JD FORD & COMPANY
INVESTMENT BANKERS

JANUARY 2, 2009

TO OUR CLIENTS AND SPECIAL FRIENDS:

KEY ISSUES FOR DIRECTORS

BACKGROUND

- Due to current events, we have prepared a list of the Top 10 Questions that you as a corporate director must be asking in the New Year.
- 2008 demonstrated to all of us that unimaginable events can happen, and happen quickly and unexpectedly, thus it's time to ask tough questions and make plans for what only recently would have been unthinkable events.

TOP 10 LIST

NO. 10: IN LIGHT OF THE ECONOMIC CRISIS, WHAT DIFFERENT FIDUCIARY OBLIGATIONS SHOULD I, AS AN INDEPENDENT DIRECTOR, BE CONCERNED ABOUT?

Generally, a director's obligation to the corporation is governed by the director's fiduciary duty to act in the corporation's best interest. The two elements are the duty of loyalty and the duty of care.

Special duty of care considerations:
The duty of care dictates that directors must act in a fully informed and considered manner. They must (i) inform themselves of all material information reasonably available to them prior to making a business decision and (ii) act with the care an ordinary prudent person in like position would use under similar circumstances.[1] As such, a board cannot adopt an "ostrich like" approach to material decision making by failing to deliberate or get adequate information regarding key corporate decisions.[2]

- The risk oversight function of the board of directors has never been more critical and challenging than it is today. In the context of the current global economic crisis,

[1] ARONSON V. LEWIS, 473 A.2d 8-5 (Del 1984).

[2] IN RE WALT DISNEY CO. DERIV. LITIG., 825 A. 2d 275 (Del. Ch. 2003).

companies now face risks that are more complex, interconnected and potentially devastating than ever before. The public and political perception that undue risk-taking has been central to the breakdown of the financial and credit markets is leading to an increased legislative and regulatory focus on risk management and risk prevention. In this environment, directors must be mindful of the possibility that courts will apply new standards, or interpret existing standards, to increase board responsibility for risk management.

- Board inaction is a frequent scenario for a breach of fiduciary duty of care claim. As a business or sector stumbles, the earlier an advisor, joint venture partner or investor can provide additional support and guidance to the declining business, the greater the probability that the enterprise's intrinsic value can be preserved. Industry survivors stay ahead of the game by recognizing issues before they become problems and turning perceived disadvantages into a competitive edge.

Special duty of loyalty considerations:

The duty of loyalty prohibits self-dealing transactions, excessive compensation, corporate waste, personal use of corporate assets, and the use of corporate funds to perpetrate control or "entrenchment" of existing management.[3] If a company is in financial distress, management often could place their interest for continued employment ahead of the corporation, which would result in a breach of the duty of loyalty.

- In the current global economic crisis, a business's decline can be precipitous. Nothing was more unexpected than the rapid demise of Lehman Brothers. Often in these situations, management can suffer denial, unpreparedness for change and resoluteness that it can resolve its own problems.

NO. 9: HAS ANY "REVLON DUTIES" BEEN TRIGGERED BECAUSE OF ANY RESTRUCTURING ACTIVITIES?

In financial distress situations, a director's fiduciary duties can differ from his duties when making ordinary director decisions. For example, a corporate distress situation may involve a transaction involving the sale of control, the break-up or restructuring of a company. Under these situations a board faces a well defined set of heightened fiduciary obligations. These fiduciary duties grew from the Delaware Supreme Court's decision in REVLON, INC. V. MACANDREWS & FORBES HOLDINGS, INC.[4] In REVLON, the court held that, once a board of directors determines that the company is up for sale, the directors are no longer defenders of the corporation, but instead become "auctioneers charged with getting the best price for the stockholders."[5] The

[3] CEDE & CO. V. TECHNICOLOR, INC., 634 A. 2d 345 (Del. Super. 1993).

[4] 506 A.2d 173 (Del. 1985) (hereinafter, "REVLON").

