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Portfolio Company Insolvency: Risk Mitigation Strategies for Fund Sponsors and Board Designees

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COVID-19 continues to disrupt normal business operations, creating liquidity problems and negative working capital for many companies. As fund sponsors take actions to help their portfolio companies navigate through this time, they should also sensitize directors to insolvency issues and the associated litigation risks. As we have previously highlighted, both funds and fund managers may face increased risks of litigation exposure when a portfolio company is running low on cash and faces the possibility of restructuring or reorganizing. The COVID-19 pandemic and the havoc it has wrought in its wake has amplified these risks, as companies scramble to shore up their cash positions. These litigation risks are also magnified when fund managers serve as directors of the distressed portfolio company, given the heightened risk of conflicting fiduciary duties inherent in such dual roles.

Risk 1: Conflicts of Interest

Fund managers who also serve as portfolio company directors should be particularly careful about the decisions they make on behalf of the company as the company nears insolvency, because they may owe fiduciary duties to both the fund and the company. These directors should also be mindful about how they use information available to them, what information is confidential, and with whom they share it. While the interests of the company, shareholders, and others are often aligned when a company is doing well, these groups' interests may diverge when a company is under financial stress, and particularly if the company becomes insolvent. In those circumstances, directors may find themselves with conflicting fiduciary duties to different entities or groups. These conflicting duties increase the potential litigation risks for the directors and the fund sponsor. Limited partners, company shareholders, or other groups who are each separately owed fiduciary duties could perceive actions by the director that benefit another group as breaching the duties owed to them.

Risk 2: Expanded Fiduciary Duties

In distressed situations, sponsor directors of portfolio companies must be mindful of creditors' rights. In Delaware, directors do not owe fiduciary duties to creditors when a company is solvent or in the "zone of insolvency" (i.e. when a company is under distress and approaching insolvency). However, they may owe fiduciary duties to all residual stakeholder-claimants, including creditors, as soon a corporation becomes insolvent. Many jurisdictions follow Delaware, but not all. A creditor of a corporation in Delaware may also obtain derivative standing to sue directors for a breach of fiduciary duty if a company is insolvent. Fund managers who also serve on portfolio company boards should be aware of the fiduciary duty rules in the relevant jurisdictions, and verify when and if duties are owed to certain groups of potential claimants.

Risk 3: Navigating the Zone of Insolvency

While the fiduciary duties a director owes to a portfolio company do not change when it is in the "zone of insolvency," there is still significant litigation risk that directors should consider. To start, whether a company has crossed into the zone of insolvency, or into insolvency itself, may be unclear. There is no single definition of insolvency. There are three principal tests that courts tend to apply, depending on what jurisdiction the court sits in, to determine if a company was solvent at a given point in time: (i) the balance sheet test; (ii) the cash flow test; and (iii) the unreasonably small capital test. While a court will always be applying these tests after the fact, directors can use these tests in the present to help gauge how close to insolvency a company might be. If a company is having balance sheet cash flow issues, is in distress, or is unable to acquire or maintain financing, those are indicators that the company may be in the zone of insolvency. Regardless of which test a court applies, in litigation the question of solvency is always assessed with the benefit of hindsight. Thus, it is important to assess solvency issues in real time to ensure a portfolio company director makes decisions that mitigate risk to the director, the company and the fund sponsor.

For example, if a company is in the zone of insolvency, portfolio company asset transfers could result in liability for officers and directors if they impair repayment of debt. Related to this, creditors could bring a variety of direct claims against the company and/or directors for actions taken during this time, such as a claim for a fraudulent conveyance seeking clawbacks or other remedies.

Mitigating These Risks

There are a number of ways that fund sponsors and their portfolio company directors can mitigate these risks and forestall potential litigation. While each situation is unique, a few potential mitigation strategies include:

- Consulting experts regarding questions such as the company's solvency, fiduciary duties and potential conflicts of sponsor appointed directors.
- Consulting outside legal counsel regarding potential creditors' claims, and possible fiduciary duties owed to creditors of an insolvent company.
- Sensitizing directors to the insolvency issues above.
- Inviting significant creditors or creditor groups to the table during decision-making when appropriate.
- Assessing exculpation clauses in the company charter and revising as necessary.
- Using special committees, getting independent valuations, and retaining independent counsel for directors or special committees for potentially conflicted transactions.
- Adhering to formalities, including retaining comprehensive minutes and documenting the bases for board decisions, to help ensure that fund managers who hold director seats are mindful of their changing hats and the flow of information.

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