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"Zone of Insolvency" – Considerations for Directors

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Article Highlights:

- There is no bright line test for the zone of insolvency but within the zone, directors' duties have shifted from concentrating on shareholders (estate).
- Preparation is the key, especially since it is unforeseen circumstances that put companies into bankruptcy.
- Enlightened directors should challenge industry standards and consult advisors who can challenge management's assumptions.

At first glance this piece may appear to deal with a fairly narrow issue. However, in the broader context this is a case study in directors' Duties of Care and Loyalty. As directors we frequently find ourselves dealing with critical strategic choices and while the specific issue may be different the lessons learned are broadly applicable. I would encourage you to find both the narrower, subject matter specific learnings as well as the broader implications for enlightened directors in this passage.

I clearly remember the board meeting, although it was almost a decade ago, as the Great Recession was beginning to rear its ugly head. The CEO started the discussion with some of the forward indicators for the business and, despite a string of record quarterly earnings going back almost three years, the forecast was for a sharp decline in demand. Our business had a high degree of operating leverage whereby changes in revenues, both on the upside and the downside, had a significant impact on bottom line earnings and cash flow. In addition, the business, like almost all others in the industry, had a high degree of financial leverage – that is, a relatively high amount of debt compared to equity as cash flows under "normal" circumstances were sufficient to support a high debt load.

The expectation is that continuous improvements in operations as well as increased demand would provide enough cash generation to cover the debt and provide a nice upside opportunity for shareholders. Naturally, under such a model it is wise to maintain a certain cash reserve. However, "excess" cash reserves are an easy target for activists (as they should be – albeit, we can differ in opinion as to what constitutes "excess cash"). Nonetheless, there we were listening to the gloomy forecasts. Joining us for this discussion were two outside professionals – a financial advisor and special counsel. As the CEO finished going through the forecasts he turned the discussion over to the attorney and the financial advisor who was a restructuring specialist. The financial advisor showed various models indicating that we could run the risk of not generating sufficient cash to cover our debt service in the near term without eating into our cash reserves. Counsel then told the board that by restructuring under a Chapter 11 bankruptcy filing we would preserve cash which is critical under the circumstances. As counsel lead us through the thought process the various scenarios involved substantial reductions in our debt and the likely elimination of any residual value for our shareholders.

After going through several potential restructuring scenarios I asked – "Why would we do this? If we go down this path our debt holders will take a substantial haircut (in some scenarios between 50% - 80% on the dollar) and our shareholders will be wiped out. If we use our cash reserves and do some belt tightening we could come out the other end with our debt holder intact (or perhaps marginally impacted) and our shareholders intact with the prospects for growth once the current tide has passed."

What I did not say (but I was thinking) was that while we would enjoy the benefit of suspending debt and interest payments during the restructuring we would be obligated to make substantial payments to both the financial advisor and bankruptcy counsel – in many cases these can almost completely eliminate the benefit of not making interest payments ! At that point counsel looked at me and proclaimed "you're being too logical… and besides, when you enter the "zone of insolvency" your duty as a director shifts from the shareholder to preservation of the estate."

At the time, that was a new concept for me. Assuming counsel was correct it was hard to argue that the estate would not be better served with only 20% of the then current debt load - even if shareholders lose all of their investments. In effect, counsel was telling me that I might be correct in principle but the case law (as it existed at that time) strongly supported restructuring to protect the estate (not to mention the officers and directors). I understood but still felt that

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something was wrong with that outcome.

The Problem/Challenge

Directors have a Duty of Care and Loyalty. The Duty of Care means that directors must make informed business decisions. The Duty of Loyalty requires directors to make good faith efforts to advance the interests of the corporation and not their personal interests. Assuming that directors meet these fiduciary duties they are generally protected by the Business Judgment Rule.

In solvent corporations (those whose assets exceed their liabilities at fair value and are able to pay their debts as they come due) directors have no fiduciary duty to creditors (Harff v. Kerkorian). The theory is that creditors are usually better able to protect themselves than dispersed shareholders and that favoring a creditor over a stockholder of a solvent corporation may constitute a breach of fiduciary duties.

In an insolvent corporation (one whose liabilities exceed its assets at fair value or who is unable to pay its debts as they come due including the inability to raise money to pay bills) directors still owe a fiduciary duty to shareholders and the corporation but also must consider the interests of creditors (Trenwick Am. Litig. Trust v. Ernst & Young, LLP – 2006, affirmed in 2007) since the creditors in an insolvency become "the principle constituency injured by any breach of fiduciary duty of directors that results in the reduction in the corporation's value" (Gheewalla – 2007).

The obligations in the zone of insolvency are more complex. Firstly, there is no bright line test for being in the zone of insolvency. Some factors that the Delaware courts have used as indicators include: Vendors refusing to make deliveries unless paid in cash; Corporations not having enough cash to meet next payroll cycle and no realistic expectation of receiving sufficient funds from operations to do so. Apparently, if a company is currently solvent but forecasts insolvency it is not yet in the zone of insolvency. This lack of a bright line test could result in a decision being made with 20/20 hindsight which could create liability issues for directors. Secondly, the view of the Delaware courts seems to have shifted a bit on directors fiduciary duties in the zone or vicinity of insolvency. The conclusion that directors owe a fiduciary responsibility to both shareholders and creditors (Credit Lyonnais) seems to have evolved to exclude creditors but include both shareholders and the corporation (Gheewalla).

