

Navigating Today's Environment

The Directors' and Officers' Guide to Restructuring

SECOND EDITION

Michael Eisenband
Consulting Editor
FTI Consulting

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THE DIRECTORS' AND OFFICERS' GUIDE TO RESTRUCTURING

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TABLE OF CONTENTS

Preface

A brief lookback at a decade of restructurings, defaults and leveraged finance

CONSULTING EDITOR 1
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1 Who's who: an introduction for officers and directors to the typical players in a restructuring transaction

LEGAL PERSPECTIVE 9
Willkie Farr & Gallagher LLP

2 The role and duty of the board of directors and the special committee of the board in distressed scenarios

I. LEGAL PERSPECTIVE 15
Weil, Gotshal & Manges LLP
II. FINANCIAL ADVISOR PERSPECTIVE 21
FTI Consulting

3 Executive compensation and incentive plans during restructuring

FINANCIAL ADVISOR PERSPECTIVE 31
FTI Consulting

4 Liquidity: key to restructuring

FINANCIAL ADVISOR PERSPECTIVE 35
FTI Consulting

5 The rise of the RSA: driving value to streamline negotiations in a restructuring process

I. INVESTMENT BANK PERSPECTIVE 41
PJT Partners
II. LEGAL PERSPECTIVE 47
O'Melveny & Myers LLP

6 Bankruptcy financing: overview and current developments

I. INVESTMENT BANK PERSPECTIVE 53
Centerview Partners LLC
II. LEGAL PERSPECTIVE 58
Skadden, Arps, Slate, Meagher & Flom LLP
III. FINANCIAL ADVISOR PERSPECTIVE 63
FTI Consulting

7	Avoiding a bankruptcy filing: corporate decision-making and liability management transactions	
I.	INVESTMENT BANK PERSPECTIVE	67
	Lazard	
II.	LEGAL PERSPECTIVE	74
	DLA Piper LLP	
8	Distressed company communications: maintaining credibility with key constituencies	
I.	LEGAL PERSPECTIVE	79
	Cravath, Swaine & Moore LLP	
II.	STRATEGIC COMMUNICATIONS ADVISOR PERSPECTIVE	84
	FTI Consulting	
9	The need for speed: accelerating the Chapter 11 process	
	LEGAL PERSPECTIVE	89
	Gibson, Dunn & Crutcher LLP	
10	Treatment of workforce-related claims in financial restructurings	
	LEGAL PERSPECTIVE	95
	Akin Gump Strauss Hauer & Feld LLP	
11	Mediation to accelerate resolution and reduce cost in bankruptcy	
	LEGAL PERSPECTIVE	103
	Paul, Weiss, Rifkind, Wharton & Garrison LLP	
12	The backstop rights offerings: securing capital during your restructuring process	
	LEGAL PERSPECTIVE	109
	Mayer Brown LLP	
13	Start your auctions: stalking horse bidding and other considerations for driving value in the Chapter 11 sale process	
I.	LEGAL PERSPECTIVE	117
	Ropes & Gray LLP	
II.	INVESTMENT BANK PERSPECTIVE	122
	Jefferies LLC	
14	Exit financing opportunities and strategies	
	LEGAL PERSPECTIVE	129
	Katten Muchin Rosenman LLP	
15	Emergence Playbook	
	FINANCIAL ADVISOR PERSPECTIVE	135
	FTI Consulting	

16	A rare luxury: remaking your board during a restructuring	
	EXECUTIVE SEARCH PERSPECTIVE	141
	Spencer Stuart	
17	Bankruptcy: considerations and strategies for directors and officers of multinational companies seeking to restructure	
	I. LEGAL PERSPECTIVE	147
	Cleary Gottlieb Steen & Hamilton LLP	
	II. FINANCIAL ADVISOR PERSPECTIVE	152
	FTI Consulting	
18	Restructuring venture-backed companies: key considerations and strategic options	
	LEGAL PERSPECTIVE	155
	Cooley LLP	
19	D&O insurance and fiduciary duties: a lesson in protecting the directors and officers during a restructuring	
	LEGAL & INSURANCE PERSPECTIVE	161
	Sidley Austin LLP	
	CAC Specialty	
20	Trust fund taxes: avoiding personal liability for directors and officers in distressed situations	
	LEGAL PERSPECTIVE	169
	Paul Hastings LLP	
21	Releases in out-of-court and in-court restructurings	
	LEGAL PERSPECTIVE	173
	Vinson & Elkins LLP	
22	Litigation trusts	
	LEGAL PERSPECTIVE	179
	Quinn Emanuel Urquhart & Sullivan, LLP	
23	Next step: the insolvency zone	
	INDUSTRY ORGANIZATION PERSPECTIVE	187
	American Bankruptcy Institute, Inc.	

