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Restructuring under a microscope: Cautionary tales for directors and officers in "distressed land"

Harvey R Miller, Senior Partner, Weil, Gotshal & Manges LLP. The author gratefully acknowledges the enormous contribution made to this chapter by Maurice Horwitz

You are the chairman and chief executive of a Delaware public company that manufactures and sells healthcare products. The company's common stock has been delisted and, from time to time, trades at approximately $10 per share. You were appointed to the board of directors and to be chief executive officer at the insistence of the preferred shareholders. Prior to your appointment, the company's operations were deteriorating and its future was dubious. The intent of the preferred shareholders was that you should lead a turnaround of the operations and find an exit transaction that will enable them to realize a recovery on their investment. The other four directors consist of three independent directors and the chief financial officer. You have developed a business strategy that was approved by the board and is in the process of implementation.

After 10 months of stabilization and signs of improvement, you are presented with a merger opportunity. After review, you have presented the proposed opportunity to the board of directors. The proposed merger transaction will result in a very substantial recovery for the preferred shareholders and will not impair any creditor obligations. However, it will leave no value for holders of common shares.

Although it has been generally recognized by the healthcare industry and financial markets that the company was open for sale proposals, there have been no comparable offers or proposed transactions. According to the company's financial advisors, the merger purchase offer is very attractive and, from a financial statement perspective, fair. The advisors have recommended acceptance.

A question of duty

The board of directors may have an easy decision to make. There is one potential problem. The company, under your leadership and your business plan, has been steadily improving. It has adequate financing for the next year provided that there is no change in the financial markets and operations that might cause a loan covenant breach. You and the board of directors are faced with the issue of immediate realization of a fair sale price for the company, but the sale will eradicate the interests of common shareholders. If the sale offer is rejected and the company's improvement ceases or declines, preferred shareholders and creditors may be seriously impaired. News of the proposed M&A transaction has leaked out. Certain common shareholders have told you that they will oppose any sale that will eradicate their interests. What action should you and the board take?

It is generally accepted that the fiduciary duties of directors of a solvent company — the duties of loyalty, care and good faith — run to the shareholders. Generally, however, once a company enters the zone of insolvency, director fiduciary duties are to the company and not to any particular constituency. Actions taken in the best interests of the company will benefit its residual stakeholders. In the context of the zone of insolvency, a director has to take into account all the interests of the company's economic stakeholders. However, in contrast to shareholders, creditors are protected by their contractual or other arrangements with the company.

As a result, when considering transformative transactions such as a merger, which may alter or shift where the residual ownership of the company lies, it is not at all obvious which stakeholders' interests should be given greater weight. In an age of increased transparency and economic turbulence, directors and officers of distressed companies may be called upon to choose from restructuring options that may limit creditor recoveries and dilute or eradicate equity interests. Financial distress is often played in the context of a zero sum game — that is to say, there may not be enough value to satisfy debts and liabilities or to extend to equity interests. Because of the enhanced transparency and increased stakeholder participation, the acts of a board or other governing body and the management will be carefully scrutinized, particularly by "out of the money" creditors and equity interest holders. Directors must be aware of the scope of their fiduciary responsibilities in considering substantive and strategic options to alleviate or resolve distress.

Your company has been steadily improving — but for how long? You now find yourself at a crossroads, where diverging options result in a different constituency potentially emerging as the company's residual stakeholder and the beneficiary of the proposed merger. One option is certain to wipe out the common shareholders but will satisfy creditors in whole and provide the preferred shareholders (who were responsible for your appointment) with the opportunity to substantially recover their investment. The other option may result in potential value for the company's common shareholders — but this option is less certain, and if unsuccessful, may leave the company's creditors impaired. Implementation of the latter option might result in claims by preferred shareholders and possibly creditors against you and the other directors for malfeasance and breach of fiduciary duties to the company if it proves unsuccessful. You have been advised of the generally applicable principles of law as derived from Delaware corporate law. Which option should the board adopt?

