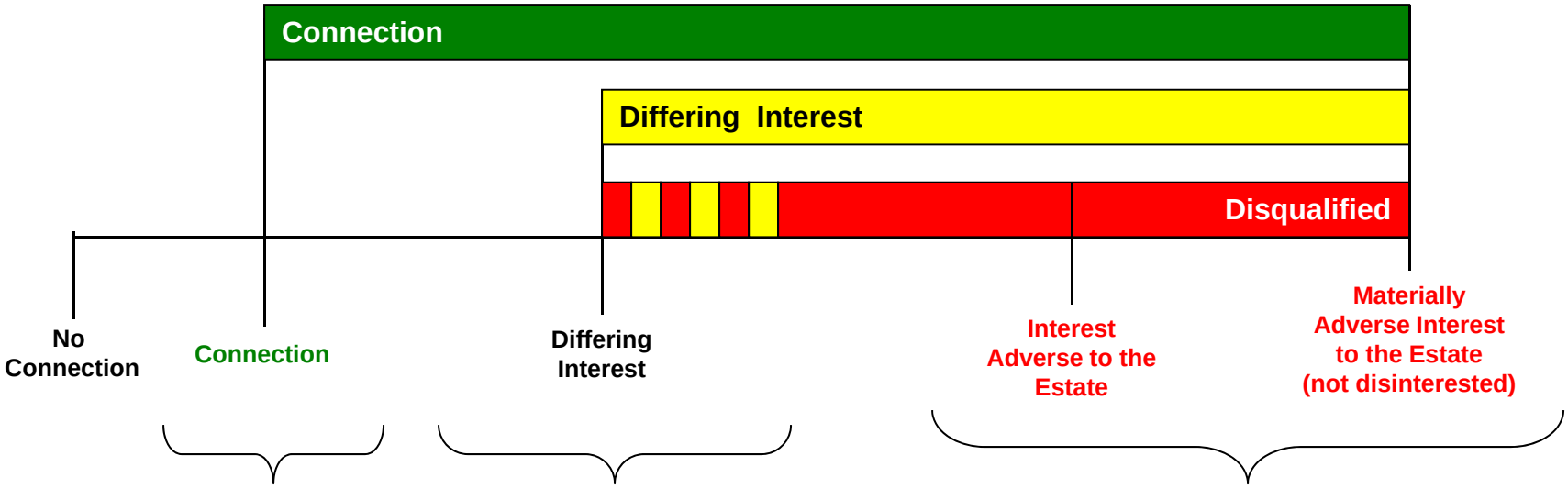
> "a set of moral principles; a theory or system of moral values (as in, 'the present-day materialistic ethic'); the principles of conduct governing an individual or group (as in 'professional ethics')."

Assumes that a group has decided upon a specific moral code by which to be *commonly bound*.

Restructuring Stakeholders



Range of "Connectivity"



Fed. R. Bankr. P. 2014 requires disclosure of all connections that are not de minimis.

A lawyer shall not represent a client if such representation involves a "differing interest" unless certain waiver requirements are met.

Debtors' counsel must be attorneys "that do not hold or represent an interest adverse to the estate, and that are disinterested persons." 11 U.S.C. § 327(a). Section 101(14)(C) defines a "disinterested person" as a person that "does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor, or for any other reason. " The Bankruptcy Code specifically authorizes an attorney to concurrently represent a debtor-in-possession and a creditor (in an unrelated matter). 11 U.S.C. § 327(c) ("[A] person is not disqualified for employment under this section solely because of such person's employment by or representation of a creditor, unless there is objection by another creditor or the United States trustee, in which case the court shall disapprove such employment if there is an actual conflict of interest.").

