What Every CEO Should Know Before Filing Chapter 11

When a company files under Chapter 11, it is a momentous event not only for the business but also for the Chief Executive Officer and senior management team. Long before the bankruptcy petitions are placed in front of him for signature, the CEO needs to make sure that he understands the process, appreciates his duties, protects himself from personal liability, and secures appropriate terms of employment for Chapter 11 case.

Understanding the process

A financially distressed company has several options. One is to restructure its obligations out of court by far the preferred choice, but not often feasible. Another is to shut down the company and file for Chapter 7 bankruptcy in which a trustee liquidates the assets, usually under the hammer. When an out-of-court solution is not practical but the company has value as an operating business, it will usually opt for Chapter 11 bankruptcy, in which management remains in control to reorganize the company or to execute a going-concern sale.

Chapter 11 changes the way corporate decisions are made. Upon filing its Chapter 11 petition, the company becomes a “debtor in possession,” which means that the company continues to control its assets and manage its business. But there are important restrictions. Prior bankruptcy court approval will be needed for certain actions, including any transaction out of the ordinary course of business, any financing other than accepting ordinary trade credit, employee incentive plans tailored to the Chapter 11 case, and any retention or payment of lawyers or other professionals. Beginning with a “first day hearing,” which typically takes place on the third day of the Chapter 11 case, the bankruptcy judge will typically hold hearings every two to four weeks. While the CEO need not attend all of the hearings, he will have to be present whenever his testimony might be required. There will be other hearings that he will want to attend because of their importance. After all, the seat of power has shifted from the boardroom to the courtroom.

Not just to the courtroom, but the corridors outside. That’s where deals are struck among the key parties to the Chapter 11 proceeding. Except for the rare case that degenerates into a legal brawl, proceedings in bankruptcy court are quite different from plaintiff-against-defendant litigation in which two sides battle over who did something wrong in the past. Most decisions in bankruptcy court concern what will happen in the future: Will a debtor-in-possession financing agreement be approved? Will a particular division be sold? Will a real estate lease be rejected? Legal principles occasionally dictate the outcome, but more often the bankruptcy judge will be guided by two factors: (1) the business judgment of the company and its professionals, and (2) the views of other significant parties, especially the Creditors’ Committee (representing unsecured creditors) and any major secured lenders.

The role of the CEO is central. Most of what takes place in a Chapter 11 case must be initiated by the company. Moreover, the company’s top managers are usually perceived as essential to maximizing the value of the business. So how does a CEO manage the Chapter 11 process while also running a business? Just as the CEO has a senior management team to help run the business, the CEO assembles a team to manage the Chapter 11 case. Strong bankruptcy counsel, with strategic savvy as well as legal skills, is a must. In addition, the CEO may look to outside financial advisors for big-picture analytical support, help with bankruptcy-related issues of financial reporting and vendor management, or both. Some companies will appoint a Chief Restructuring Officer.

The team will succeed only with strong leadership from the CEO. The CEO should enter Chapter 11 with a game plan, but also maintain flexibility to address changing circumstances while still steering toward the legal goal. Just as crucial is a communication plan. Managers need to understand the big picture why the company filed under Chapter 11, and what the CEO hopes to accomplish. They also must be taught the rules of the road for operating a Chapter 11 for example, the pre-bankruptcy obligations cannot be paid without a court order. It is essential to assure suppliers that they will be paid for new shipments, customers that their orders will be filled, and all constituencies that the business will survive. The CEO's involvement and credibility are critical to the communication plan, as well as other aspects of the Chapter 11.

How about the board of directors? Because the key transactions are subject to court approval, the role of the board is less critical than outside bankruptcy. Yielding their ore-bankruptcy authority to make final decisions has an important benefit to the directors: there is much less danger of liability. In some cases, the board will simply expect the CEO to manage the Chapter 11 process. More often the board will continue to function much as it did before the bankruptcy, such that the CEO will be expected to obtain board approval for any important transaction before proposing it to the court.

And the stockholders? A transaction that under corporate law would require stockholder approval outside bankruptcy can be accomplished under Chapter 11 simply by obtaining bankruptcy court approval. However, stockholders retain their right to elect directors, subject to being overridden by the bankruptcy court if a change in directors seems designed to disrupt the Chapter 11 process. In order to save money, a public company in Chapter 11 may sometimes provide a reduced level of public reporting and stop holding stockholders' meetings. But limited participation in the Chapter 11 process is perhaps the least of the stockholders' problems. Their difficulties began long before Chapter 11 when the company entered the "zone of insolvency."

To Whom Does the CEO Owe a Duty?