The importance of process

Process, due deliberation and judgment must be the mantra of directors and officers who pursue restructuring solutions — particularly when these fiduciaries may have relationships to certain stakeholders whose interests may be in conflict with those of the company. For example, directors and officers having personal relationships with investors may find themselves pressured to pursue sales or other restructurings that may be advantageous to such investors. To avoid potential liability in these circumstances, directors and officers should proceed with heightened caution. The sale or restructuring of a distressed company, while "cashing out" some stakeholders, may limit or deny recoveries to other groups. Those groups may, in turn, question whether the directors and the company's officers have acted disinterestedly and solely in the best interests of the company. All actions must therefore be based upon a comprehensive record of mature consideration and deliberation as to the interests of the company that need to be served in the particular circumstances of financial distress and the applicable duties of care and loyalty imposed on all directors.

Process is critical in building such a record to support the exercise of business judgment. It may provide directors and officers with the insulation needed to survive assertions of potential claims and litigation by adversely affected creditors or shareholders.

The MIG case

The case of Metromedia International Group Inc (MIG) illustrates the importance of process. In February 2003, when a new chairman of the board was appointed, the company faced "a severe liquidity crisis". To generate cash flow, the chairman's strategy included selling several of MIG's subsidiaries. The strategy was successful, as reported:

'Following its August 2005 $212 million sale of ZAO PeterStar, a fixed-line telephone provider based in St Petersburg, Russia, [MIG] has operated free of any substantial long-term or secured debt. Additionally, [the] resurgent performance [of its subsidiary, Magticom,] in the past three years has generated sizable free cash flow and EBITDA. [MIG]'s common stock, which traded at 3 cents per share in February 2003, has experienced a more than fifty-fold increase in value.'

In 2006, this success attracted a group of investors to propose a sale of Magticom, MIG's principal asset and the Republic of Georgia's leading mobile phone provider. According to MIG's board: 'The consideration offered for [MIG]'s 50.1% interest in Magticom far exceeded that of any previous unsolicited offer and represented an objectively fair valuation of the asset.'

There was only one problem. As a "sale of all or substantially all" the assets of the company, MIG was required to hold a shareholder meeting and solicit the vote of the company's common shareholders. MIG was not able to hold such a meeting, however, because it was not current in its filings with the SEC as required by the Sarbanes-Oxley Act of 2002. On the advice of counsel, the board concluded 'that the federal securities laws barred it from calling a meeting or soliciting proxies, and thus prevented a vote of the common shareholders' to approve the sale. Nonetheless, the board viewed the sale as being in the best interests of the company and its economic stakeholders.

Finding itself in an unusual position due to 'this combination of burgeoning financial results and delinquent reporting', the board sought an alternative strategy for approving the sale. This strategy involved executing the sale agreement and then seeking court approval of the sale pursuant to section 363(b) of the Bankruptcy Code, followed post-sale by a plan of reorganization. To ensure approval, MIG negotiated a "lock-up" agreement with the holders of roughly 80 per cent of the company's preferred shares. During the course of negotiations, the preferred shareholders were provided — subject to confidentiality agreements — with a sizable amount of non-public information regarding MIG's financial condition in order to value their interests. In those negotiations, preferred shareholders were also able to exert their bargaining power to guarantee a highly favorable treatment for the preferred shares in the transaction.

Under the proposed transaction, MIG granted preferred shareholders a vote — and, therefore, bargaining power — that they would not otherwise have under the terms of the preferred shareholders' certificate of designation, thus depriving common shareholders of the exclusive voting right that they would otherwise have outside bankruptcy. When MIG publicly announced its intention to consummate the sale under section 363(b) of the Bankruptcy Code, two common shareholders that owned a substantial amount of common stock sued the board of directors in the Delaware Chancery Court, seeking to enjoin MIG from executing the sale agreement and the lock-up agreement.

An inequitable course of action

The Delaware court found the board's decision to circumvent the need for common shareholder approval to sell Magticom by using the bankruptcy process to be inequitable for two reasons. First, the court found it to be an 'an abuse of the bankruptcy process for a robust and healthy corporation, encumbered by virtually no debt, to seek out the vast and extraordinary relief a bankruptcy court is capable of providing'. The board's decision to place the company in Chapter 11 therefore 'inequitably abridged the justified expectations of the common stockholders'. Second, the Delaware court was deeply concerned about the unwarranted disenfranchisement of the company's true residual owners — the common shareholders — that would result if the company consummated the sale of Magticom through the bankruptcy process.