CONTRIBUTOR PROFILES 191

CHAPTER EXCERPT

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When a business experiences an acute cash flow shortfall and is unable to access conventional sources for additional financing, directors and officers of the company are presented with difficult choices. Preserving the value of the business for all stakeholders is critical, and directors and officers, quite rightly, will exhaust all available avenues to unlock liquidity to maintain operations and preserve the business. It may be tempting for directors and officers to use funds designated for another purpose to cover essential operating expenses in the short term, expecting that those funds may be replaced once additional revenues are generated. The impulse to preserve the business at all costs, however, must be checked against the legal and fiduciary realities that directors and officers face.

This is particularly true with respect to a company's "trust fund taxes," which consist of funds that are withheld or collected by the company, in trust, for the benefit of applicable taxing authorities. These funds are typically collected in the ordinary course of business, but are often not paid until future dates, typically on a quarterly basis. Accordingly, these funds might seem like a useful short-term, low-cost financing tool to meet immediate operational needs, but if future revenue forecasts are inaccurate and anticipated revenues fail to materialize within the expected time frame, the result could be significant tax delinquency, potential penalties, or worse, personal or criminal liability for directors and officers (as well as other responsible employees). It is essential, therefore, that directors and officers have a sound understanding of trust fund tax liabilities and ensure that the company is collecting and paying all such tax obligations, including in connection with a bankruptcy filing of the company.

Trust fund taxes and the trust fund recovery penalty

The phrase "trust fund taxes" encompasses a number of obligations that a company may owe to federal, state and local taxing authorities when, pursuant to statutory requirements, the company receives the funds in question and holds them in trust for the taxing authority. Common forms of trust fund taxes include certain withholdings from

an employee's wages, sales taxes collected at the point of sale and excise taxes that are required to be collected in connection with activities as diverse as the sale of coal mined from specific regions to the provision of indoor tanning services.

Trust fund taxes can vary based on state and local laws as well as the type of business conducted by the company. Directors and officers should consult with tax and legal advisors to understand fully the company's actual trust fund tax obligations, including all trust fund taxes that are collected or held by the company prior to payment to the taxing authority. Because the general principles concerning officer and director liability for misappropriation of trust fund taxes are largely similar regardless of the specific type of trust fund tax at issue, a full discussion of all possible trust fund tax liabilities will not be addressed within this chapter. Instead, this discussion will focus primarily on the federal trust fund taxes based upon withholdings from employee wages, which is applicable to every business that has employees.

Under the Internal Revenue Code (the "IRC"), employers are required to withhold amounts from employee wages for federal income taxes and the employee's share of Social Security and Medicare taxes. The IRC further requires that these withholdings be held by the employer in trust for the United States government. Pursuant to regulations issued by the U.S. Department of the Treasury, the amounts withheld from employee wages and held in trust by the company must be reported and paid to the government each quarter. There is no requirement for these funds to be held in a segregated account (e.g., they can be held in the employer's general operating account). Nevertheless, the withheld amounts are for the exclusive use of the government and are not to be used to pay the employer's expenses. If the trust fund taxes are not paid, the Internal Revenue Service ("IRS") has a number of tools for collecting the unpaid amount, including charging the company penalties of up to 25 percent of the amount of tax owing.

