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THE SPOTLIGHT

BROUGHT TO YOU BY ROBINS KAPLAN LLP'S
WEALTH PLANNING, ADMINISTRATION, AND DISPUTES GROUP

THE MORE YOU KNOW: MANAGING FIDUCIARY RISKS

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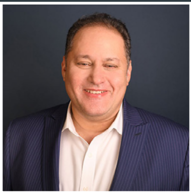

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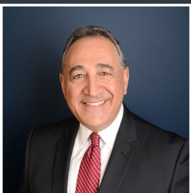

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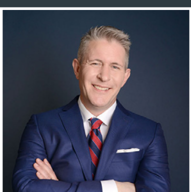

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WELCOME TO THE SPOTLIGHT

BROUGHT TO YOU BY ROBINS KAPLAN LLP'S WEALTH PLANNING, ADMINISTRATION, AND DISPUTES GROUP

The Spotlight is the result of ongoing collaboration between our national trial practice and estate planning groups, with the goal of providing a forum to discuss the latest news and other issues impacting the trusts and estates community. Whether you are a trustee, beneficiary, trust officer, attorney, financial advisor, or other professional in this area, we hope that you will find this newsletter interesting, informative, and perhaps at times even a bit entertaining.

As leaders and teachers in the field of wealth planning and administration, our attorneys have built a reputation for excellence in meeting the needs of individuals and organizations from basic to complex testamentary planning. We counsel individuals and business owners in all aspects of estate planning and business succession, providing them with peace of mind and reassurance that their legacy is in the best of hands.

Furthermore, should a conflict arise, our wealth disputes attorneys are well positioned to resolve the matter with thoughtfulness, creativity, and compassion. Our national reputation for litigation excellence includes wins in the fiduciary arena for trustees and fiduciaries, personal representatives, beneficiaries, guardians, and conservators. Whether litigating fiduciary matters, inheritance issues, or contested charitable donations, we help clients cut through confusion to find a path to resolution.

Is there a topic affecting your practice that you would like us to discuss in an upcoming issue of The Spotlight? Let us know at all_marketing@robinskaplan.com.

– Denise S. Rahne and Steven K. Orloff

SAVE THE DATE

Wealth Planning, Administration, and Fiduciary Disputes Group Annual CLE Event

Thursday, October 13
12:30 p.m. – 5:00 p.m.

(with networking reception to follow)

The seminar will take place live in our Minneapolis office with simulcast to other cities. This year's program will include presentations and panel discussions on ethical issues and dilemmas in fiduciary disputes, as well as our regular roundup of current issues in wealth planning, administration, and fiduciary disputes.

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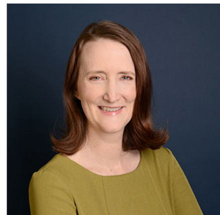
BE WARNED: AS FIDUCIARY DUTIES SHIFT, SO, TOO, CAN PRIVILEGE OWNERSHIP

BY ANNE M. LOCKNER



Picture this. Years after leaving your in-house counsel role at Company A, you find yourself being deposed in a litigation matter with Company A's adversary inquiring into your legal notes and internal privileged communications. Sound scary? Unfortunately, this could happen in several scenarios, but you can take steps to mitigate the risk.

So how does a former in-house counsel find herself in this position? One example is where Company A declares bankruptcy. Once that happens, the trustee or creditor's committee of the now-bankrupt Company A will likely look for all opportunities to assert claims—including fiduciary duty claims—against the company's officers and directors, both former and current (which may or may not include the general counsel in her official capacity). But what may surprise those former D&Os is that the party now controlling the bankrupt entity, whether it be a trustee or creditor's committee, now controls Company A's privilege. Therefore, any privileged communications within the possession of Company A are fair game, and counsel in the adversary proceeding can freely ask questions regarding those communications.