Under MIG's organizational documents, the common shareholders were the only constituency entitled to vote on a fundamental change of the company's form, such as the sale of substantially all the company's assets. Preferred shareholders, in turn, were entitled to appoint two representatives to the board of directors if the company failed to pay dividends for six consecutive quarters, and were entitled to a liquidation preference but not the power to authorize the proposed sale. The board's bankruptcy solution warped this arrangement. It expanded the rights of preferred shareholders and relegated common shareholders 'to the status of sideline objectors in bankruptcy court', irrespective of the fairness of the purchase price. The bankruptcy solution deprived the shareholders of the bargaining leverage implicit in the right to approve or reject the proposed sale.

The primary interests protected by the bankruptcy process are those of creditors. Because of this simple fact, the Bankruptcy Code does not contemplate a freestanding right to vote by the holders of common equity. Were such a vote available, the legal rights of the creditors to the remaining assets of the entity would take a subsidiary position to the interests of the residual owners who, at least where a company is insolvent, no longer have any identifiable financial interest to protect.

Accordingly, the Delaware court entered an order 'prohibiting the corporation and its directors from making any agreement to sell all or substantially all of the assets that is not conditioned upon the approval of the corporation's common stockholders'. With respect to the requirement of Sarbanes-Oxley, the court's order 'expressly contemplate[d] that [MIG would] promptly seek exemptive relief broad enough to permit it to comply with the order's requirement of a stockholder vote'.

Perhaps if the MIG board had obtained the support of a percentage of its common shareholders as well as the preferred classes — indeed, if MIG had reached out to the two objectors that were substantial holders of common stock — the sale of Magticom might not have been derailed. In this respect, MIG's case is illustrative of how certain constituencies may act — not only how courts may react — when directors undertake decisions affecting or determining the interests of the residual stakeholders of a company, or otherwise deprive such stakeholders of their statutory rights. The disenfranchisement of a shareholder class entitled to vote on any major transaction is a significant action. Failure to employ the correct process and analysis might give rise to potential claims of breach of fiduciary duties with attendant personal liability.

Beware the conflicting demands of private equity

It is typical for private equity sponsors to cause the appointment of directors in their portfolio companies as a means of monitoring and protecting their investments. This involvement of investors in company governance, and particularly in the sale of distressed assets, has dramatically increased the potential conflicts of interest that directors and officers face when making material decisions, such as when evaluating the sale of a company (or of substantially all its assets).

As the masters of the policies and affairs of a company, directors are charged with fiduciary duties in the discharge of their respective obligations. State statutes and the common law of the state of incorporation generally govern these fiduciary duties. As over 850,000 businesses have elected to be incorporated under the laws of Delaware, the Delaware statutes and court decisions construing those statutes generally establish norms and governing principles for company management. In Delaware (and most other states), the primary fiduciary duties owed to the company are the duties of loyalty and care.

The duty of loyalty requires that directors abstain from any actions that could be detrimental to the company and its shareholders, or that are intended to benefit the director's own interests or the interests of a third party. The duty of care mandates that directors and officers exercise 'that degree of care which a person of ordinary prudence would exercise under the same or similar circumstances' (*Meyers vs Moody,* 1982). This duty incorporates an obligation for directors to, among other things, inform themselves 'prior to making a business decision, of all material information reasonably available to them', including a responsibility to consider alternatives and obtain professional advice where appropriate (*Aronson vs Lewis,* 1984). The duties encompass the obligation that fiduciaries also act in good faith.

The business judgment rule

In discharging their fiduciary duties, directors, generally, have the protection of the business judgment rule. This, if properly invoked, insulates directors in their decision-making. The rule 'is 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' (*In re Trados Incorporated Shareholder Litigation,* 2009). The party challenging the directors' decision bears the burden of rebutting the presumption. The essence of the rule is based on the proposition that, in the absence of clear grounds for rebutting the rule's presumption, a court should not micromanage or second-guess the business decisions of a board of directors. If the presumption is rebutted, then the burden of proving the fairness of the proposed action shifts to the directors.

The business judgment rule mandates that courts focus on process, not content, when evaluating the decisions made by the directors of a company. As the Delaware Chancery Court noted in *In re Caremark Int'l Inc Derivative Litig*, the evaluation of a director's discharge of fiduciary duties can never be appropriately 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.

To employ a different rule — one that permitted an "objective" evaluation of the decision — would expose directors to substantive second-guessing by ill-equipped judges or juries, which would, in the long run, be injurious to investor interests. Thus, the business judgment rule is process-oriented and informed by a deep respect for all good-faith board decisions.

