Alerts and Newsletters

Independent Directors: A Potent Vaccine for Financially Distressed Companies

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When a company is experiencing financial distress, addressing problems as soon as possible is critical to achieving the best outcome. As the situation deteriorates over time, the odds of saving the business and maximizing value will be minimized. Typically, once a company's board recognizes the gravity of the situation, it will hire restructuring counsel and advisers, and sometimes a Chief Restructuring Officer (CRO), especially if creditors have lost confidence in company insiders. However, if the CRO reports to a board that is perceived as tainted, creditor concerns may not be assuaged. Therefore, companies should not overlook the prospect of bringing on one or more independent directors,[1] the presence of which may inoculate the company from potential harm as it navigates its way through financial difficulties.

Benefits of Adding Independent Directors to the Board

Besides providing objective guidance to the company during its financial crisis, many other benefits can be obtained by adding one or more independent directors to the board. Whether the company seeks to restructure in or out of court, it will need to obtain some level of creditor support. Even in the absence of fraud or misconduct, creditors may be distrustful of corporate insiders who are viewed as having presided over, if not having caused, the troubles the company is now experiencing. The presence of a newly added independent director who was not involved in any suspect transactions may help restore creditor confidence in the company. In fact, because broader creditor consensus is generally required to effect a restructuring outside of court than in Chapter 11, the extra degree of creditor confidence that an independent director is likely to instill may be the difference between a successful or unsuccessful out-of-court restructuring.

An independent director can be utilized to oversee the plan or sale process, especially when insiders are conflicted. For instance, if insiders will be bidding on assets of the company, or if current executives will be retained by the proposed stalking horse bidder, the independent director can oversee the sales process. This can assure creditors, and the court if Chapter 11 relief is sought, that a thorough and honest process was run which did not favor the insiders. Obviously, it is best that an investment banking firm is hired to run any sales process, but the investment bank will of necessity report to the board. Likewise, a CRO could oversee the sales process or supervise the investment bankers, but the CRO also reports to the board. Therefore, merely appointing a CRO once troubles arise does not solve this problem from a corporate governance and accountability standpoint. Having the CRO and/or investment bankers report directly to a special committee of the board comprised of independent directors when insiders are conflicted alleviates these concerns.

If there are serious allegations of fraud or other insider misconduct, the restructuring effort could be hampered by creditor motions seeking the appointment of a Chapter 11 trustee or examiner, attempts to obtain standing to pursue causes of action against insiders, and/or creditor refusal to support a restructuring until potential causes of action have been fully analyzed and any colorable claims are assured of being pursued. The presence of an independent director may stave off a Chapter 11 trustee or creditor standing motion. As previously noted, the mere presence of

the CRO may not be sufficient to defeat a trustee motion where there appears to have been pre-petition misconduct, because the CRO reports to the board. However, by putting in place adequate controls supervised by a CRO who reports to the independent director, the impetus for appointing a Chapter 11 trustee may be neutralized.

Creditor motions alleging that viable claims exist and should be pursued against insiders and/or non-insiders can delay if not derail plan negotiations. A thorough analysis of potential causes of action by independent directors can be used to inoculate the company from this onslaught, while efforts are undertaken to resolve any potential litigation claims under a plan of reorganization. For instance, in December 2015, a special investigation committee consisting of two independent directors of Sabine Oil & Gas filed two reports analyzing various litigation claims against insiders and non-insiders.[2] The first report, analyzing constructive fraudulent transfer claims, concluded, *inter alia*, that the debtor is not likely to prevail on the avoidance of the first lien loan, and may likely prevail in part on the avoidance of the second lien loan. The second report concluded there were no colorable claims for intentional fraudulent transfer, breach of fiduciary duty and equitable subordination. Unfortunately, the issuance of these thorough and unbiased reports does not appear to have defused tensions in the Sabine case – no solution works every time – but the reports may influence whether the bankruptcy court grants the creditors' motion for standing to prosecute and settle litigation claims on behalf of the debtors' estates.

When companies file Chapter 11, they often seek to implement management incentive plans. Creditors and the United States Trustee are often concerned that managers are receiving a windfall for merely doing their jobs, or that the hurdles set in the incentive plans can be satisfied too easily. If the independent director takes the lead in negotiating the management incentive plan, it will go a long way to ameliorating those concerns.

An Ounce of Prevention is Worth a Pound of Cure

It is best to appoint an independent director as soon as possible to preserve value and avoid costly legal battles, as a case in which the authors were involved amply demonstrates. In the Chapter 11 case of Friedman's, Inc., Case No. 08-10161 (Del.), an independent director was ultimately appointed who achieved substantial positive results.[3] However, an earlier appointment could have spared much time and expense and preserved value for all stakeholders.