When a company enters the zone of insolvency, then (at least in the case of a Delaware corporation) directors and officers owe a fiduciary duty to creditors, not just stockholders. The theory is that if the company's real value is less than the amount of its debts, then creditors have replaced stockholders as the residual risk-bearers of the company. If things get worse, creditors will receive fewer cents on the dollar; if things get better, creditors will get more. So there is a certain logic in saying that the company should be managed for the benefit.

This requires a dramatic change in focus for a CEO accustomed to the mission of maximizing return to shareholders. And even then, the questions have just begun. For example:

What does it mean to manage the company for the benefit of creditors? Does it mean the company must be liquidated and the assets distributed to them? Not necessarily; the answer will depend on the directors' business judgment about how best to maximize the value of the enterprise, which will often mean trying to preserve its going-concern value.

How do the creditors supply input about how they want their corporation governed? In Chapter 11, as discussed above, the creditors have an important voice. Outside bankruptcy, the law provides no way for creditors to govern the corporation, and indeed holds out the threat of liability to creditors who try to control the company. Moreover, as a particular matter, calling a meeting of the company's creditors outside bankruptcy may lead to fatal disruption of operations.

For the benefit *which creditors* should the company be managed? The bank leaders who have a lien on all assets? The seller who took back a note by reason of an acquisition two years ago? The trade creditors who badly want their customer to survive? The trade creditors who want the company to fail so they can sell more to its quicker-paying competitor? How about the customers, who may have substantial claims if the company shuts down suddenly? How about the employees? There are no clear answers to these questions. Having decreed the principle that fiduciary duties are owed to creditors, the courts have largely left it to distressed companies and their counsel to figure out how to execute.

So what happens if an insolvent company gets it wrong, as later determined by a court? The company itself, already liable for its debts but unable to pay them in full, can pay no additional penalty. Creditors may look for other sources of recovery such as directors and officers. So how can the CEO minimize the chance of personal liability? The closest thing to a safe harbor is Chapter 11, where the requirement of judicial pre-approval for significant transactions, with input from creditors, will in most circumstances eliminate any threat of liability for corporate decision-makers. Absent a Chapter 11, the best approach for the CEO and directors is to engage professionals with insolvency experience and make sure to give thorough consideration to creditors' interests before making any significant corporate decision. Finally, it is essential that D&O insurance coverage be reviewed with insolvency issues, and a potential Chapter 11 filing, in mind.

Other Sources of Personal Liability

In addition to potential claims for breach of fiduciary duty, the CEO of a distressed company faces three other sources of potential liability; (1) personal guaranties, (2) liability imposed by law for payroll and taxes, and (3) credit fraud.

Personal Guaranties. Personal guaranties are almost never given by CEO's of public companies and seldom by CEOs of venture-capital owned companies. CEOs of other private companies, however, find their personal signatures much in demand. When the CEO has guaranteed a debt, the only escape is for the company to pay the debt in full. Apart from the practical difficulty of finding the necessary cash, there are legal considerations.

Bankruptcy law favors equality of distribution, meaning that all creditors should get the same percentage distribution. To implement this policy, the law provides that if a creditor obtains a preferential paydown or lien within 90 days before bankruptcy, the preferential transfer will be set aside. Read the fine print of a personal guaranty and it typically provides that if the creditor gives back a payment because it is recovered as a preferential transfer, the personal guaranty is reinstated. Worse yet, when a creditor holding the guaranty of the CEO or other insider has received a preferential transfer *up to one year* before the bankruptcy, the value of the transfer can be recovered directly from the guarantor. So trying to escape from a guaranty by causing a company to pay or secure the guaranteed obligation within one year before the bankruptcy may not work. If that were the only danger, then the CEO would be no worse off by causing the company to pay the guaranteed obligation than just by doing nothing. But if making the preferential transfer damages the company, the CEO may be liable for breach of fiduciary duty. Dangers could far exceed the amount of the preferential transfer.

Personal Liability for Payroll and Taxes. Under the law of certain states, unpaid employees may sue responsible officers, including the CEO. Since companies pay their employees in arrears sometimes issuing payroll checks 10 days or more after the start of a pay period accrued but unpaid salaries could be enormous in the case of a sudden shutdown. But in addition to regular pay, personal liability may extend to vacation pay, fringe benefits, bonuses and/or severance.

The CEO also faces potential personal liability for "trust fund taxes," which are taxes that the company collects from someone else and then fails to turn over to the government. If the company withholds but fails to remit taxes from employees' paychecks, responsible officers have personal liability. The same would be true for sales taxes collected from customers but not paid over to the government. Taxes not collected from someone else, including the employer's portion of the Social Security payroll tax as well as corporate income taxes, do not give rise to personal liability. Even so, the amount of accrued and unpaid taxes for which the CEO has personal liability will often be enormous because even if the company is current in its obligations for trust fund taxes, there is typically a lag between the time such taxes are withheld or collected and the time they are remitted to the government.