Although it is originated in common law, the rule has been adopted, with some variation, in every state. For the protection of the business judgment rule to hold, however, a director or officer must be able to demonstrate that he or she is disinterested in the transaction. As more and more directors and officers have relationships with outside investors, such as private equity firms or hedge funds, such disinterestedness may become stretched. Accordingly, it will be crucial to approach any restructuring transactions with a sharp focus on process and the creation of a clear record of deliberation as regards the impact on all stakeholders of the company as a result of the proposed transaction.

Focus on Trados Inc

A Delaware Chancery Court case is illustrative. In *In re Trados Inc Shareholder Litig*, Trados Inc, a German software company, moved to the United States and became a Delaware company in March 2000 with the intent of ultimately becoming a public company. Trados accepted investments from venture capital firms in exchange for preferred stock and the right to place representatives on the board of directors. Of the board's seven members, besides the CEO, four were designees of this preferred shareholder group, while two others were representatives of the company's employees.

By April 2004, the company's underperformance prompted the board to form a special "mergers and acquisitions committee" — comprised of three board members from the preferred shareholder constituency — to explore a sale of the company. Of the two board members who represented Trados's employees, one was appointed president, the other CEO. The CEO's charge was 'to grow the company profitably or sell it'. At the time, 'the Company was losing money and had little cash to fund continuing operations'. The directors decided that the 'fair market value of Trados's common stock was $0.10 per share'.

By the fourth quarter of 2004, circumstances for Trados had changed for the better. The company 'was well financed and experiencing improved performance' under the leadership of the CEO, who at the February 2, 2005 board meeting 'presented positive financial results from the fourth quarter of 2004, including record revenue and profit from operations'. It appeared that a sale of the company was no longer critical. Nevertheless, directors persisted in pursuing that objective. As one member of the board reported to his constituency of preferred shareholders, the company's performance was improving, but '[the CEO's] mission is to architect an M&A event as soon as practicable.' The obvious objective of the preferred shareholders was to execute a sale and reap a large recovery on their investment.

A review of the board's members is indicative of the incentives behind the board's persistence. A majority of the members were designees of the preferred shareholders:

- **David Scanlan**: designee and partner in preferred shareholder Wachovia Capital Partners LLC.
- **Lisa Stone**: designee, director and employee of Rowan Entities Limited and Rowan Nominees Limited RR, transferees of the preferred stock held by Hg Investment Managers Limited, of which Stone was also a director and employee.
- **Sameer Gandhi**: designee and partner in several preferred shareholder entities known as Sequoia.
- **Joseph Prang**: designee of Sequoia and owner of Mentor Capital Group, another holder of preferred shares.

The preferred shareholders represented venture capital firms that had made substantial investments in Trados in 2000, when the goal was to take the company public. Four years later, these firms were looking to recapture their investments and, if possible, a significant profit, based upon the preferred stock's high liquidation preference of $57.9 million. That preference explains why Trados rejected the initial $40 million offer made in August 2004 by an interested party, SDL plc, which would ultimately acquire Trados for $60 million.

The only apparent obstacle to the board's pursuit of the SDL merger was that the company's executive officers did not have the same incentives as the preferred shareholders and they might not vote in favor of a sale. As reported: '[In] July 2004, Scanlan (as a preferred shareholder and director) expressed concern that the executive officers of the Company might not have sufficient incentives to remain with the Company or pursue a potential acquisition of the Company, due to the high liquidation preference of the Company's preferred stock.'

The preferred shareholders recognized that they needed to align the interests of the executive officers more closely with their own if a successful sale was to be effected. 'This led to the December 2004 board approval [of a] graduated compensation scale for the Company's management based on the price obtained for the Company in acquisition.' The result was to incentivize the officers to seek and approve a sale of the company that would benefit the preferred shareholders.

Accordingly, when the deal was struck to sell Trados to SDL for $60 million, $7.8 million was allocated for the executive officers and management, with the balance going to the preferred shareholders in partial satisfaction of their $57.9 million liquidation preference. In that context, the Chancery Court described the sale: 'In contrast, the common stockholders received nothing as a result of the merger, and lost the ability to ever receive anything of value in the future for their ownership interest in Trados. It would not stretch reason to say that this is the worst possible outcome for the common stockholders. The common stockholders would certainly be no worse off had the merger not occurred.'