Friedman's and its subsidiary Crescent Jewelers were jewelry retailers operating over 450 stores, when they filed for Chapter 11 protection in Delaware in 2008 with over $100 million in debt. The majority shareholder of Friedman's was the private equity firm Harbinger Capital Partners. Harbinger also had significant secured and unsecured claims and controlled the board. The principal non-insider claims were held by trade creditors owed over $60 million (and a senior lender that was fully satisfied about five months into the case). Because Harbinger was wearing so many hats in the case and had lost creditor confidence, a CRO was hired before the Chapter 11 filing. However, the unsecured creditors' committee was extremely mistrustful of Harbinger and the board, and wanted to bring various litigation claims. The appointment of a highly skilled, experienced CRO did not placate the committee because he reported to the tainted board. Thus, the case cried out for an independent director.

After five months of acrimony, a settlement was reached whereby Harbinger waived its claims and relinquished control over the Debtors in exchange for releases. In addition, the settlement provided for the replacement of the existing board with an independent director selected by the committee. After the independent director was appointed, he quickly and consensually resolved objections by the United States Trustee to a management incentive plan and a key employee retention plan. Doing so was instrumental in maximizing value by retaining the key individuals responsible for the successful orderly self-liquidation of the company. As a result, the unsecured creditors received in excess of a 35% recovery in a case that had earlier appeared to be administratively insolvent. However, if an independent director had been appointed earlier, much time and expense could have been spared and better results may have been achieved. In fact, when Harbinger waived its claims it believed such claims were out of the money,

but based on the results ultimately achieved by the independent director, Harbinger would have recovered more than $10 million.

Selection, Qualifications, Compensation and Other Issues

In order to reap all the benefits that an independent director may bring, it is necessary that the director be truly independent. Appointing the CEO's brother-in-law or golfing buddy to the board simply will not do. True independence requires that the director have no business relationships with, and not be beholden to, the company or any of its affiliates, officers, directors or shareholders. Other than the right to receive directors' fees, true independence requires that the director have no economic stake in the company.

In light of the problems faced by a company in financial distress, it is recommended that, in addition to being truly independent, the independent director have extensive experience in the restructuring industry. While the company's counsel and advisers can certainly explain restructuring issues to the board, the presence of a director who has been through the restructuring war zone many times before will likely make this challenging process run more smoothly. For this reason, the authors believe that it is more important that the independent director have restructuring experience, than it is that the independent director have significant experience in the company's particular industry. Of course, the independent director must be kept fully informed of all material issues or creditor confidence will be severely undermined.

Because a company experiencing financial distress will require a significant investment of time by the board, standard directors' fees are not appropriate. Companies should consider compensating the independent director on an hourly basis in order to correlate the fees with the time commitment. If a fixed fee arrangement is preferred, then it will need to be at a higher level than directors would receive in a non-crisis situation to adequately compensate the independent director for the intense job ahead. While insiders may be willing to render board services without insisting on a D&O insurance policy, no savvy independent director candidates would be willing to do so, especially in a crisis situation which can easily lead to litigation.

Conclusion

A carefully chosen, highly qualified independent director may be instrumental in garnering creditor support and guiding a troubled company through the many pitfalls inherent in the restructuring process. Hiring a CRO and/or investment banker may not be sufficient to quell creditor concerns when those persons report to a board that is viewed as tainted. Therefore, an independent director will be especially valuable to a troubled company where there are serious allegations of insider misconduct or when creditor confidence and support have been significantly eroded.

For more information on how these issues may affect your rights, contact Nicholas F. Kajon at 212.537.0403 or Lee E. Buchwald at 212.551.1040. Mr. Kajon is a Shareholder of Stevens & Lee, P.C., and the Co-Chair of the Bankruptcy and Corporate Restructuring Group practicing in the firm's New York office. Mr. Buchwald is the founder and president of Buchwald Capital Advisors LLC in New York City, an investment banking firm specializing in financial reorganizations.

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guide in structuring transactions in which they are involved, but that professional advice be sought.

[1] The principles discussed herein apply in equal measure to an independent manager of a limited liability company, but for ease of reference the term independent director will be used throughout this alert.

[2] *Sabine Oil & Gas Corp.*, Case No. 15-11835 (SDNY), Docket No. 650, filed 12/22/15 (PDF available upon request).

[3] Mr. Buchwald was the independent director, and he hired Mr. Kajon's firm, Stevens & Lee, to replace Debtors' counsel.

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