This scenario can play out with even more complications when Company A is a subsidiary of Parent, Inc. Once Parent, Inc. begins to make plans to divest a subsidiary or affiliate or put it into bankruptcy, that company should immediately begin to take steps to not only ensure that fiduciary duties are met under the *Revlon* standard[1] but also to protect both Parent, Inc.'s *and* Company A's respective and joint attorney-client privileges.

In many corporate enterprises with multiple entities, often a single legal department serves all corporate entities, often through an intercompany-services agreement. This usually works well and is more efficient when all the corporate entities' interests are aligned. But once a parent begins to look for either strategic divestment opportunities or restructuring options for its subsidiary (here Company A), that alignment can shift.

As a result, the officers and directors of Company A (who are often the same or overlapping officers and directors of Parent, Inc. or other sister companies) need to ensure they are meeting their fiduciary duties to Company A, and they must be very careful about which hat they are wearing at any given time. One potential safeguard is to ensure that Company A has its own general counsel—not an attorney who is also serving in some capacity for Parent, Inc. but rather someone whose sole duty is to Company A.

Not only is this prudent from a governance and fiduciary-duty perspective, but it also helps both companies preserve their respective attorney-client privileges. If care is not taken to draw a clear line between Company A and Parent, Inc.'s respective legal representation, even Parent, Inc.'s privileged information could also be vulnerable. Consider this scenario: Company A does not have its own general counsel, and Parent, Inc. continues to offer Company A legal advice even after Parent, Inc. decides to divest Company A. After the sale, Parent, Inc. retains possession over those communications. Parent, Inc.—once served with a subpoena or discovery requests during later litigation—will have a hard time withholding those communications as privileged because it no longer controls Company A's privilege. And those communications and notes often reflect advice to both Company A *and* Parent, Inc., creating a sticky wicket for Parent, Inc.'s litigation counsel, who must try to decipher and draw a line between the two—and then defend that line. Thus, it is imperative that Parent, Inc. take steps to ensure that Company A has its own general counsel once it is put up for sale if it did not already have one.

So, how can both counsel for Parent, Inc. and Company A best protect themselves in these scenarios?

- Identify if there is a chance that Parent, Inc.'s and Company A's interests could become adverse or, at least, less aligned. Is Company A struggling, and will Parent, Inc. need to consider various restructuring options? Is Parent, Inc. looking to otherwise strategically divest Company A? In either of these situations, Parent, Inc. would be well served by appointing a general counsel to serve solely as Company A's general counsel.
- If Parent, Inc. appoints someone from the cadre of Parent, Inc.'s in-house counsel to serve as Company A's general counsel, which often happens, follow these precautions:
  - Make clear the date that the person went from representing Parent, Inc. to Company A and ensure that the transition is complete by that date. It is too easy for employees of Parent, Inc. to continue to turn to that person, blurring the line between the two companies and jeopardizing the very purpose of appointing a general counsel for Company A in the first place.
  - Make every effort to use a separate means of communication for the new role. Continuing to use the same email the person used when she served as counsel for Parent, Inc. will result in Company A's privileged materials being mingled with Parent, Inc.'s.
- Where a common interest exists on certain issues between Parent, Inc. and Company A, it may make sense to formalize an agreement to recognize such a common interest and make clear that—by sharing communications—neither party is waiving their respective privilege. While this agreement may not prevent Company A's new owners from inquiring about or obtaining its privileged materials, it should give Parent, Inc. some leverage to ensure that Company A cannot waive privilege over common-interest communications without Parent, Inc.'s consent.
- Utilize Parent, Inc.'s and Company A's retention policy and ensure that it is followed—subject, of course, to any litigation hold requirements. There is often a considerable volume of communication reflecting the negotiation of Parent, Inc.'s divestment of Company A. And depending on the circumstances surrounding that divestment, it could be quite contentious and adverse. It may not be helpful for the new owners of Company A to have full access to Company A's former owners' privileged communications during the sale process. Therefore, absent prohibitions to destroy those otherwise privileged (or even non-privileged) communications, it may be wise to delete them. Obviously, great care must be taken in doing so.