Clearly the interests of the preferred shareholders and common shareholders diverged. Common shareholders promptly sued the directors for allegedly breaching their fiduciary duties to shareholders. The Delaware Chancery Court denied the directors' motion to dismiss, noting that it is a settled point of Delaware law that where the interests of common and preferred shareholders diverge, 'generally it will be the duty of the board, where discretionary judgment is to be exercised, to prefer the interests of common stock — as the good faith judgment of the board sees them to be — to the interests created by the special rights, preferences, etc, of preferred stock, where there is a conflict.'

Inability to exercise independent judgment

Of greater interest to directors and officers, however, was the court's finding that the plaintiffs had 'alleged facts sufficient to demonstrate that at least a majority of the members of Trados's seven-member board were unable to exercise independent and disinterested business judgment in deciding whether to approve the merger [because of these relationships to preferred shareholders]'. As the court noted, ordinarily '[directors] of Delaware corporations are protected in their decision-making by the business judgment rule, which "is 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".' The common shareholder plaintiffs in Trados, however, alleged two facts that 'support[ed] a reasonable inference that Scanlan, Stone, Gandhi, and Prang, the four board designees of preferred stockholders, were interested in the decision to pursue the merger with SDL, which had the effect of triggering the large liquidation preference of the preferred stockholders and resulted in no consideration to the common stockholders for their common shares'.

First, each of the four challenged directors had been designated by a holder of a significant number of preferred shares. The court acknowledged that 'this, alone, may not be enough to rebut the presumption of the business judgment rule', (but nonetheless cited a recent case involving such association with shareholders 'which, in their institutional capacities, are both alleged to have had a direct financial interest in this transaction'). In addition to being their board designees, however, 'Scanlan, Stone, Gandhi, and Prang each had an ownership or employment relationship with an entity that owned Trados preferred stock'. While it is unclear whether merely being a designee of these entities would have yielded the same result, the court held that '[the] allegations of the ownership and other relationships of each of Scanlan, Stone, Gandhi and Prang to preferred stockholders, combined with the fact that each was a board designee of one of these entities, [was] sufficient to rebut the business judgment presumption with respect to the decision to approve the merger with SDL.'

The above combination of facts, compounded by the plausible argument that the SDL merger was no longer necessary, made Trados an extreme example of directors' failure to recognize the interests of all of the economic stakeholders and thereby lose the protection of the business judgment rule. Nevertheless it is worth noting that the directors did not lose this battle because the decision to go forward with the merger was a bad one; the quality of the decision to sell had nothing to do with the fairness of the sale. The directors lost because of the context in which that decision was made — in other words, because nobody reviewing the record could reasonably conclude that the directors were anything but acutely interested in the outcome of the SDL merger and the board had not adopted a process that would insulate the integrity of its decision and be compliant with the duty of loyalty.

The establishment of a special committee to review and decide whether to approve this or any transaction may have produced a different result for the company. As the case discussed below will demonstrate, however, even measures such as those may not be sufficient to cleanse an already tarnished record.

Fiduciaries in Chapter 11

Once a company is in Chapter 11, the need for directors and officers to establish a clear record to dismiss any doubt as to their disinterestedness is accentuated. A company in Chapter 11 will be subject to a variety of divergent interests — not only among creditors and shareholders, but even divergent interests within different creditor groups. These types of conflicts are common in restructuring and bankruptcy cases. When particular stakeholders appoint one of their chosen people to positions on boards or as officers of companies that ultimately commence Chapter 11 cases, those directors and officers will inevitably face heightened scrutiny.

One remarkable example of this is the battle of competing reorganization plans that took place in the Chapter 11 cases of Coram Healthcare Corporation and Coram Inc (collectively, Coram). The battle over reorganization plans was waged primarily between Coram, through its chief executive officer, a major venture capital firm as an investor, and an Equity Interest Holders Committee that was appointed by the court two months after the commencement of the Chapter 11 case. Among the noteworthy members of this committee were Samstock, a Delaware limited liability company devoted to investments, whose president was the noted investor Samuel Zell. Samstock had purchased 450,000 common shares of Coram at an average price per share of $1.146 pre-petition, and an additional 2,050,000 shares post-Chapter 11 at an average price per share of 8.4 cents.

