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Examining the Role of Independent Directors in Chapter 11
UTLAW CLE

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Introduction: Appointment of independent directors in financially distressed situations

- Important tool to consider: the appointment of unaffiliated individuals with expertise in navigating distressed situations to act as independent directors.
- Charged with analyzing management's decisions and authorizing major transactions or investigations; particularly useful when the company expects its actions to come under greater scrutiny by its creditors.
- A company's lenders may also demand the appointment of an independent director as part of a forbearance agreement or in connection with providing funding for a comprehensive restructuring.

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What are the benefits of appointing an independent director?

- Can help bolster relationships and credibility with key creditors and other important constituents.
- Independent evaluation/insulation of non-ordinary course transactions (e.g., asset sales, new employee compensation programs, new financing arrangements or modifications to these arrangements). *See e.g.* 11 U.S.C. § 363(b)(1).
- These may include "insider" transactions subject to heightened scrutiny.

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What are the benefits of appointing an independent director? (cont.)

- Prepetition board of directors' decisions are protected by the business judgment rule so long as the board is well-informed and acts in the company's best interest.[1]
- Post-petition decisions of management are protected by the business judgment rule so long as there is an articulated business justification.[2]
- Because an independent director has not previously been involved in a company's business affairs, his or her decisions are not influenced by the self-interests of existing stakeholders and therefore are more likely entitled to deference under the business judgment rule.[3]

1. *Walt Disney Co. Derivative Litig*., 907 A.2d 693, 746-47 (Del. Ch. 2005) (directors of a corporation enjoy a presumption that in "making a business decision the directors of a corporation acted on an informed basis and in the honest belief that the action taken was in the best interest of the company.")
2. *Institutional Creditors of Continental Airlines, Inc. v. Continental Airlines, Inc.*, 780 F.2d 1223, 1226 (5th Cir. 1986); *Committee of Equity Security Holders v. Lionel Corp.*, 722 F.2d 1063, 1070-71 (2d Cir. 1983).
3. *E.g., Friedman v. Dolan,* 2015 WL 4040806 (Del. Ch. June 30, 2015). If a conflict of interest exists, the decision will be held to the heightened "entire fairness standard. *In re LATAM Airlines Group, S.A.*, 620 B.R. 722, 769 (Bankr. S.D.N.Y 2020).

Rise of Independent Directors

The use of independent directors in bankruptcy cases has increased from 3.7% in 2004 to 48.3% in 2019.[3]

Potential Reasons:

- The Sarbanes-Oxley Act of 2002 (15 U.S.C. §§ 7201-7266) and related listing rules tightened independence standards and required public corporations to staff their boards and committees with independent directors.
- Institutional investors emphasize board independence.
- A means to avoid regulations and preserve corporate autonomy.
- Court deference to board decisions made by independent directors.

3. Jared A. Ellias, Ehud Kamar, and Kobi Kastiel, *The Rise of Bankruptcy Directors*, Forthcoming 95 *Southern California Law Review* (2022).

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