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Litigation Risks For Energy Executives During Bankruptcy

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(May 4, 2020, 3:21 PM EDT) - Spurred by the dispute between Russia and the Organization of the Petroleum Exporting Countries, and the worldwide lockdown to prevent the spread of COVID-19, the price of oil has fallen to historical lows. Many oil and gas companies face substantial doubt about their ability to continue as going concerns. A deluge of bankruptcies in the oil sector appears inevitable.


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Bankruptcy trustees, plan agents, and creditor and equity committees will no doubt second-guess the business decisions of officers and directors in the months preceding the filing of bankruptcy. Now more than ever it is vital that directors and officers in the oil and gas industry understand (1) the legal framework that governs their conduct as corporate fiduciaries, (2) the types of transactions that will face enhanced scrutiny during bankruptcy proceedings, and (3) what to do now to minimize their bankruptcy litigation risks.

This article provides timely advice for directors and officers to protect themselves from potential litigation during the months preceding a bankruptcy filing.

Litigation Risks for Directors and Officers During Bankruptcy

When a company declares bankruptcy, plaintiffs attorneys, creditors and bankruptcy trustees often sue directors and officers for a breach of their fiduciary duties. Plaintiffs lawyers are typically eager to take these cases, even on a contingency-fee basis, because the D&O insurance policies are an enticing source of funds.

Additionally, the bankruptcy trustee or, following confirmation of a bankruptcy plan, a litigation trustee has an obligation to maximize the value of estate assets, and will likely view claims against former directors and officers as an aspect of discharging that duty.

In our view, breach of fiduciary duty claims are more dangerous when pursued by a litigation trustee than when pursued by shareholders in derivative litigation, for several reasons.

First, a litigation trustee generally has access to all the bankrupt company's documents and emails, without the need to engage in litigation discovery.

Second, to the extent the litigation trustee needs additional discovery, it may have access to the more expansive discovery procedures provided by the bankruptcy court. For example, some courts have allowed trustees to take presuit, "fishing expedition" depositions under Bankruptcy Rule 2004.

Third, the estate — not the directors and officers — owns the attorney-client and work-product privileges, and often the litigation trust shares the privilege with the estate. Therefore, directors and officers cannot shield from discovery emails or discussion with in-house or external counsel that occurred during their involvement with the company.

Finally, unlike shareholder actions, a litigation trustee generally does not have to comply with Delaware requirements such as making a formal demand on the board before bringing litigation.

Common Claims Against Directors and Officers of Bankrupt Companies

The most common claims against directors and officers of a bankrupt company allege a breach of the duty of care or the duty of loyalty.

Duty of Care

The duty of care requires officers and directors to make decisions on an informed basis.[1] A Delaware company can immunize their directors for monetary liability for breach of the duty of care by including exculpatory clauses in the company's bylaws, but officers cannot be so immunized.[2]

In a duty of care case, the most powerful defense for directors and officers is the business judgment rule, which is "a presumption that in making a business decision the directors [and officers] 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."[3] To overcome this presumption, plaintiffs must show that the directors and officers acted in bad faith, were reckless, or made a decision in haste without adequate information or deliberation.[4]

It can be helpful to establish a special committee of independent directors to review important transactions and to document their deliberative process in meeting minutes. Another important defense for directors is appropriate reliance on management, accountants, counsel and other advisers in reaching their challenged decision.

Duty of Loyalty

The duty of loyalty "requires an undivided and unselfish loyalty to the corporation."[5] To establish a breach of loyalty, a plaintiff must show that the officers or directors authorized a transaction when they either were self-interested (i.e., stand to obtain a unique benefit that is not available to shareholders) or lacked independence.[6]

If an officer or director discloses a personal interest prior to the transaction in question, and that transaction is approved by a majority of independent, disinterested directors, then the protection of the business judgment rule will apply to the transaction.[7]

For this reason, it is important for boards to convene a special committee of independent directors to approve any transaction that raises, or may appear to raise, a conflict of interest. This process helps establish that the corporate decision was approved by a majority of disinterested and independent directors, and thus entitled to the protections of the business judgment rule.

Finally, the duty of loyalty also requires directors to "make a good faith effort to implement an oversight system and then monitor it."[8] To show a breach of directors' Caremark duty to supervise management, a plaintiff must show that directors were so negligent that "their indolence ... could not be ascribed to anything other than a knowing decision not to even try to make sure the corporation's officers had developed and were implementing a prudent approach to ensuring law compliance."[9]

To avoid a Caremark claim, directors should take care to document deliberations and, in particular, note instances when management is challenged or questioned.