Coram filed its first joint plan of reorganization (POR) along with its Chapter 11 petitions on August 8, 2000 (*In re Coram Healthcare Corp,* 2004). The POR essentially proposed to give certain noteholders, and others, total ownership of the company, wiping out Zell and the other equity holders. The POR provided for (i) cancellation of all existing shareholder interests; (ii) the issuance of new shares of common stock, representing 100 per cent of the reorganized debtors' equity, to the noteholders, who collectively held 100 per cent of the debtors' outstanding unsecured notes; and (iii) payment of $2 million to unsecured creditors.

The equity committee opposed the first POR, and at the confirmation hearing it was revealed that the CEO was also employed as a consultant for one of the major noteholders and had been receiving compensation of approximately $1 million a year from that noteholder, in addition to his salary as CEO of Coram. The court concluded that 'this employment created a conflict of interest which tainted the Debtors' restructuring efforts.' Confirmation was denied by a bench decision because the court was 'unable to find that the Debtors had proposed their POR in good faith in accordance with section 1129(a)(3) [good faith] of the Code'.

Back to the drawing board

The court sent the parties back to the drawing board. In an effort to overcome the lack of good faith, Coram proceeded to establish a 'special committee of independent directors to review the Debtors' affairs and propose a new [POR]'. This committee retained an expert 'to perform an impartial investigation', after which Coram proposed a second POR, under which (i) noteholders, again, would receive all the reorganized debtors' equity, and (ii) shareholders would share $10 million if they accepted the POR.

For Zell, with ownership of 2,500,000 shares at an average price per share of less than 8 cents, the second POR represented a material return on his investment. Nevertheless, the equity committee opposed the second POR. After seven days of confirmation hearings in November and December 2001, the court again denied confirmation, finding in its published opinion that the employment relationship between [the CEO] and [the noteholder] had not changed since the first confirmation hearings. Accordingly, [the court] again held that it 'could not conclude that the Debtors' Second Plan satisfied the [good faith] requirements of Section 1129(a)(3)'.

As a result, on January 18, 2002, the United States Trustee in Delaware filed a motion for the appointment of a Chapter 11 trustee 'to oversee the Debtors' operations and to facilitate the reorganization process'. The court granted the motion. On March 7, 2002, the court approved the appointment of Arlin M Adams, a retired Third Circuit judge, as trustee. With the appointment of a Chapter 11 trustee, Coram lost its exclusive right to file and solicit acceptances of a POR. Accordingly, in December 2002, the equity committee filed its proposed POR under which the common shareholders would retain ownership of the reorganized debtors. The court's response was to defer consideration of the equity committee's POR until the Chapter 11 trustee had been given reasonable time to assume his duties and have an opportunity to consider the proposal of a POR.

The instructive irony in this battle over the integrity of Coram's CEO was that the appointed CEO was an excellent choice. He had turned the business around and was uniformly applauded by all parties. Indeed, the Chapter 11 trustee filed a motion seeking to extend his employment, in which the trustee provided an impartial positive assessment of the CEO's performance. The trustee had 'independently examined the actions undertaken by [the CEO] as the Debtors' chief executive officer' and found 'that [the CEO] has operated the company profitably and efficiently'. Specifically, the trustee found that '[under the CEO], notwithstanding being in these bankruptcy proceedings, the Debtors have experienced positive operating margins and EBITDA, reduced cost of services, reduced operating costs, improved inventory management, improved information systems, improved management tools, and maintained a stable cash position with no net borrowing to fund post-petition operations.'

Nevertheless, the CEO suffered from a severe lack of disinterestedness because of his contemporaneous employment by a dominant noteholder with obligations to give the interests of the noteholders priority — a conflict that could not be glossed over, as there would be continual doubt as to which master the CEO was serving. The dismissal of the CEO or the appointment of an independent fiduciary — ie, a Chapter 11 trustee — were the only alternatives.

Coram illustrates the degree to which an officer or a board's potential lack of disinterestedness may undermine any of the protections ordinarily available to a company's directors. It is also noteworthy that the court could not rely upon Coram's second POR, which had the benefit of a special committee, due to the process employed and the ineffectual conduct of the engaged expert.