How can these personal liabilities be avoided? The only surefire way is for payroll and trust fund taxes to be funded in cash on a pay-as-you-go basis. Funded amounts would need to include items like vacation and severance pay to the extent that these might be personal liabilities under applicable state law. It may be necessary to utilize escrow accounts in order to prevent the funds from being seized by unpaid creditors or becoming part of the bankruptcy estate. To the extent that such arrangements are impractical, the CEO can take comfort from the regular practice of certain bankruptcy courts to permit timely payment of payroll and trust fund taxes accrued before bankruptcy, in the context of a Chapter 11 reorganization involving ongoing operations. Furthermore, to the extent these types of obligations accrue during a Chapter 11 case, they are almost always funded; and even if unpaid, it is likely that the CEO would not have personal liability.

Credit Fraud. When a company falls behind in its payments to trade creditors, their usual response is to pick up the phone. They'll ask questions like: Why haven't I been paid? When will I be paid? What's going on with the company? Will I be paid for goods you've asked me to ship this week? Company personnel who receive such calls, aware that the company needs an ongoing flow of goods or services from its vendors will be tempted to provide whatever answer the vendors want to hear. Often this is bad strategy, because when the company's overall optimistic assurances prove false, the resulting loss of credibility will compound the company's problem. Even worse, making a false statement to obtain credit including shipment of goods against future payment can lead to personal liability and even to conviction of a crime. So can obtaining goods without intention to pay for them. The fact that a manager is acting for the company rather than for person gain will not be a defense to personal liability.

The period leading to Chapter 11 filing is particularly difficult. It can take months to prepare for a major Chapter 11 filing. A creditor could later argue that throughout this period, the company did not intend to pay the debts it incurred. Yet even when the company continues to accept goods on credit through the very day of the Chapter 11 filing, it is rare for corporate officers to be sued. No doubt this is due to a combination of company circumspection and creditor sophistication. During the period leading to Chapter 11, creditors have typically placed the company on C.O.D. or a similar arrangement whereby for each dollar of new goods received, the company must pay a dollar towards its oldest invoices. Most companies will avoid inducing any creditor to increase its aggregate exposure as Chapter 11 nears; this both decreases the likelihood of a suit for credit fraud and avoids the animosity that can result early in a Chapter 11 case when creditors feel abused by the company's pre-bankruptcy conduct. For further safety, most companies will engage a crisis manager to help manage vendor relations. This has the dual effect of insulating management and assuring the creditor inquiries are handled by, or at least with the advice of, a professional having experience and judgment about what can and cannot be said. Finally, for most major creditors, a customer's Chapter 11 filing is not a new experience. They understand the process, and distinguish between fraudulent conduct and the inevitable temporizing that proceeds a Chapter 11 filing.

Why Not Just Resign?

Given the challenges of leading a company in financial distress, why would a CEO who sees Chapter 11 on the horizon choose to remain at the helm? Sometimes the CEO may feel obligated to fellow managers and employees to see the company through its period of crisis. From a purely pragmatic perspective, the CEO may conclude that potential personal exposure (reputational as well as legal) can be managed more effectively by remaining in office. Finally, Chapter 11 may represent an attractive opportunity both for near-term incentive payments and potential long-term employment with the reorganized company or its purchaser.

Chapter 11 Employment Contracts

The key Employee Retention Plan (KERP) is a common yet often controversial feature of Chapter 11. Unsophisticated creditors, journalists and the general public may choke on the notion that "those who created the problem" should be paid a bonus to solve it. Although most creditors and bankruptcy judges accept the employee incentives as necessary to maximize value, Congress recently imposed significant restrictions on KERPs for insiders such as the CEO. As a result, there is substantial uncertainty concerning the nature and scope of incentives that are now permissible. It is likely, however, that even with the new restrictions, creative counsel will be able to obtain approval of appropriate incentives for the CEO as well as any insider whose efforts add value to the Chapter 11 case.

Conclusion

Every CEO who has steered a company through Chapter 11 will describe the project as intense, challenging and strikingly different from other experiences in the business world. Some would describe the experience as nerve-wracking, some as rewarding, and some as both. Almost none express the desire to go through another Chapter 11, but almost all consider it extremely valuable experience. Most are proud of what they were able to accomplish. Many are willing to share their insights with other CEOs about to embark on the same adventure.