Board Perspectives: Risk Oversight

When Insolvency Issues Arise

Issue 13

This issue of Board Perspectives: Risk Oversight *was co-authored by Protiviti Inc. and Whiteford, Taylor & Preston.*

Now more than ever, as the risk of personal liability rises, independent directors must take every precaution to protect themselves. Following the enactment of the Sarbanes-Oxley Act – and with bankruptcy filings currently at a 50-year high – independent directors are becoming a target for shareholders, management, creditors and regulatory agencies, as evidenced by a recent increase in litigation against them. Although independent directors are aware that their decisions can have an impact on their reputations, they may not know what action to take to reduce personal exposure while fulfilling their duties to the companies they serve.

Key Considerations

Independent directors are charged with protecting the interests of the organization and its shareholders by providing appropriate oversight and making objective, impartial decisions. When the organization is in financial distress, a whole new set of issues arises:

- Independent directors ordinarily have a fiduciary responsibility to the organization and its shareholders. Directors must exercise reasonable care, loyalty and good faith in the decision-making process and in overseeing the operational and financial performance of the organization. They have the duty to act in the best interest of the organization, even to the extent of foregoing personal gain.
- When the corporation is insolvent, the interests of the corporation's creditors must be considered. Creditors must be protected against actions that would improperly benefit one class of creditors over another. The corporation must take actions to preserve corporate assets and avoid improper depletion of assets.
- When an organization is experiencing financial difficulties, its risk profile will likely change. Independent directors need to have a solid understanding of the organization's risk profile and be able to assess the impact and long-term effects of key decisions they make or approve.
- In insolvency environments, monitoring the effectiveness of financial and operational internal controls, as well as thoroughly reviewing and understanding the organization's financial statements, are vital to ensuring informed decisions. Directors should look for any red flags, which can include negative cash flows, restructuring of debt or a search for new sources of financing.
- When an organization files bankruptcy, claims against the directors and officers typically follow as creditors seek all available assets in an attempt to satisfy unpaid debts. The creditors will review the actions of the board to look for potential wrongdoing that would be the basis for a claim against the directors. The coverage provided by the company's D&O insurance may be insufficient, even if it does provide coverage for the type of claim asserted. In bankruptcy cases, actions against directors and officers are often the most significant because their

personal assets are frequently unencumbered and provide a source of recovery for unsecured creditors, making it all the more likely that the actions of directors will be scrutinized closely. If any hint of wrongdoing is found, litigation surely will follow. Examples of causes of actions against independent directors include requests for the recovery of excessive compensation and value of the use of corporate assets and information for their personal benefit.

- When the organization is considering a merger or acquisition, directors may be liable for not using reasonable care in determining whether the proposed action is in the best interest of the organization and its shareholders. This scenario often gives rise to a heightened legal standard for scrutiny of the decision or inaction. Directors need to understand the organization's financial status fully, as well as the impact the proposed transaction could have.

When the organization is in financial distress, experienced independent directors can provide a fresh unbiased perspective on corporate issues. Most important, in circumstances involving matters of insolvency or potential insolvency, directors should be mindful of the issues involved.

Questions for Boards

- Are there warning signs that the organization is in financial distress? Have directors investigated any troubling reports or accounting restatements, scrutinized related-party transactions, and analyzed acquisitions, divestitures, restructurings and recapitalizations?
- Does the board need to hire outside financial advisors and/or counsel to assist in the decision-making process and/or to rely upon as a basis for its decisions?
- Do independent directors have any conflicts of interest that would prevent them from making a fair decision?
- Do directors have adequate financial protection through sufficient D&O insurance? Does the policy provide coverage if bankruptcy is filed? Does the organization's indemnification provision provide the maximum protection for directors permitted by law?
- During times of financial distress, do independent directors have all the information they need regarding the organization's risk profile? Are they willing to challenge and disagree with management on matters they believe are germane to the interests of outside stakeholders?

About the Co-Authors

Protiviti (**www.protiviti.com**) is a global business consulting and internal audit firm composed of experts specializing in risk, advisory and transaction services. The firm works with directors in public and private companies to identify and manage the challenges and opportunities as they negotiate difficult financial times. Protiviti's professionals offer an experienced, unbiased perspective on issues separate from those of company insiders. The firm has substantial experience in providing financial, operational and restructuring consulting services, due diligence support, and strategic planning.

With over 150 attorneys, Whiteford, Taylor & Preston (**www.wtplaw.com**) is a mid-Atlantic based law firm serving clients throughout the nation with offices in Baltimore, Maryland; Washington, D.C.; Falls Church, Virginia; Wilmington, Delaware; Towson, Maryland; and Columbia, Maryland. The firm's attorneys work with businesses ranging from single-owner entrepreneurial and professional firms to large public companies. Whiteford, Taylor & Preston provides corporate governance guidance and advice to directors of their fiduciary duties in ordinary and financially distressed circumstances. It also conducts investigations on behalf of boards of directors, and represents directors and officers in the defense of civil, administrative, and criminal investigations and lawsuits. When restructuring advice is needed, its attorneys can provide comprehensive advice on out-of-court workouts, refinancings, recapitalizations and bankruptcy.

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