DIRECTOR FAQ
May 2020

Governance of Distressed Companies

Q: How can a board be most effective in responding to financial distress?

A: Financial distress can occur in the life of any company, despite the best efforts of management and boards to prevent it through prescient planning and strong financial oversight.[1]

In the case of financial distress, the board can expect to be meeting more often with management (the CEO, chief financial officer, and others), along with outside advisors, in order to assess the situation, make any necessary disclosures, and then consider next steps. These steps could range from changing the business plan to restructuring finances to moving to the "last resort" of filing for protection from creditors under the bankruptcy code.

This memo will address the board's role in detecting and responding to financial distress and insolvency in the following sections:

1. Fulfilling Fiduciary Duties in the "Zone of Insolvency"
2. Assessing the Gravity of Financial Distress
3. Ensuring Proper Financial Disclosures
4. The Role of Board Committees
5. Weighing Strategic Options for Recovery

In conclusion, this memo offers a summary of guidance, along with questions for directors to ask and suggested resources.

Fulfilling Fiduciary Duties in the "Zone of Insolvency"

When a company is approaching insolvency—and so enters a so-called "zone of insolvency" or "vicinity of insolvency"[2]—its fiduciary duties remain the same. A director is a fiduciary on behalf of the entire corporation and its owners. With multiple stakeholders, there are times when interests conflict, and directors must choose one interest above others. The safest course in most jurisdictions is to favor the long-term interests of all shareholders first and foremost. This "shareholder primacy" concept is firmly established in Delaware, where most major public companies are incorporated, and which serves as the model for many other states.[3] While there are many court decisions and state laws that interpret a director's fiduciary duties to include consideration of other stakeholders, along with broad social support for a stakeholder model, shareholder primacy continues as a dominant judicial theory.

When and if directors determine that the company may be approaching insolvency, their fiduciary duties to shareholders do not change. As stated in the case of *Quadrant Structured Products Co., Ltd. v. Vertin,* C.A.,[4] citing precedent, "the business judgment rule protects the directors of solvent, barely solvent, and insolvent corporations, and . . . creditors of an insolvent firm have no greater right to challenge a disinterested, good faith business decision than the stockholders of a solvent firm."[5] Furthermore, "at the point of insolvency, . . . stockholders do not lose their ability to pursue derivative claims. Rather, the universe of potential plaintiffs expands to include creditors."[6]

Directors, then, need to understand that if the corporation does become insolvent by any definition (including the balance sheet definition), creditors will gain the right to file a derivative lawsuit against them. In a derivative lawsuit, a plaintiff files a lawsuit against directors on behalf of the corporation. So, to avoid liability in the future, directors of a corporation that may become insolvent need to take extra care to balance the interests of shareholders against those of creditors, and to note their actions in board minutes that can later be used as evidence of good faith.

Assessing the Gravity of Financial Distress

In the earliest days of financial problems, the role of the board is to sound a note of caution, advising management of the need to take a closer look at finances with a focus on liquidity—the availability of cash and other liquid assets.

In some cases, the distress signals are obvious. If a retail company with many brick and mortar locations has to close all of its stores due to a declared state of emergency, it is painfully clear that a cascade of financial problems will soon follow. It is easy to project that revenues from store sales will cease, which in turn will cause a plunge in incoming cash flow, which in turn will mean (if a company lacks large cash or investment reserves) that the company may not be able to pay its debts when they come due. The inability to pay debts when due is considered to be a proof of insolvency under the US Bankruptcy Code and Delaware law (see Sidebar: Definitions).

Definitions

The US Bankruptcy Code (Chapter 11 of the US Code) defines bankruptcy in a corporation as a "financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation."[20]

- "**Balance sheet" definition** refers to assets and liabilities—key categories in a balance sheet.
- **"Cash flow" definition** of bankruptcy is the inability to pay debts when they come due.
  - This is not generally used for corporations unless a creditor is trying to force a company to declare bankruptcy against its will.[21]
  - The Bankruptcy Code allows a court (faced with a petition from an unpaid creditor) to force a company to file for bankruptcy involuntarily if "the debtor is generally not paying such debtor's debts as such debts become due."[22]

The laws of Delaware, where most major US public companies are incorporated, recognizes both types of bankruptcy.