While these steps do not guarantee that in-house counsel will not find herself subject to a deposition if control of the privilege shifts to a now-adverse party, they will hopefully help to protect the various privileges in play. If nothing else, appreciating the risk of your words and advice landing in unexpected hands should cause one to think twice about what is stated in writing.[2]

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[1] *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986) (landmark decision of the Delaware Supreme Court holding that when the breakup or sale of company was inevitable, "[t]he directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company").

[2] For some excellent tips on managing risk in email communications, please see Thomas Berndt's article published in the Spring 2022 issue of *Spotlight*.

WE DON'T TALK ABOUT INSOLVENCY (NO, NO, NO ...)

BY THOMAS BERNDT

As a parent of three young children, Disney's excellent new movie, *Encanto*, has been on heavy rotation in my household. It's a story of an extended family whose members possess unique magical gifts. Through several humorous songs, the film reveals that the family has ostracized one member, Bruno, whose mystical visions of future calamities upset the rest of the family. Rather than confront the unpleasant aspects of the future, the family finds it easier to simply "not talk about" them, or Bruno.

This is typical human behavior. It's easiest to simply avoid difficult topics. For these reasons, directors of struggling businesses may feel reluctant to raise the topic of potential insolvency. Directors of public companies, in particular, may be wary of broaching the topic for fear it would be recorded in board minutes or draw increased scrutiny from the company's auditor. Social forces may also be at play; management or fellow directors may become defensive and see it as critical of their performance.

But the truth is that businesses can – and do – fail. And avoiding the topic doesn't make it any less likely to occur. While fear of failure shouldn't paralyze business leaders, corporate directors should nonetheless educate themselves on the basics of insolvency: what it is, why it matters, and its impact on their fiduciary duties.

WHAT IS INSOLVENCY?

Defining exactly when a failing company becomes insolvent can be deceptively tricky. Courts in most jurisdictions identify insolvency using either the balance sheet test or the cash flow test. The balance sheet test asks if the company's assets exceed its liabilities, while the cash flow test asks if the company is able to pay its debts as they come due. A third (less common) test—the adequate capital test—assesses whether the company possesses adequate capital to continue future operations.

Despite these tests' seeming simplicity, there is enough subjectivity involved in valuing a company's assets, liabilities, or future operational costs that even experts can disagree on whether a company is insolvent. This is particularly true with respect to companies teetering on the brink of insolvency (often referred to as in the "zone of insolvency").

If directors are in doubt about whether their company is insolvent, they should seek professional advice and not rely exclusively on their or management's best guess. A professional solvency analysis can help directors understand the company's options, including potential bankruptcy or restructuring, and protect their decisions from being criticized as uninformed.

DOES INSOLVENCY AFFECT A DIRECTOR'S FIDUCIARY DUTIES?

Before 2007, courts and commentators frequently stated that once a corporation enters the "zone of insolvency," directors' fiduciary duties shift from shareholders to creditors. Some courts found that these fiduciary duties to creditors implied an obligation to manage the corporation conservatively as a trust fund for the creditors' benefit.

But much of this changed in 2007, as a result of the Delaware Supreme Court opinion in *N. American Catholic Educ. Programming Found. v. Gheewalla*, 930 A.2d 92 (2007) ("*Gheewalla*"). There, creditors of a company operating in the "zone of insolvency" brought direct claims against the company's directors for breach of fiduciary duty. The court dismissed these direct claims, holding that "[t]he creditors of a Delaware corporation that is either insolvent or in the zone of insolvency have no right, as a matter of law, to assert direct claims for breach of fiduciary duty against its directors." *Id.* at 103.

