BeardGroup

*Twentieth Annual*

# Distressed Investing 2013

*Maximizing Profits in the Distressed Debt Market*

## Ethics Hour:
### Navigating Ethical Challenges Presented By Stakeholder Activists and Insider Principals

**Helmsley Park Lane Hotel**
**New York City**
**December 2, 2013**

# Ethics Hour:
# Navigating Ethical Challenges Presented By Stakeholder Activists and Insider Principals


**Panel Moderator**

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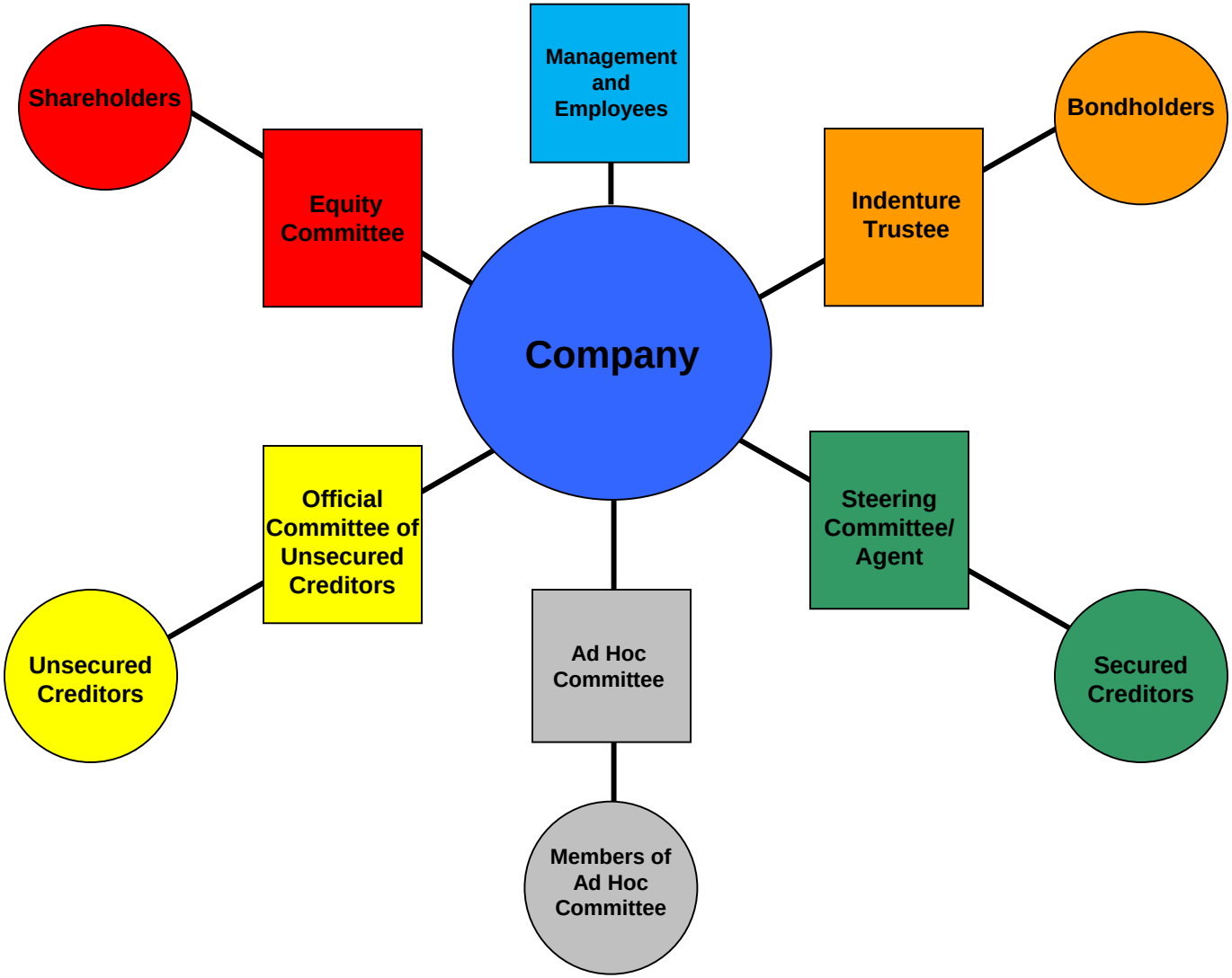
# Defining “Ethic”