ABA Model Rule 1.10

CONFLICTS OF INTEREST

- 1.10(a) states generally that a **firm of many professionals is essentially one professional** for purposes of establishment of conflicts of interest (i.e., a conflict on the part of a single professional is a conflict to the entire firm) unless:
  - the professional with the conflict is **timely screened** from the conflict, and
  - **written notice is promptly given** to the other client to enable them to ascertain compliance with this Rule

- Doesn't apply to non-attorneys, but is a good thing to keep in mind in restructuring practice

ABA Model Rule 1.4

COMMUNICATIONS

- (a)(2) [A lawyer shall] reasonably consult with the client about the **means by which the client's objectives are to be accomplished**;
- (a)(3) [A lawyer shall] keep the client reasonably informed about the status of the matter;
- (a)(5) [A lawyer shall] consult with the client about any relevant **limitation on the lawyer's conduct** when the lawyer knows that the **client expects assistance not permitted** by the Rules of Professional Conduct or other law
- (b) A lawyer shall explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation.

ABA Model Rules 7.3 & 8.4

RULE 7.3 - PROFESSIONAL CONTACT WITH PROSPECTIVE CLIENTS

A lawyer shall not by in-person, live telephone or real-time electronic contact **solicit professional employment from a prospective client** when a significant motive for the lawyer's doing so is the lawyer's pecuniary gain, unless the person contacted: (1) is a lawyer; or (2) has a family, close personal, or prior professional relationship with the lawyer.

RULE 8.4 - PROFESSIONAL CONTACT WITH PROSPECTIVE CLIENTS

It is professional misconduct for a lawyer to:

(a) violate or attempt to violate the Rules of Professional Conduct, knowingly assist or induce another to do so, **or do so through the acts of another**…

Fiduciary Duties

- Generally, the directors and officers of a solvent US corporation owe fiduciary duties exclusively to the shareholders of the corporation
  - Duty of Loyalty: directors and officers must refrain from conduct that would injure the corporation and its shareholders or that would be solely in the directors' or officers' own interests or the interests of another person or organization
  - Duty of Good Faith: directors and officers must act in a manner that they honestly believe to be in the best interests of the corporation
  - Duty of Care: directors and officers must act with the care an ordinarily prudent person would exercise under the same or similar circumstances

Fiduciary Duties

- The Delaware Chancery Court has acknowledged that older "[d]ecisions from the Delaware Supreme Court and the Court of Chancery are far from clear with respect to whether there is a separate fiduciary duty of good faith . . . ."
- However, the Delaware Supreme Court recently clarified that good faith is, in fact, a separate fiduciary duty. (In re The Walt Disney Company Derivative Litigation, 2006 WL 1562466 at 67 (Case No. 411,2005, Del. Supr. Ct., June 8, 2006)
- While good faith is a separate fiduciary duty, the Delaware Supreme Court has held that the duty of good faith does not "stand[] on the same footing as the duties of care and loyalty. (William Stone, et al. v. C. Dowd Ritter, et al., Case No. 93,2006, Del. Supr. Ct., Nov. 6, 2006) at 16)

Fiduciary Duties

- The Delaware Supreme Court determined that:
  - A failure to act in good faith therefore will not, in and of itself, give rise to the direct imposition of liability
  - Rather, the duty to act in good faith is a subsidiary element of the duty of loyalty
  - Thus, only the duties of care and loyalty, where violated, may directly result in liability, "whereas a failure to act in good faith may do so, but [only] indirectly" as an aspect of the duty of loyalty
  - In short, the fiduciary duty of loyalty "is not limited to cases involving a financial or other cognizable fiduciary conflict of interest[; for i]t also encompasses cases where the fiduciary fails to act in good faith"

Fiduciary Duties

- Directors and officers may rely on managements ad advise of outside advisors
- Directors and officers who breach such duties can be held personally liable to the corporation and its shareholders

Fiduciary Duties

- Business Judgment Rule
  - Business judgment rule is a presumption that directors and officers of a corporation have acted on an informed basis, in good faith, and in the honest belief that the action was in the best interest of the company
  - Protects a disinterested director from personal liability to a corporation and its shareholders, even though a corporate action approved by the director ultimately is unwise or unsuccessful

Fiduciary Duties

- Business Judgment Rule, cont'd
  - The business judgment rule bars judicial inquiry into the actions of a corporate director when such director has acted in good faith, was reasonably informed and rationally believed the action taken was in the best interests of the corporation
  - Protection is unavailable in cases of fraud, bad faith, gross negligence or self-dealing