In addition to the collection efforts that the IRS may make against the company, the IRS may also seek collection of the full amount of unpaid trust fund taxes

from any person found to be responsible for their payment, such as the company's officers and directors. This provision of the IRC is commonly referred to as the "trust fund recovery penalty." Despite its name, the trust fund recovery penalty is not technically a penalty but rather a collection device because it allows the IRS to collect the original amount of the unpaid trust fund tax (plus interest), not an additional penalty amount. While the company is, of course, responsible for the payment of its trust fund taxes, the taxing authority can choose to enforce the trust fund recovery penalty against directors and officers prior to attempting collection from the company.

Liability under the trust fund recovery penalty

In order to be found liable for a company's unpaid trust fund taxes, an individual must be found to be both a "responsible person" and to have acted "willfully" with respect to the nonpayment of the trust fund tax obligation. (IRC § 6672(a); *Slodov v. United States*, 1978). These terms have been the subject of substantial litigation and courts have developed criteria for determining when an individual is a "responsible person" and when the nonpayment of trust fund taxes is "willful" but, as described below, it will be difficult for directors and officers to avoid liability when a company fails to pay required trust fund taxes.

Generally, a "responsible person" is anyone who is required to collect, withhold (account for) or pay the trust fund taxes. Whether an individual is a responsible person is a very fact-intensive inquiry and can be the source of extensive and costly litigation, the costs of which could fall to the directors and officers. While the number of factors considered by various courts may differ, the substance of the analysis is largely the same and is focused on whether the individual (i) is an officer, director or shareholder of the company, (ii) is active in the day-to-day management of the company, (iii) makes decisions concerning the priority in which taxes and debts will be paid, (iv) has the ability to hire and fire employees, (v) has check signing authority and (vi) exercises control over accounts and disbursement records. These factors cover a wide range of potentially responsible parties, and directors and officers often

are identified specifically by courts as meeting the criteria of a responsible person.

There are other factors that courts have used to expand the parties that can be a responsible person. For example, an individual needs only to have the authority to exercise control of the financial decisions of the company and is not required to actually exercise that power. This could directly expose directors and officers who have authority over certain matters but may not exercise that authority on a day-to-day basis, delegating such tasks to others. Further, exclusive control is not required, so the authority and decision making can be shared by multiple individuals. By contrast, individuals that perform purely ministerial acts that do not involve exercising independent judgment or control are not considered responsible persons for purposes of trust fund recovery penalty liability, although this exception will be of little use to anyone occupying a director or officer position.

To be liable for a trust fund recovery penalty, a responsible person's failure to collect, account for or pay the trust fund tax must also be willful. A merely negligent failure to pay trust fund taxes may be excusable. Willfulness is considered to be a voluntary, conscious, intentional act to prefer other creditors over the taxing authority, but willfulness does not require a showing of bad motives or an actual intent to defraud the government. Willfulness has also been established based upon an individual's reckless disregard for the payment of trust fund taxes where there was a grave risk that the taxes would not be paid, the taxpayer clearly should have known about the risk, and the taxpayer was in a position to find out for certain very easily.

There are two common situations where courts have found, as a matter of law, that funds were willfully misappropriated. The first is where other creditors of the company are paid with funds that are needed to pay the trust fund taxes. For example, a responsible person that elects to pay company employees their full net wages and then is unable to pay the applicable withholding taxes, would be liable for a willful misappropriation of the trust fund taxes. In such a circumstance, the wage claims of employees

are treated as any other creditor of the business, and giving preference to those claims over the claims of the taxing authority is willful. Continuing with this example, suppose that a company has enough available cash to pay the full amount of net wages owing to its employees but, after doing so, would have insufficient funds to pay the required withholding taxes for the same pay period. In that case, to avoid liability for a willful misappropriation of the trust fund taxes, the company would have to reduce the amount of net wages that it pays to employees to a point where it can also pay the full amount of withholding taxes for the net wages that are actually remitted. Courts have upheld this principle even in cases where employees threaten to quit if they did not receive the full amount of net wages owed to them. The second situation where willful misappropriation may be found as a matter of law is where a responsible person becomes aware of a delinquency in the payment of trust fund taxes and subsequently permits the payment of other creditors ahead of the taxing authority. In such a situation, the responsible person must use all unencumbered funds (i.e., funds that are not subject to a security interest senior to the taxing authority that prevents payment of the delinquency) to satisfy the trust fund tax delinquency before paying other creditors.