[5] *ID.*

Delaware Supreme Court expressly noted whether the "sale" takes the form of an active auction or a "restructuring," Revlon duties are triggered.

These Revlon duties require directors to obtain the highest value reasonably available for the shareholders and the corporation. In these cases, courts will apply an "enhanced scrutiny" standard. This enhanced scrutiny standard focuses on the directors' process and action, the adequacy of information relied upon by the directors, and the reasonableness of the directors' decision. In NETSMART,[6] a decision noted by legal commentators to be a legal watershed in Delaware, the Delaware Chancery Court imposed a duty requiring the target to show that it pursued both financial and strategic buyers:

> [A]n inert, implicit post-signing market check [through a window-shop provision, relying on publicity to elect offers] does not, on this record, suffice as a reliable way to survey interest by strategic players. Rather, to test the market for strategic buyers in a reliable fashion, one would expect a material effort at salesmanship to occur. To conclude that sales efforts are always unnecessary or meaningless would be almost un-American, given the sales-oriented nature of our culture.[7]

As such, the retention of a qualified and experienced financial advisor or investment banker, with experience and expertise to canvass both financial and strategic buyers, is an essential initial step to be pursued by the board.

NO. 8: WHAT IS OUR COMPANY'S ALTMAN Z SCORE?

Director's have a fiduciary duty to monitor balance sheet issues, including leverage, liquidity, debt maturities, share buybacks and dividend obligationss, and to be aware of the problem of underwater pension and other employee benefit plans, or off balance sheet obligations. One way for directors to monitor the solvency of a company is to require management to compute an Altman Z Score.

The Altman Z-Score is a combination of profitability, liquidity, turnover and solvency ratios designed to predict the likelihood of business failure leading to bankruptcy. It is a metric that has accurately predicted over 70% of bankruptcies in the past several years. An Altman Z-Score between 1.8 and 3.0 indicates that a company has an increased risk of bankruptcy, and a Z-score below 1.8 indicates that bankruptcy is highly likely.

- In light of the current financial crisis, we believe the predictability factor of this indicator to be even higher.

[6] IN RE NETSMART TECHNOLOGIES, INC. SHAREHOLDER LITIG., Civ. No. 2563-VCS (Del. Ch., March 2007).

[7] ID. at p. 48.

- Trends in Altman Z-Score should be analyzed.
- As a public company, investors, analysts and plaintiff's counsel can quickly compute an Altman Z-Score based on public filings, thus directors should also monitor this important indicator.

NO. 7: IS OUR COMPANY IN THE ZONE OF INSOLVENCY?

When an organization is solvent, a director's fiduciary duties run to the corporation's shareholders and to the corporation itself, but not to creditors. However, additional concerns arise when it is not clear whether the corporation is solvent, the so-called "zone of insolvency." While courts have not defined the amorphous term "zone of insolvency," generally, it refers to the situation where an organization's financial condition deteriorates to the point where it is at risk of becoming insolvent.[8]

By the count of others, a majority of jurisdictions, including many federal courts, have held that the fiduciary duties of directors of an insolvent corporation, or one in the zone of insolvency, extend to its creditors.[9] However, recently, the Delaware courts rejected this line of cases and made clear that directors' and officers' fiduciary duties do not change when the corporation enters the zone of insolvency. [10] It is uncertain if other states will adopt the recent Delaware decisions.

If a company is incorporated in a state that imposes fiduciary duties to creditors for companies in the "zone of insolvency," the outside director could potentially owe fiduciary duties to the creditors of Company. As such, it is important for directors to explore with his counsel if the company is incorporated in a jurisdiction that follows the Delaware court's GHEEWALLA line of reasoning (no fiduciary duty to creditors) or imposes a fiduciary duty to creditors. If the latter, consideration should be given to resign from the board or implement other risk reduction strategies.