The Duties in the "Zone of Insolvency" and Bankruptcy

Generally speaking, directors and officers owe the same fiduciary duties notwithstanding the financial condition of the company. These duties are always owed to the company, not to shareholders or creditors. Of course, the company's beneficiaries can change as its financial condition deteriorates.

Delaware law no longer recognizes a "zone of insolvency" during which fiduciary duties begin to be owed to creditors. Rather, creditors only become beneficiaries to which duties are owed when a company is in fact insolvent.[10]

Further, Delaware law does not recognize a claim for deepening insolvency, and the business judgment rule applies with equal force to companies in financial distress.[11] So long as the company was not insolvent at the time of the transaction, creditors generally lack standing to challenge the board's decision to approve transactions, including deals which in hindsight cause or exacerbate financial harm to the company.

However, as a practical matter, directors and officers generally will not know in real time the precise moment a company becomes insolvent and thus creditors become its beneficiaries. In addition, some courts continue to refer to duties owed to creditors in the "zone of insolvency" without a nuanced consideration of the change in Delaware law caused by North American Catholic Educational Programming Foundation Inc. v. Gheewalla.

Thus, it is prudent for directors considering a transaction during times of financial distress to document that their company is in fact solvent at the time of the transaction.

Further, the duty of care may be heightened as a practical matter when bankruptcy is on the horizon because many difficult, important and complex decisions arise during financial distress. Delaware courts require a director or officer to be more deliberate and informed the more complex or important a decision is. Similarly, a duty of care case may be premised on a failure to investigate irregularities or alleged misconduct, and conducting an expensive internal investigation may be less attractive when a company is flirting with insolvency.

During these challenging times, directors and officers must consider carefully how they can discharge their duty of care if they, or others in the company, are working remotely. Although many courts and regulators are relaxing wet-signature and in-person requirements during the pendency of this crisis, the board may be unable to make certain decisions without an in-person meeting under the law of the organizing state or the company's charter.

Future plaintiffs will undoubtedly scrutinize whether adequate information-sharing and discussion occurred before key decisions. Remote work may encourage people at all levels of an organization to send via email information that would have otherwise been shared in person, creating a potential treasure trove of problematic documents for future litigation.

Any relevant privacy laws may be difficult to comply with when working outside the office. In addition, cybersecurity risks increase as employees share information in new ways that may not be adequately controlled by the company.

As with the duty of care, the duty of loyalty does not change during insolvency or bankruptcy, but directors and officers may find themselves in tricky situations that implicate this duty during times of financial distress.

For example, quintessential duty of loyalty claims allege unfair deals between parent corporations and subsidiaries, or the use of corporate authority to oppress minority shareholders or out-of-the-money creditors. Creative financial solutions or out-of-court restructurings, including liquidity and liability management transactions, may involve parent-subsidiary deals or changes of control that unhappy shareholders, creditors or a litigation trustee could view skeptically.

Transactions Plaintiffs Are Likely to Target

The uncertain trajectory of COVID-19 and the recent collapse of oil prices — as well as the creativity of the plaintiffs bar — make it difficult to project precisely which decisions taken now are likely to be challenged in a later bankruptcy. However, certain types of decisions are more likely to be subject to future litigation and should be treated with particular care.

First, as noted above, displaced shareholders often challenge restructuring agreements that result in a change of control. Such challenges are more likely to be brought — and more likely to succeed — when the restructuring transaction is undertaken before a bankruptcy court is involved. While directors and officers are permitted to pursue creative restructuring plans, they should carefully document the reasoning supporting such a decision.

Second, a litigation trustee may challenge investments in affiliated businesses that are not entirely owned or controlled by the primary company. If these affiliates don't provide the expected return to the primary company, then a litigation trustee may allege that such payments breach the duties owed to the primary company's shareholders.

Directors and officers should carefully review any current funding provided to affiliates to ensure that the funds are provided according to the contracts with the affiliates and that any loans are properly papered. If the company creates new funding obligations to affiliates during this time, then the directors and officers should be particularly careful to document the advantages of this arrangement to the primary company.