In other situations, however, a company's financial fault lines may stem from causes that are hidden. A company many be generating revenues, but the source of the revenues may be shifting, and its quality deteriorating. In the first quarter of 2020, for example, hospitals were operating around the clock to treat COVID-19 patients, but their overall revenue levels declined due to a halt in elective surgery. This was catastrophic for hospitals storing little cash yet carrying heavy debt loads.[7] In at least one such case, the drop in revenues triggered a demand for COVID-19 relief.[8]

In nonobvious cases of financial distress, a range of factors from denial to fraud can cloud management and board interpretation, raising ethical issues. Company leaders may not want to admit there is a problem, or they may perceive a problem but wish to hide it from others. In some cases, the financial distress may be caused not by external events but by the actions of the owners (including some directors) in transferring wealth away from the entity to themselves. For example, company leaders may engage in leaseback financing, where owners sell real estate to gain cash for dividends, and lease the buildings back from the buyer, often at high rates, causing financial strain that goes unrecognized for too long. Yet in contrast to all these scenarios, where the financial threat is real, there can be false alarms. Worried creditors or overreaching regulators may be too quick to claim that an entity is insolvent, when in fact the company's problems are relatively superficial and temporary in nature.

Clearly, conscientious directors should recognize financial weakness sooner rather than later, yet there should be no rush to judgment. Objectivity is essential in assessing the true financial condition of a company.

Red Flags

The concept of assets and their impairment is one of the lenses through which financial regulators view a company's financial health. The Financial Accounting Standards Board (ASC 360-10-35-21) provides impairment indicators for a long-term asset that includes these:

- A significant decrease in the market price of the long-lived asset
- A significant adverse change in the long-lived asset's extent or manner of use
- A significant adverse change in the long-lived asset's physical condition
- A significant adverse change in legal factors, such as actions or assessments by regulators
- A significant adverse change in the business climate
- An accumulation of costs significantly in excess of the amount originally expected for the long-lived asset's acquisition or construction

- A current-period operating or cash-flow loss combined with a history of operating or cash-flow losses or a projection or forecast predicting continuing losses associated with use of the long-lived asset
- A current expectation that, more likely than not, the long-lived asset will be disposed of through sale or some other means significantly before the end of its previously estimated useful life

Note: ASC 360 should be viewed in tandem with ASC 350, accounting for goodwill.[9]

Ensuring Proper Financial Disclosures

Companies facing financial distress due to events occurring after issuance of their financial statements are not generally required to issue accounting restatements. However, public companies are required to make disclosures about their challenges.[10]

When companies file their annual reports on Form 10-K, their quarterly reports on Form 10-Q, and their disclosures of material events on Form 8-K, they should be aware of special reporting obligations. These include the following:[11]

- Asset impairments (including good will)
- Contract penalties
- Defined benefit plan assets and obligations—valuation
- Employment termination benefits
- Going concern status changes
- Insurance recoveries related to business interruptions
- Lease concessions
- Loss contingencies
- Receivables, loans, and investments—impairment and valuation
- Stock compensation performance conditions and modifications
- Subsequent events (occurring after the filing of financial statements)

While it is the responsibility of management to make these disclosures, the board needs to pay attention to this area. Since directors can be held accountable for a company's disclosures, and are sometimes sued for disclosure failures,[12] this is an area to watch. In 2020, the US Securities and Exchange Commission granted an extension on the due dates of these filings.[13]

The Role of Board Committees

Throughout the experience of financial problems, the board can receive help from committees, including an audit committee, a finance committee, and/or a special committee.

The Audit Committee

This committee typically focuses on financial reporting and risk oversight. It must be composed entirely of independent directors, including one designated as an "audit committee financial expert." If this committee member (or another) has a background in financial reporting, then this member could oversee corporate disclosures. In addition, or alternatively, if the committee's designated expert (or another committee member) has a background in corporate finance, then the committee would be a good candidate for the task of financial analysis.

The Finance Committee

This committee, a voluntary committee present in only about 10 percent of public companies,[14] generally focuses on the inflow and outflow of capital, rather than on how it is reported. With membership that may include an insider board member such as the CEO, this committee looks at the company's balance sheet and cash flow, making it a good candidate to help the board assess the company's financial health. A finance committee charter typically tasks the committee with monitoring the allocation of financial resources and overseeing financial risks.