The *Gheewalla* court went on to clarify at least two other important points. First, while creditors of an insolvent company do not have standing to bring *direct* claims, they may assert *derivative* claims on behalf of the company. The court explained that "when a corporation is *solvent*, [directors' fiduciary duties] may be enforced by its shareholders, who have standing to bring *derivative* actions on behalf of the corporation because they are the ultimate beneficiaries of the corporation's growth and increased value." *Id.* at 101. But when a corporation is *insolvent*, "its creditors take the place of the shareholders as the residual beneficiaries of any increase in value" and, accordingly, "have standing to maintain derivative claims against directors on behalf of the corporation for breaches of fiduciary duties." *Id.*

Second, the point at which creditors replace shareholders as residual beneficiaries of the company—and gain standing to assert derivative claims—is *actual insolvency*, not the so-called zone of insolvency. The court explained that "[w]hen a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners." *Id.* at 101. Thus, the oft-used term "zone of insolvency" no longer had significance under Delaware law; only actual insolvency mattered.

Gheewalla has proven influential. In 2015, a Delaware Chancery court discussed the sea change *Gheewalla* represented in *Quadrant Structured Products Co. v. Vertin,* 115 A.3d 535 (2015). The *Quadrant* court observed that *Gheewalla* represented a "regime" change in which the following "principles" are now true:

- There is no legally recognized "zone of insolvency" with implications for fiduciary duty claims. The only transition point that affects fiduciary duty analysis is insolvency itself.
- Regardless of whether a corporation is solvent or insolvent, creditors cannot bring direct claims for breach of fiduciary duty. After a corporation becomes insolvent, creditors gain standing to assert claims derivatively for breach of fiduciary duty.
- The directors of an insolvent firm do not owe any particular duties to creditors. They continue to owe fiduciary duties to the corporation for the benefit of all its residual claimants, a category which now includes creditors. They do not have a duty to shut down the insolvent firm and marshal its assets for distribution to creditors, although they may make a business judgment that this is indeed the best route to maximize the firm's value.

Id. at 546-47.

While some jurisdictions haven't embraced *Gheewalla*, it is still binding precedent under Delaware law. And that's significant given the State of Delaware's claim that more than half of all U.S. publicly traded companies are incorporated under Delaware law. Thanks to *Gheewalla*, directors of companies incorporated under Delaware law can rest assured that, upon insolvency, their fiduciary duties continue to run to the company itself (not creditors) and that the business judgment rule continues to protect their decisions. Directors of companies incorporated under another state's laws should consult their attorneys to determine if that state adopts *Gheewalla* and, if not, how insolvency impacts directors' fiduciary duties under that state's laws.

THE TAKEAWAY

When navigating potential insolvency, professional advisors can be invaluable. Not only can professionals help diagnose insolvency, but they can explain the associated risks and help directors make informed decisions about the company's best options. Of course, none of this is possible unless directors are aware of and communicate with each other about potential insolvency. Take it from Disney, putting off difficult conversations or avoiding them altogether doesn't solve anything. Talk about insolvency, ask questions, and seek professional input when in doubt.

THE ABCS OF PBCS: HOW THIS RELATIVELY NEW CORPORATE FORM MANDATES A BROADER VIEW OF BUSINESS

BY PETER FOUNDAS AND MANLEEN SINGH

Socially beneficial causes now play a large role in consumers' and employees' decision-making. A recent survey from 2021 shows that 44% of millennials and 49% of Gen Zers reported making choices about the type of work they are prepared to do and the organizations for which they are willing to work based on their personal ethics.[1] A 2019 survey found that 77% of U.S. consumers are motivated to purchase from companies committed to making the world better, and 49% of Americans believe it is more important for a company to "make the world a better place" than "make money for its shareholders."[2]

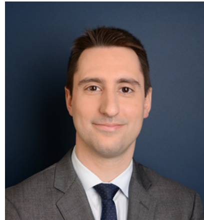
The law has responded to this call for more socially conscious businesses with a relatively new type of corporate form called the public benefit corporation ("PBC"). At its core, a PBC allows a business to pursue socially beneficial goals while also seeking to earn a profit. As of 2021, 40 states have enacted a corporate benefit statute. As Candice Ciresi, chief legal officer of the fintech PBC Sezzle, explains, a corporate social purpose can have significant benefits for the right company: "The winds of change support corporate social responsibility. Adjusting our sails to embrace these winds of social, environmental, and governance concerns provides new opportunities and adventures. We are able to sail with confidence having a clear north star."