Duties When Insolvent

- The general duties owed by directors and officers expand to include an obligation to maximize the value of the enterprise for the "entire community of interests" when the corporation becomes insolvent
- The directors and officers of an insolvent corporation
  - Have an obligation to maximize value for the primary benefit of all creditors, not shareholders
  - Duty to shareholders is not terminated, but is generally subordinated to duty to creditors

Duties When Insolvent

- Courts generally have held that directors and officers are trustees or "quasi-trustees" for an insolvent corporation's creditors
  - This standard requires directors and officers of an insolvent corporation to exercise the care and skill that a person of ordinary prudence would exercise in dealing with his or her own property
    - More rigorous than business judgment rule
  - A trustee's actins are to be judged with reference to the facts and circumstances existent at the time of the challenged conduct

Duties When In Zone of Insolvency

- Some courts have held that directors and officers owe fiduciary duties to creditors prior to insolvency, when the company is in the "zone of insolvency" or "in the vicinity of solvency"
- A company is operating in the "zone of insolvency" when it is not yet technically insolvent under either the "bankruptcy test" or the "equitable insolvency test," but is nevertheless experiencing financial difficulties
  - As the risk that creditors will not be paid increases, the likelihood that a company is in the zone of insolvency increases

Duties When In Zone of Insolvency

- Directors of a corporation operating in the zone of insolvency should consider the rights of the corporation as an entity, and not only the rights of creditors and shareholders, when making corporate decisions
- However, the Delaware Court of Chancery has emphasized in Production Resources Group, L.L.C. v. NCT Group, Inc. that the general notion that fiduciary duties expand to include creditors while in the zone of insolvency does *not* give rise to independent causes of action by creditors if they feel that a board or management has breached its duties, nor does it create a new body of creditor rights law

Duties When In Zone of Insolvency

- The Court explained that the purpose of its original decision invoking this notion – Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp. – was intended to clarify that a board and management of a company in the zone of insolvency will be shielded from breach of fiduciary duty claims by *shareholders* who believe that the board and management have made decisions with other constituencies – including creditors – in mind, especially more conservative decisions designed to preserve value rather than more risky decisions designed to maximize shareholder returns

Duties When In Zone of Insolvency

- This shield from stockholder claims ultimately redounds to the benefit of creditors by preserving enterprise value and avoiding litigation -- this benefit, however, was *not* intended to serve as a sword for use by creditors in threatening or bringing litigation in their own right against directors or management for alleged breaches of fiduciary
- Thus, a creditor may obtain standing to bring such a claim if the company refuses to do so, but that claim must be pursued on behalf of, and for the collective benefit of, the company and *all* its creditors -- individual creditors or creditor groups have no right to bring such claims in their own names for their exclusive benefit

CASE STUDY: The Outside Director

- You are an outside director for the second largest toy manufacturer in the world with diversified global operations. A courier has delivered a package to your home in which there is a letter from an investment fund challenging your conduct as a director of the company and accusing you of breach of fiduciary duty for 47 different reasons. You immediately call your lead director and find out that only she, you and the other committee chairs were made demand upon. She and you call an old friend and hire her as independent Board counsel.

CASE STUDY: The Investment Banker

- You are the senior investment banker for the same Company. You also receive a demand letter accusing you of breach of duty for arranging a rescue financing for the Company three months ago that only "masked" the "real" problems that need to be addressed. You immediately contact your lawyer who immediately faxes an indemnity notice letter to the Company's CEO and general counsel.

CASE STUDY: The Lender

- You are the lead commercial banker for the same Company. There are two letters on your desk – one from the Company seeking approval of an amendment to the loan facilities and the other from the same institutional investor accusing your financial institution of financing the Company into "oblivion." The investor cites your motivation as fee driven – and asks whether you have submitted any DIP financing proposals to the Company. (You have.) It's a busy morning for lawyers . . .

CASE STUDY: The Management

- You are the CEO of the same toy manufacturer and have been working around the clock to turnaround the business and avoid chapter 11. Your GC walks into your office with faxes from lawyers from the Board, the investment banker, the agent for the financing syndicate and . . . the investment fund accusing you of "pillaring the Company for the benefit of management, banks and professionals." Your assistant interrupts to tell you that your spouse is on the phone "just checking in."

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