A Special Committee

In some cases, even if a board has one or more committees that may seem appropriate for a deep dive into a company's financial state, it can be advisable to have an independent, special committee devoted to some aspect of the crisis at hand. For example, on April 7, 2020, Chuck-E-Cheese owner CEC Entertainment made a disclosure (on Form 8-K) that included an announcement that the board had appointed a special committee to focus on restructuring: "The Restructuring Committee is authorized to, among other things, consider, evaluate and approve strategic alternatives including financings, refinancings, amendments, waivers, forbearances, asset sales, debt issuances, exchanges and purchases, out-of-court or in-court restructurings (pursuant to which the Company may seek relief under the Bankruptcy Code), non-ordinary-course transactions and/or similar transactions involving the Company. . . ."[15]

As this committee charter indicates, boards have many alternatives to consider as they travel the road from financial distress to recovery.

Weighing Strategic Options for Recover

In addition to assessing financial condition and ensuring proper reporting, boards and committees can make the important financial decisions that are reserved for the board alone to make. (Whereas most corporate decisions can be delegated to management, these decisions cannot be delegated, and must be approved by the board.[16])

Financial Restructuring

As a first alternative, before considering the more drastic options of a merger or acquisition (M&A) or bankruptcy, directors may wish to consider financial restructuring. Financial restructuring can be accomplished in many ways, including refinancing of debt, renegotiation of debt terms, purchase or sale of company stock, sale of a division or a key asset, leaseback on real estate, and more. Working with a qualified financial advisor can help.

M&A Transaction

Another avenue out of financial trouble is to acquire, merge with, or be acquired by a company with stronger financials. For more on the board's role here, see NACD's *Director Essentials: Strengthening Oversight of M&A*. Ideally, this would be on voluntary terms, rather than via an unsolicited bid. For more on antitakeover protection, see NACD's *FAQ: Anti-takeover Protection*.

Workout, Assignment For the Benefit of Creditors, or Receivership

If a company decides that it cannot or will not continue to operate under its stressful conditions, it can arrange for a workout, or declare bankruptcy. A workout is an out-of-court agreement with creditors to restructure existing debt—for example by renegotiating the duration, the interest rate, the timing of payments, and the like. Other alternatives to bankruptcy include assignment for the benefit of creditors (ABC) or federal or state receivership.[17]

Bankruptcy

A bankruptcy is a filing with the government under the bankruptcy code. There are two main filings for businesses: a Chapter 7, which allows for orderly liquidation (sale) of assets to repay some or all debts; and Chapter 11, which allows a company to continue operating while protected from its creditors. In the case of Chapter 7, the company ceases to exist. In the case Chapter 11, the company can continue operating and often (but not always) avoids liquidation and emerges as a strong new company. So far in 2020, the absolute number of bankruptcies does not match the level seen in the financial crisis of 2009-2010, but the large size and iconic status of some of the filers have had an economic and symbolic ripple effect.[18]

The topic of Chapter 11 governance is well beyond the scope of this FAQ, but resources are available.[19]

As directors explore these options, they can also assess their own skills in relation to them. Which directors have experience in finance, in M&A, or in bankruptcy? These directors can add a particularly strong value in times of financial crisis.

Summary Guidance

As a company suffers financial distress and enters a "zone of insolvency," directors still have fiduciary duties to shareholders. However, they should not neglect creditors, who are not only valued stakeholders but also potential litigants post-insolvency. The work of the board in financial distress begins at the earliest signs of distress, and continues through resolution of the issue and beyond. Directors should strive to assess the gravity of the situation, to ensure proper reporting, and to consider a range of alternatives. Committees, including audit, finance, and special committees, can help boards accomplish their goals.

Questions for Directors to Ask

- How severe is our financial problem? What caused it and what are the best ways to address it?
- Are we making decisions that are in the long-term interests of all stockholders?
- What actions can we take to protect the interests of our creditors?
- Are management's scenario plans for the worst-case scenario severe enough, or are they wearing rose-colored glasses?
- What disclosures do we need to make at this time, if any?
- Which board member(s) are responsible for engaging with shareholders? Does the company need to provide more insight into strategy, budgeting, and investment decisions to maintain investor confidence?
- What alternatives do we have to avoid liquidation?
- How can we use our committees?

Resources

NACD Resource Center: Responding to the COVID-19 Crisis

John Fletcher, *Getting Behind the Numbers* (NACD: 2019)

Questions for Audit Committees Contemplating the Impact of the Pandemic (BDO 2020)

"COVID-19 | Financial Reporting: Resource centre on the financial reporting impacts of coronavirus" (KPMG 2020)

"COVID-19: Finance and Liquidity" (PwC 2020)

"COVID-19: Accounting, Reporting, and Other Related Considerations" (BDO 2020)

Brian L. Cumberland and J. D. Ivy, "Preparing for Board Compensation in Times of Distress," *NACD BoardTalk*, April 28, 2020.