Boards of directors of conventional corporations must act with one goal in mind – to maximize shareholder value. All decisions, whether the issue at stake involves key business operations or selling the company, must be made in an effort to obtain the highest price per share of stock. Failure to do so risks litigation from shareholders.

PBCs, on the other hand, add more considerations to boardroom decisions, such as stakeholders and the public benefit identified in the charter documents. A PBC's board must consider, as part of its fiduciary duty to the PBC, whether the stated public benefit is advanced with the board's decision-making. For instance, Delaware requires directors to manage the PBC's business affairs in such a way "that balances the pecuniary interests of stockholders, the best interests of those materially affected by the corporation's conduct, and the specific public benefit or benefits identified in its certificate of incorporation."[3] Some jurisdictions, such as California, expand the groups whose interests directors must consider: employees, customers, the community, and even the "local and global environment." Most states allow for a shareholder or director to bring a derivative suit to enforce the balancing test or to require the PBC to follow its stated public benefit, but such suits are typically limited to injunctive relief, and Delaware enacted a minimum 2% ownership requirement to bring such a suit.[4]

There are also additional reporting requirements for PBCs to ensure they stay focused on their public benefit. A Delaware PBC must provide biennial statements to its shareholders describing how the company promoted its public benefit. Some jurisdictions (not Delaware) require the appointment of a benefits director to ensure the PBC is pursuing its stated benefit and to report to the shareholders whether the PBC's directors and officers are actually pursing that goal.

It is also worth discussing the difference between a PBC and a certified "B Corp." A registered PBC is simply the corporate form a company elects to take when incorporating with the state. A "B Corp" certification, however, is a certification provided by the nonprofit organization B Lab. It certifies that a company "demonstrate[s] high social and environmental performance," legally obligates itself to be held accountable not just to shareholders, and is transparent about its performance. Companies seek out the B Lab certification as a marketing tool and to show the marketplace that the business is seriously committed to conducting its operations in a socially conscious manner. Certification can take a long time and even before B Lab will consider a candidate, the company must take a self-assessment and obtain a certain threshold score. As Ciresi further explains, the B Lab certification process is not an easy process: "The questionnaire is a sizeable analysis with significant breadth; it is not for the faint of heart, but the analysis can propel a PBC toward B Corp certification, and even if certification is not desired, the process can still offer meaningful options for directing the focus of the company."



Business owners and directors should consider whether the PBC corporate form is right for their business and consult with a professional to evaluate the following questions:

- Does the company want to articulate a specific public benefit in its charter, or does it want to incorporate only with a general benefit?
- What jurisdiction is the best place to incorporate, given the different reporting requirements, potential need for a benefit director, and varying fiduciary standards?
- Should the company appoint a dedicated benefit officer to oversee the benefits reporting requirements?
- How can the company clearly articulate criteria to measure progress toward its general and/or specific public benefit?
- Should the company pursue B Corp certification, and, if so, what steps can it take at the outset of incorporation to increase its chances of obtaining certification?

PBCs are likely to grow in frequency and popularity. The trend lines and attitudes point toward an increased focus on corporate social responsibility in the coming years, and more investor money is likely to flow in that direction.

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[1] https://www2.deloitte.com/content/dam/Deloitte/global/Documents/2021-deloitte-global-millennial-survey-report.pdf
[2] https://www.aflac.com/docs/about-aflac/csr-survey-assets/2019-aflac-csr-infographic-and-survey.pdf
[3] Del. Code tit. 8, § 365.
[4] Del. Code tit. 8, § 367.

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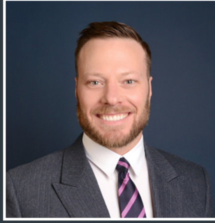

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