Finally, a corporation's creditors may challenge management's actions effecting a dividend, redemption or stock purchase (i.e., a stock buyback or stock repurchase) — or other liability management or liquidity management transactions. If the corporation was insolvent when these distributions to shareholders were made or was rendered insolvent by these distributions or other transactions, then the creditors may allege that the directors and officers breached their fiduciary duties by effecting these distributions or that these distributions were fraudulent transfers.

Before making a distribution, directors and officers should determine whether the corporation, after making the distribution, would become insolvent under the traditional balance-sheet test, be unable to pay its debts as they become due, or have unreasonably small capital for its business.

Delaware law "fully protect[s]" directors who rely in good faith on corporate records, corporate officers and outside experts to determine the value of the corporation's assets and liabilities.[12] For this reason, directors considering a dividend payment or stock buyback generally solicit a certification from the chief financial officer or an outside expert.

The business judgment rule generally protects the board of directors' decision to declare a dividend or approve a stock buyback; it, however, does not shield the board from liability in situations of potential or actual conflict of interest.

In certain situations, such as when a dividend distribution is part of the defensive measures against a hostile takeover, the potential conflict of interest may trigger enhanced scrutiny of the board's actions.[13] In other situations, such as when a board approves a stock-buyback transaction to purchase shares from the directors, the actual conflict of interest may trigger the entire fairness standard (the most burdensome standard of review under Delaware law).

While Delaware law allows a corporation to include an exculpatory clause in its certificate of incorporation to exculpate directors for breaching their duty of care, it does not allow directors to escape liability for breaching their duty of loyalty by making an unlawful distribution.[14]

A final consideration is that, although directors are jointly and severally liable for an unlawful distribution, a director who was absent when the distribution was made or who voted against the distribution may avoid liability by having her dissenting vote recorded in the meeting minutes.[15]

Tips for Directors and Officers of Financially Troubled Companies

With these considerations in mind, we recommend the following to directors and officers of companies facing financial trouble:

1. Document the decision-making process.

- If working remotely, create systems to ensure that decision-makers receive important information that would normally be shared face-to-face in some other manner.
- If working remotely, be sure that adequate discussion and debate occurs (and is noted) before important decisions.
- If an investigation into alleged misconduct is not undertaken, note the rationale for that decision in contemporaneous documents.

2. Adhere to corporate formalities to the extent possible, including wet-signature and in-person

requirements that may apply notwithstanding the COVID-19 crisis.

3. Avoid conflicts and guard board independence.

4. Use third-party studies to set compensation.

5. Conduct a board-level briefing on company indebtedness and solvency.

6. Review advancement and indemnification agreements and D&O insurance.

- Insurance agreements should provide enough coverage but not too much (in order to avoid too high of premiums).
- Partner with a reputable insurer.
- Include adequate Side A coverage.
- Ensure there is coverage for restitution and disgorgement.
- Timely place your insurer on notice.
- Be sure the insurance agreement covers in-house counsel.

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[1] Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985), overruled on different grounds by Gantler v. Stephens, 965 A.2d 695 (Del. 2009).

[2] 8 Del. C. § 102(b)(7); see also Gantler v. Stephens, 965 A.2d 695, 709 n.37.

[3] Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984), overruled on different grounds by Brehm v. Eisner, 746 A.2d 244 (Del. 2000).

[4] Id.; Brehm v. Eisner, 746 A.2d 244, 264 n.66 (Del. 2000).

[5] Guth v. Loft, Inc., 23 Del. Ch. 255, 270 (1939).

[6] See Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 358 (Del. 1993), decision modified on reargument, 636 A.2d 956 (Del. 1994).

[7] See 8 Del. C. § 144(a); Benihana of Tokyo, Inc. v. Benihana, Inc., 906 A.2d 114, 120 (Del.2006) ("After approval by disinterested directors, courts review the interested transaction under the business judgment rule.").

[8] Marchand v. Barnhill, 212 A.3d 805, 820–21 (Del. 2019) (citing In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996)).

[9] Desimone v. Barrows, 924 A.2d 908, 935 (Del. Ch. 2007).

[10] N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007); see also Trenwick Am. Litig. Trust v. Ernst & Young, LLP, 906 A.2d 168, 191–192 (Del. Ch. 2006).

[11] Id.

[12] 8 Del. C. § 172.

[13] See, e.g., Reis v. Hazelett Strip-Casting Corp., 28 A.3d 442, 457 (Del. Ch. 2011).

[14] 8 Del. C. §§ 102, 174.

[15] 8 Del. C. § 174.