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Heightened Judicial Scrutiny Faces Directors Designated by Corporate Creditors

By David A. Jaffe, Esq.

The pressure on U.S. financial institutions to reform past practices will continue unabated for the foreseeable future. In this new "normal" environment, investors, creditors, and other corporate stakeholders who have suffered financial losses are likely to attempt to hold directors accountable. This could very well take the form of litigation, with claims alleging that directors ignored warning signals, took undue risks, or engaged in reckless behavior. If any form of director self-dealing or conflict of interest is implicated, the risk to corporate decision makers is greatly enhanced. Directors, officers, and their advisers need to be proactive in heading off the potential for these issues to occur.

Directors have a legal obligation to manage the business and affairs of the bank in good faith and in a manner they reasonably believe to be in its best interests. In fulfilling this function, directors are viewed as fiduciaries of the institution and must fulfill two essential duties in that role—the duty of loyalty and the duty of care. In discharging those duties, directors are generally insulated from judicial second-guessing by a legal doctrine known as the business judgment rule (BJR). The BJR originated as a judicial rule (subsequently codified in the statutory corporate law of many states) that protects disinterested corporate directors from liability for corporate acts or omissions through a presumption that they have exercised due care and loyalty and have acted in the company's best interests.

There are exceptions to the BJR where courts will examine a board's conduct more closely and more actively. One situation where enhanced scrutiny will occur is in transactions where conflicts of interest have emerged. In a conflict scenario, when a director has interests in a transaction on both sides of the table—on one side as a fiduciary of the bank and on the other side, for example, as a principal beneficiary or counterparty under the deal—the BJR will not apply because any form of director self-dealing will be perceived to compromise the independent thinking and objectivity of directors. In those circumstances it is well settled under the law that the board has the burden of establishing the entire fairness of the transaction sufficient to pass the test of careful scrutiny by the courts. An especially vexing form of this dilemma can arise when a director is also a creditor.

The Creditor/Fiduciary Conflict Scenario

Certain types of creditors are often represented on a bank's board of directors. This scenario arises frequently where hedge funds, private equity investors, and other nontraditional lenders have made investments in convertible debentures or other debt obligations of the issuer. When this occurs, the director designee is burdened with two conflicting sets of obligations—one of a fiduciary nature to act in the best interests of the institution and the other to act in the interests of the creditor who appointed that individual to fill the board seat. Faced with this dilemma, the conflicted director serves neither of his corporate masters optimally. On one hand, his fiduciary obligations as a director could preclude him from taking actions that may maximize a recovery for his creditor-principal. On the other hand, his interests as a creditor cast a dark cloud over his impartiality as a director. For example, if the bank is insolvent and the board is considering various restructuring alternatives, the creditor-director will feel significant pressure to act in the

interests of his principle, even if those actions are not optimal for the debtor corporation. The resulting quandary is that the director's fiduciary obligations may preclude him from taking a course of action that maximizes the position of his creditor principal at the very moment when creditor's rights are most important.

In order for the board to preserve its autonomy and decision-making discretion under the BJR in this context, it must identify and address all potential conflicts of interest among the directors and in the management ranks. It must undertake prophylactic measures to insulate corporate decision makers from any actual or potential undue influence by interested parties. After a dispute has arisen (and therefore with the benefit of hindsight), courts will examine carefully the board's deliberative processes in order to ascertain whether or not it implemented procedural safeguards to ensure fair and informed decision making.

The Role of the Special Committee

Among other mechanisms that may be employed, the proper use of a special committee of independent directors is often afforded great deference by the courts in establishing prima facie evidence of procedural fairness. However, as with any mechanism, the devil is in the details. If the actions taken by the board in establishing the committee, or the behavior of the committee itself, suggest that the special committee is a sham or merely window dressing, courts will disregard the BJR and apply the higher standard of enhanced scrutiny to the board's behavior regarding the transaction.

Recent cases out of the Delaware Chancery Court offer some clear guidelines for boards to follow when they establish a special committee of independent directors. First and foremost, each director appointed to the committee must be truly independent. The board should be able to demonstrate that every member of the committee is free from undue influence by controlling stockholders, influential creditors, and other members of the board or senior management. Second, the mandate of the special committee must be clear and unambiguous and the committee should be vested with a level of authority sufficient to accomplish that mandate. The special committee must have authority to exercise real bargaining power (including the authority to reject a transaction) and not act merely in an advisory capacity to the board. Third, the special committee must have the authority to hire its own legal and financial advisers who should be separate from, and independent of, the bank's legal and financial advisers. In situations where the special committee has relied on the company's advisers, courts have found the advice provided to the committee to be tainted because of the financial inducements inherent in the adviser's relationship with the corporation and its control parties.

Similarly, in light of the considerable risks facing the directors of an insolvent financial institution, the board will be well-advised to engage an independent financial adviser to perform a solvency analysis. While the subtleties and nuances of the analysis might not be beyond the capabilities of management to perform, the importance of obtaining a solvency opinion from a third party should not be underestimated. When litigation is commenced, in addition to having to defend claims for fraudulent and preferential transfers, directors can anticipate personal claims for breach of fiduciary duty in approving the disposition of corporate assets and the incurrence of corporate liabilities. Claims alleging breach of the duty of loyalty have the potential to expose directors to personal liability for which corporate indemnification may not be available. Thus, addressing these issues ahead of time, can help a board better understand the potential for litigation that exists today, as well as the triggers for liability, before a crisis occurs.

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