noun, \e-thik\

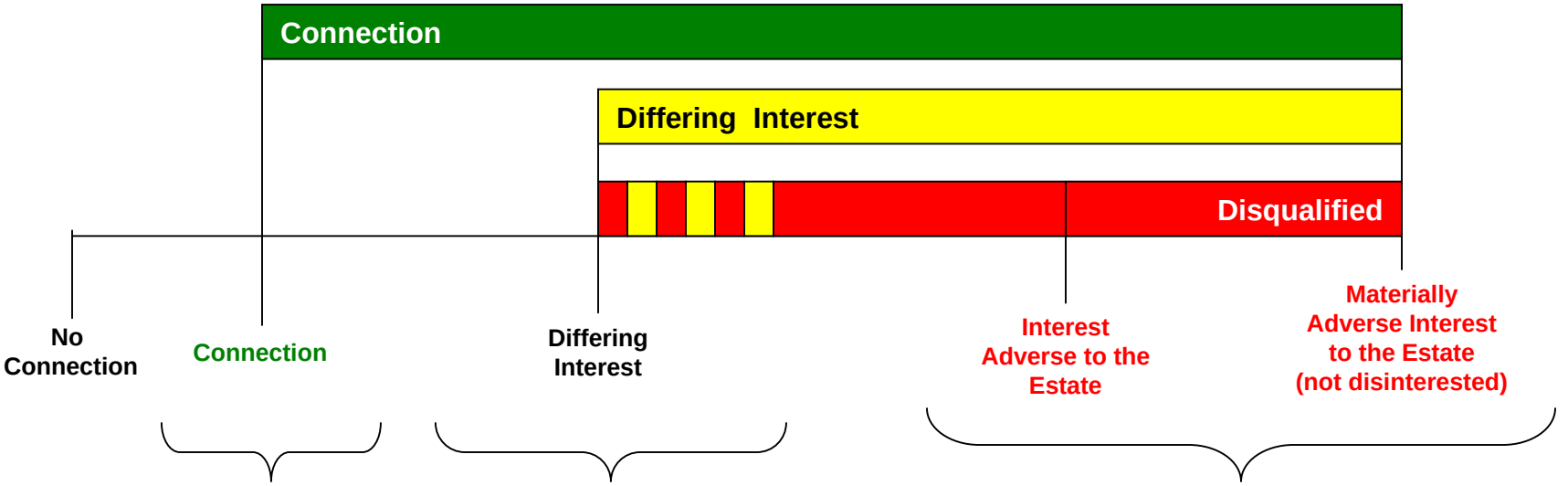
> “a set of moral principles; a theory or system of moral values (as in, ‘the present-day materialistic ethic’); the principles of conduct governing an individual or group (as in ‘professional ethics’).”

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.").

# Implications of Shareholder Activism for Distressed Companies

- Due to low-to-no equity value in most “normal” restructuring situations, shareholder activism is typically not a fruitful exercise -- even investors that may fairly be characterized as activists are acutely aware of how public discord may harm an already fragile state of affairs at the subject company
- Usual activist-proposed break-up, M&A and dividend strategies generally are unavailable to the distressed company -- more typical for the distressed company to be approached privately by interested creditors, lenders and shareholders
- A more pressing concern for the distressed company is the promulgation of inaccurate and harmful information by short sellers, buyers of CDS, etc.

# Shareholder Activism in the Zone of Insolvency

- Activist investors that are not privy to material non-public information may voice opinions publicly and trade as they see fit, provided they act in accordance with applicable law, including securities laws -- unclear whether a company's level of distress should alter the rights of public investors
- However, to the extent an activist shareholder's campaign results in (or is followed by) a bankruptcy and loss of value, the activist's actions likely will be subject to greater scrutiny by aggrieved creditors
- Activist investors that serve on boards of directors should act in a manner consistent with their fiduciary duties -- investor-insiders should act first as fiduciaries and second as investors

# Shareholder Activism in the Zone of Insolvency

- Additional discretion is required when a company is distressed or on the verge of distress
- Rumors, the voicing of opinions or criticisms publicly, even if confidential information is not disclosed, can have a significant impact on a company's finances and operations
- Public commentary reflecting board or strategy disagreements or discord may "spook" the trade or key customers and affect a company's ability to access needed financing
- While investor-insiders should probably refrain from taking public positions detrimental to the company, this dynamic often leads to activists remaining on the "outside" even if the company would benefit from them being insiders

# Practice Pointers when Confronted with Activist Stakeholders

- Listen to what the activist has to say
- Raise liquidity if available on reasonable terms, even if in excess of amounts required to operate
- Develop coordinated public and investor relations strategies
- Develop a consensus approach at the board level
- Deliver consistent message to key stakeholders, lenders, vendors and other counterparties
- Focus on the business

# Ad Hoc Committees: A Restructuring Analog to Shareholder Activism

- Ad hoc noteholder committees are relatively commonplace with members remaining unrestricted so as to maintain their ability to trade, and retaining financial and legal advisors to act on their behalf, with the company at risk for intervening claims trading and changes in committee composition
- How effective can an ad hoc noteholder committee be prior to its members getting restricted when left to rely on committee advisors to be the perfect filter?
- If committee members need confidential information to make informed decisions, at what point should members get restricted and for how long?
- What level of information must be released to “cleanse” restricted holders?