What is an Enlightened Director To Do ?

The circumstances surrounding the restructuring experience I've described above were quite unusual in that the impact of the Great Recession on the industry hit very quickly and very deeply. I've asked myself many times – what could we have done differently? After a lot of reflection I believe the answer is that we could not have predicted the timing or magnitude of the economic turmoil. By the time it hit the window of opportunity to raise additional capital had passed. Of course, there was no way to predict how long the dark days would stay with us so the decision to "tighten our belts" and avoid the formal restructuring is still a difficult one. If we stuck it out and we were able to come out the other side intact we would have been heroes to both our creditors and shareholders. If we were wrong we would have been forced into a bankruptcy process with a diminished financial position and subject to potential liability by Monday morning quarterbacks.

So what is an enlightened director to do under similar circumstances? My conclusions based upon my experience above and the benefit of almost a decade to reflect on the situation is as follows:

- While all actions/decisions by the board should be made in accordance with the Duties of Care and Loyalty there are few circumstances where going above and beyond these basic requirements is more important than when a potential "life event" (e.g. merger, major acquisition, restructuring inside or outside of bankruptcy court) is under consideration.
- An enlightened director (as part of an enlightened board) would challenge the standard industry metrics/assumptions – a form of "stress test" might be considered for an industry that operates with high leverage. Ideally, these discussions take place long before a potential "life event".
- In response to the "stress test" above be prepared with strategic priorities in the event that the company appears headed for one of those stress points. Are there selected assets that we would sell? Is there a "layered" internal restructuring that could take place – i.e. with various degrees of aggressiveness depending upon the severity of the situation?
- Consult an independent financial advisor with experience in your industry so that they can not only crunch the numbers that management provides but will also challenge management's assumptions based upon their own knowledge.

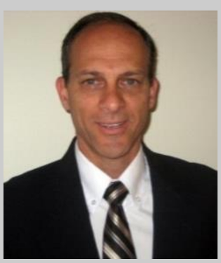
- Hire legal counsel with restructuring/bankruptcy expertise. In deciding on appropriate counsel I would consider, in addition to deep experience in this area, counsel who has some track record for advising their clients against the formal bankruptcy process. I am not suggesting that it is always the wrong decision to pursue the formal process but I would like to have the benefit of an experienced, objective counsel that will provide advice that is clearly in the client's best interest without regards to how his/her firm will benefit.

- Get clear on whether the company is solvent, insolvent or in the zone of insolvency. Again, this may not be a bright line test but the question is where does the preponderance of evidence suggest you are?

The objective is to do as much preparation before the event hits so that the organization is prepared with a measured response that could avoid a bankruptcy proceeding. If a bankruptcy filing is unavoidable due to some unforeseen circumstance the initiatives and preparations that the board had done in advance will reflect well on fulfillment of Duty of Care and you should be well within the protections afforded by the Business Judgment Rule.

In the current economic environment this article may have renewed relevance. However, the subject could just as easily been about activist investors, a transformative acquisition or any other major event in a company's history. The implications for directors are the same.

About the Author



Vincent DiVito

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Vincent DiVito is an experienced director and a successful executive who has served in the life science, gaming, hospitality, software, manufacturing and public accounting industries. Vincent provides strong financial expertise, strategic vision and international perspective. Currently a consultant at his own firm, Vincent L. DiVito, Inc., he understands his responsibility to shareholders and recognizes the privilege of board service. As a CPA and financial expert, he contributes greatly to the audit and compensation committees given his work in M&A, integration, capital raising and structuring, taxes and financial reporting. Vincent invests the time to stay current on board best-practices, and to focus on personal education and effectiveness in the boardroom as a means of elevating the contribution of his peers to increase overall shareholder value. He is a thoughtful and engaged director who is highly valued and esteemed by his colleagues.

Mr. DiVito is currently serving on two boards of directors, Entertainment Gaming Asia (EGT - NASDAQ) since 2006 and Acqua Metals, Inc. (NASDAQ) since 2015. He previously sat on the board of directors for Riviera Holdings Corp. from 2002 to 2011 and served as Chairman from 2010 to 2011. Vincent serves as chairman of the Audit Committee for EGT, and serves as a member of the Compensation Committee. He is the Chairman of the Audit Committee and serves on the Compensation and Nominating Commitees at Aqua Metals. Through his years of board service Vincent has acquired extensive knowledge of today's most pressing corporate governance issues and effectively dealt with a variety during his tenure, such as strategic planning, organic and acquired growth, recessionary impact and implementation of Sarbanes-Oxley and Dodd-Frank Act measures.

Vincent has spent over 30 years in corporate financial management with a long career covering the full range of CFO responsibilities including M&A, treasury, tax, controlling, strategy development, internal and external reporting in a range of businesses that operated in North America, Europe, Asia and Latin America. Most recently he served as President and CFO at Lonza America, Inc. until 2010. During his career he had oversight responsibility for IT, HR & Benefits, Pension Management, Legal and SHE in addition to Finance.

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