Directors are typically protected when relying in good faith on the advice of such special committees or the company's professional advisors, such as attorneys, auditors or financial advisors — provided that the special committee and such professionals have acted appropriately and comprehensively. Reliance on outside advisors establishes a record of due deliberation and must establish that the decisions made were based upon independent evaluation free of any bias or loyalty to a particular constituency within the company.

For directors and officers with ties to outside investors, such as the Coram CEO, it is essential to establish a process that includes reliance on outside, independent advisers, or on special independent committees when considering restructuring solutions that may wipe out a particular group of stakeholders.

But as Coram demonstrates, in these circumstances, any appearance of impropriety may render any reliance upon such experts futile. There can be no suspicion whatsoever that the advisors whose opinions are relied upon were "bought" for the purpose of consummating the proposed transaction.

The trustee's POR confirmed

Despite the Chapter 11 trustee's validation of the CEO's skill, and Coram's reliance on a special committee and expert for its second POR, Coram never regained control of the reorganization process. On May 2, 2003, the Chapter 11 trustee filed a POR. This provided for, among other things, cancellation of shareholders' equity for a pro rata distribution of approximately $40 million plus interests in litigation claims against the directors and others, and issuance of all equity in the reorganized debtors to the noteholders. It also (i) included a settlement with the noteholders of the estate's claims — including derivative claims — against them arising from their relationship with Coram's CEO; and (ii) preserved the estate's claims against the CEO and Coram's outside directors for the benefit of Coram's shareholders.

While the outcome of the case came down to a contest between the trustee's and the equity committee's PORs, the court ultimately confirmed the trustee's plan for several reasons, including the support of Coram's creditors who favored it by 'substantial margins'.

Nevertheless, Coram's shareholders fared considerably better than they would have under either of Coram's proposed PORs, catapulting from an initial proposal of $0 under the first POR, to $10 million under the second, and then $40 million plus interests in litigation claims against the directors and others under the trustee's POR. Thus, as a result of their persistence and their ability to exploit the lack of good faith and breach of fiduciary duties of the directors, the shareholders were ultimately able to reap a substantial recovery.

Summing up

The word fiduciary, from the Latin "fides", implies a reliance based on faith and trust. For directors and officers to maintain their viability as fiduciaries, it is imperative for them to instill and maintain the trust of the stakeholders, especially when interests among constituencies diverge. Moreover, in a corporate environment permeated with private equity funds, distressed debt traders and other activist investors, directors and officers will frequently hold relationships with particular stakeholders in a company that may result in conflicts that impair governance. Faith is fragile, and easily tainted by any indication of impropriety or self-interested behavior. No degree of skill or qualification on the part of a director or officer can remedy a loss of faith on the part of stakeholders or courts — even where an officer's skills translate into positive results for the company.

Directors and officers with ties to any one stakeholder should therefore be continually focused on process when deliberating over transactions as material as a sale of the company, or any other material restructuring. Their deliberations should include a meticulous documentation of their analysis of the impact that a transaction may have on different constituencies. The documentation should include fairness opinions and third-party valuations, board minutes and related documentation — keeping in mind that all will be reviewed in hindsight.

Above all, private equity and other similar investment groups, if they install their own appointees as directors and officers, should develop and implement safeguards to insulate such appointees from undue influence. Certainly any employment relationship with a particular investor, as existed in Coram, may be incurable, particularly if not disclosed. If a relationship must exist, full disclosure must be made and, if possible, appropriate consents from board members and other stakeholders should be obtained so that these parties will be on notice of the relationship.

If a particularly significant transaction is on the horizon — one that is more likely to result in litigation by disaffected stakeholders — a special committee of truly independent directors should be created to bolster the presumption of the business judgment rule.

Directors should not be misled, however, into thinking that the degree of protection offered by the business judgment rule changes depending on the size or significance of the transaction. As one recent decision by the Delaware Chancery Court confirms: 'Delaware law simply does not support this distinction. A business decision made by a majority of disinterested, independent board members is entitled to the deferential business judgment rule regardless of whether it is an isolated transaction or part of a larger transformative strategy'(*In re Dow Chemical Company Derivative Litigation*, 2010).

Ultimately, courts will find it difficult to question truly independent directors. If their decisions and actions are to be safeguarded from the growing threat of litigation in the turbulent world of a distressed economy and an aggressive plaintiff's bar, directors, like Caesar's wife, must be above suspicion and compliant with their duties of care and loyalty.