# Managing Interactions With The Company and Company Management

- Interactions with a company in financial distress and its management in the months leading up to or during a chapter 11 filing can give rise to conflicts of interest that could disqualify counsel from service as a chapter 11 debtor's counsel
- When Management of a distressed company reaches out to counsel soliciting advice about its options questions relating to the compensation, duties, and retention of management are inevitable, in terms of continued employment, personal liability, insurance coverage, incentive compensation, tax matters, and similar issues
- As fiduciaries, management's focus should be, and most often is, on what is best for the company and its stakeholders

# Managing Interactions With The Company and Company Management

- While company's counsel can appropriately discuss issues of concern with management, it must navigate the discussion carefully and avoid crossing the line from providing advice to the company with respect to management issues to providing direct legal advice to individual members
- One way to fail the "adverse representation" prong of section 327 of the Bankruptcy Code would be to develop an attorney-client relationship with a member of management prior to a chapter 11 filing -- effort should be made to ensure that prepetition interactions with management cannot subsequently be construed, through the prism of hindsight, to have created such a relationship of management

# Illustrative Middle Market Conflicts

- Closely held businesses
  - -- Line between “client” and “Management”
  - -- Line between company and owners
  - -- Issues related to owner guarantees/pledges
- Multi-generational “family businesses” present special challenges
  - -- Shareholder “demands” on companies close to insolvency
  - -- When is “severance” a “dividend”
  - -- The line between TMM/ISS and breach of fiduciary duty

# Illustrative Middle Market Conflicts

- Blurred Line between Client and Relationship
  - -- Party that brought you to the dance often not the party to whom duty is owed
  - -- Pressures from management, lenders, other stakeholders
  - -- Fiduciary duty doesn't always exist – but when it does, obligations can change
  - -- Difficult to know exactly the moment actors have a fiduciary duty, and to whom

# Harsh Remedies: The Brown Publishing Company Decision

- In the chapter 11 case of In re Brown Publishing Company, 2013 WL 1795924 (Bankr. E.D.N.Y. Apr. 29, 2013), the Bankruptcy Court granted the motion of the debtors' former CEO, shareholder and director to disqualify the company's law firm – which had represented the debtors during the chapter 11 cases – from representing the liquidating trust that was established under the debtors' confirmed plan – and ordered the law firm to disgorge $100,000 in prior payments to the liquidating trust

# Harsh Remedies: The Brown Publishing Company Decision

- The Bankruptcy Court granted the motion of the debtors' former CEO, shareholder and director to disqualify the debtors' law firm – which had represented the debtors during the chapter 11 cases – from representing the liquidating trust that was established under the debtors' confirmed plan
- The Court found that the law firm represented both the debtors and the debtors' principals, in their individual capacities, in connection with, among other things, their efforts to acquire all of the debtors' assets in a section 363 sale

# Harsh Remedies: The Brown Publishing Company Decision

- Despite the law firm's contention that it never agreed to represent the debtors' principals, the court found that the principals had "manifested a desire" to be represented by the firm and its "fail[ure] to manifest lack of consent" to the representation had resulted in the formation of an attorney-client relationship
- The court noted that "there is a fine line between debtor's counsel's capacity to differentiate between adequate information on behalf of the debtor and legal advice strictly for the benefit of the individuals. The insiders need to be informed that they need to retain separate counsel to pursue their individual needs."

# Harsh Remedies: The Brown Publishing Company Decision

- The law firm also never told management to retain its own counsel, and "rather than refusing to provide such advice, or at least making clear that any advice it did provide was only on behalf of the Debtors, [the firm] instead simply offered input which [management] could easily have interpreted as being for their own personal benefit" – resulting in the Court concluding that the firm had been conflicted throughout its representation of the Debtors in the case
- The firm was found to have also failed to make the disclosures required under Bankruptcy Rule 2014, including with respect to its "connections" to management, which the court determined provided an "independent basis for the disallowance of fees or even disqualification"

# Practice Pointers

- Upfront disclosure -- At initial meeting, state clearly that counsel represents only the company and does not represent management and discuss potential need for separate counsel for management, with whom lead counsel can work closely
- Engagement letter -- Include an express, written disclaimer in the engagement letter that counsel will not represent management and its representation of the Company will not create an attorney-client relationship with any member of management – and endeavor to obtain executed engagement letter prior to protracted interactions with company or management

# Practice Pointers

- Corporate law compliance -- In applicable cases, ensure consultation with compensation committee with respect to management issues
- Circumstance-Based Solutions – Recognize that there is no one-size-fits-all solution and tailor the response to the circumstances -- agree on a set of ground rules about what issues can and cannot be addressed by company counsel and avoid ambiguity as to the identity of the client while fully disclosing all “connections” with management

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