Endnotes

[1] For an NACD guide to financial oversight, see John Fletcher, *Getting Behind the Numbers* (Arlington, VA: NACD, 2019).

[2] Creditors have argued (at first successfully) that director duties change in the "zone of insolvency," but that theory has been rejected in recent years. See Brad Eric Scheler, Gary L. Kaplan, and Jennifer L. Rodburg, Fried, Frank, Harris, Shriver & Jacobson LLP, "Director Fiduciary Duty in Insolvency," *Harvard Law School Forum on Corporate Governance* (blog), April 15, 2020.

[3] As then Delaware Supreme Court Chief Justice Leo Strine said in a 2015 *Wake Forrest Law Review* article, a "clear-eyed look at the law of corporations in Delaware reveals that, within the limits of their discretion, directors must make stockholder welfare their sole end, and that other interests may be taken into consideration only as a means of promoting stockholder welfare." (Cited in Peter Atkins, Marc Gerber and Edward Micheletti, Skadden, Arps, Slate, Meagher & Flom LLP, "Social Responsibility and Enlightened Shareholder Primacy: Views from the Courtroom and Boardroom," *Harvard Law School Corporate Governance Forum* (blog), February 21, 2019.)

[4] *Quadrant Structured Products Co., Ltd. v. Vertin*, C.A. No. 6990-VCL, slip op., 2014 Del. Ch. LEXIS 193 (Del. Ch. Oct. 1, 2014), *reconsideration denied*, 2014 Del. Ch. LEXIS 214 (Del. Ch. Oct. 28, 2014).

[5] Ibid.

[6] Ibid.

[7] For a heavily researched paper critical of such a practice, see Private Equity Buyouts in Healthcare: Who Wins, Who Loses? Institute for New Economic Thinking, March 15, 2020.

[8] Ibid. See also Brian Spegele and Laura Cooper, "As Coronavirus Cases Climbed, Private Equity Owned Hospital Demanded Bailout," the *Wall Street Journal*, April 26, 2020.

[9] Kevin Cannon and Paul Legoudes, "5 Questions To Consider in the COVID-19 Environment Around Goodwill & Asset Impairment Testing", Opportune LLP, May 14, 2020.

[10] Robert Durak et alia, "Consequences of COVID-19 Financial Reporting Considerations," *AICPA Special Report*, March 18, 2020. See also "COVID-19: Accounting considerations—Considerations related to the pandemic and an economic downturn," Deloitte, updated May 7, 2020.

[11] This list is based on a discussion by Deloitte: "Financial Reporting Considerations for Virus Impacts," March 3, 2020.

[12] Note: Although Delaware courts no long accept "disclosure only" complaints, such complaints (based solely on alleged violations of disclosure rules) can still be accepted in other jurisdictions, or included in a pleading in Delaware as one of the complaints.

[13] A March 4, 2020, order gives public entities an additional 45 days from the original due date to file Forms 10-K, 10-Q, and 8-K, among other reports, that would otherwise have been due from March 1 to July 1, 2020, if the filers meet certain conditions.

[14] NACD, *2019–2020 Public Company Governance Survey* (Arlington, VA: NACD, 2019), p. 8.

[15] CEC Entertainment 8-K, April 7, 2020, p. 2.

[16] See NACD, FAQ: The Role of the Board vs. the Role of Management (Washington, DC: NACD, 2016), pp. 1–2.

[17] David G. Dragich, "Not Every Financially Distressed Company Should Turn to Chapter 11," CFO, April 29, 2020.

[18] For trends, see QUARTERLY U.S. BUSINESS FILINGS. For examples, Áine Cain and Madeline Stone, *These 14 retailers and restaurant chains have filed for bankruptcy or liquidation in 2020*, Business Insider, May 18,2020

[19] See PWC, *Bankruptcies and Liquidations* (September 2019). For trends and resources, see abi.org.

[20] 11 USC § 101(32).

[21] As noted by the Internal Revenue Service, "a debtor's inability to pay debts as they become due may be relevant if a debtor contests an involuntary petition filed against it. (11 USC § 303(h))." Chapter 11 Bankruptcy (Reorganization). Internal Revenue Service January 3, 2020.

[22] 11 U.S. Code § 303. Involuntary cases.

National Association of Corporate Directors
1515 N. Courthouse Road, Suite 1200
Arlington, VA 22201
571-367-3700
NACDonline.org