A responsible person, under certain circumstances, may be excused for relying on false statements made by another person attesting that the trust fund taxes have been paid; however, directors and officers should take additional measures to verify such statements because relying on simple assertions of others, without more, is insufficient to avoid liability. In addition, a responsible person generally cannot assert a defense to a claim based on the fact that they were merely following the orders of their supervisor. Further, it is not an excuse that the company did not have sufficient funds to pay the taxes when due because the withheld amounts were used to pay other debts that were essential to maintain operations. Similarly, a taxpayer's claim that it expected the financial condition of the business to improve has been uniformly rejected as a defense to the willfulness of a responsible person that does not pay trust fund taxes. Simply put, an

inability to pay is unlikely to be a successful defense, even if the motivation of the director or officer was to save the company for the benefit of all stakeholders.

In addition to the civil claims that may be brought to collect under the trust fund recovery penalty, in egregious cases failure to pay trust fund taxes may result in felony criminal prosecution. In statutory language that mirrors the responsible person and willfulness provisions of the trust fund recovery penalty, the IRC also provides for a fine of up to \$10,000 and imprisonment for up to 5 years. (IRC § 7202).

Proper planning for trust fund taxes (in and out of bankruptcy)

In every scenario, it is critical for directors and officers to properly plan and prepare for payment of trust fund taxes. Further, in cases where a company becomes insolvent or is forced to file for bankruptcy protection, if appropriate procedures and safeguards are not put in place, a company's bankruptcy filing could increase the likelihood that directors and officers become subject to claims under the trust fund recovery penalty or similar statutes for unpaid trust fund taxes.

An example of how a company and its officers and directors could be liable for unpaid trust fund taxes may be helpful. Consider a situation where, faced with an acute cash flow shortfall, management used cash withheld from employee wages to cover immediate operating expenses with the expectation of replacing the funds with anticipated future revenues that never materialized and the company subsequently filed for bankruptcy. The unpaid trust fund taxes are now a pre-petition debt of the company and the IRS, like other creditors, is prohibited from attempting to collect the debt from the company because of the automatic stay that was put in place upon the filing of the company's bankruptcy petition. However, while the automatic stay prevents the IRS from taking action against the company, it does not prohibit the IRS from pursuing collection of the trust fund recovery penalty from the officers and directors (and any other responsible persons) of the company, and it is difficult to get court approval to extend the automatic stay to protect the company's officers and directors with respect to trust fund recovery

penalty liability. In this scenario, pursuit of the trust fund recovery penalty against officers or directors who were responsible for the nonpayment of the trust fund taxes is likely the most appealing and least burdensome course of action for the IRS. Moreover, it is possible that any amounts that the company does pay to the IRS on account of delinquent taxes (e.g., through a Chapter 11 plan of reorganization) may first be applied to non-trust fund taxes and, therefore, will not reduce the liability of responsible persons under the trust fund recovery penalty.

This situation is entirely avoidable through careful planning and the implementation of some common sense safeguards. First, the company should consult with its tax and legal advisors to ensure that all relevant personnel have a complete understanding of the company's trust fund tax responsibilities at the federal, state and local levels. Second, the company should limit the number of individuals that can be considered responsible persons by designating the authority for the collection, accounting and payment of trust fund taxes to a small group of individuals. Third, the company should implement procedures to ensure that all applicable trust fund taxes are collected and paid at every applicable interval. In the event that the company faces a potential bankruptcy filing, it should coordinate with its legal and financial advisors concerning the timing of collection and payment of its trust fund taxes to ensure that no amounts are unpaid as of the bankruptcy filing date. Bankruptcy counsel will typically also prepare a motion to seek authority from the bankruptcy court to continue paying the company's tax obligations (including trust fund taxes) during the bankruptcy, and such motions are routinely approved.

Regardless of how strong the desire to preserve a distressed business may be, the legal and fiduciary requirements related to the collection and payment of a company's trust fund taxes are clear, and the potential liability for officers or directors that run afoul of those requirements is severe. By understanding the rules regarding trust fund taxes and taking appropriate measures to ensure compliance, officers and directors can avoid potential pitfalls while managing financial distress.

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