When a corporation is *insolvent*, however, its creditors take the place of the shareholders as the residual beneficiaries of any increase in value. Consequently, the creditors of an *insolvent* corporation have standing to maintain derivative claims against directors on behalf of the corporation for breaches of fiduciary duties. The corporation's insolvency "makes the creditors the principal constituency injured by any fiduciary breaches that diminish the firm's value."[11]

[8] *See id.* at 98 (declining to define the zone of insolvency); PROD. RES. GROUP, L.L.C. V. NCT GROUP, INC., 863 A.2d 772, 790 (Del. Ch. 2004) (referring to the zone of insolvency as "some imprecise and hard-to-define vicinity of insolvency").

[9] *See e.g.*, CREDIT AGRICOLE INDOSUEZ V. ROSSIYSKIY KREDIT BANK, 94 N.Y.2d 541, 550 (N.Y. 2000).

[10] *See* N. AM. CATHOLIC EDUC. PROGRAMMING FOUND., INC. V. GHEEWALLA, 930 A.2d 92, 99 (Del. 2007).

[11] *Gheewalla*, 930 A.2d at 102.

Creditors of insolvent corporations may bring derivative claims on behalf of the corporation. The Delaware Supreme Court, however, has not expressly addressed whether creditors of a corporation operating in the "zone of insolvency" have standing to bring a derivative claim for breach of fiduciary duty.

NO. 6:
ARE WE AT RISK FOR VIOLATING ANY FINANCIAL COVENANTS?

As the current economic crisis grows more severe, navigating the dangerous shoals when a company has solvency issues that create a conflict between the interests of shareholders and creditors.

In recent months Banks are relying on even the slightest technical defaults of loan covenants to accelerate loans, increase interest rates or deny renewals. This is substantially different than the attitude of lenders during the days of easy credit.

NO. 5: DOES OUR COMPANY HAVE A SUFFICIENT LIQUIDITY AND CAPITAL SOURCES TO SURVIVE A DOWNTURN?

At this moment the global economy is experiencing the most severe recession since the Great Depression. Many economist, are predicting that the recession will worsen in 2009 and migrate to slow recovery sometime in 2010. This recession is accompanied by severe constraints on capital. Thus, companies must conserve cash, and generate liquidity in order to survive and prosper in the future. Directors should ask about plans to:

1. *Reduce unnecessary spending*
2. *Delay or re-budget capital projects*
3. *Modify compensation plans for executive and non-executive personnel*
4. *Divest noncore assets*
5. *Renew or extend existing lines of credit*
6. *Revise dividend payouts*
7. *Protect liquid assets and cash*

NO. 4: HOW SOLVENT IS OUR PRIMARY FINANCIAL INSTITUTION AND OUR KEY SUPPLIERS?

The failure of Lehman Brothers, the near collapse of CitiGroup, and the U.S. Automaker bailouts make it clear that no institution is immune to the global financial crisis. Companies that relied on Lehman Brothers for project or other financing have found themselves between a rock and hard place, with few alternative sources of capital stepping into to void. Companies like Ford Motor's have found that there supply chain can be significantly disrupted by failure of other companies within its industry.

Directors should ask management what steps have been taken to ensure that the financial institutions, and key suppliers that are relied on are a solvent and not on the watch list of troubled financial institutions. Directors should also insist that management maintain relationships with multiple financial institutions, and closely monitor the financial solvency of key suppliers.

Obtain watch list of troubled financial institutions for distribution at meeting

NO. 3: IS OUR D&O STATE OF THE ART AND INDEMNIFICATION PROVISIONS?

- When deals go bad, litigation follows. Anticipate litigation.

- Given the litigation risk, review with legal counsel to make sure that the company's D&O liability insurance coverage is "state of the art." Particularly, review with counsel the following:

    - Confirm that the D&O insurance policy will not become part of the company's bankruptcy estate. As such the policy should name the individual directors and not the corporation as the direct insured beneficiary/payee.
    - The policy should provide for the advancement of defense costs on an ongoing basis.
    - Since the company's indemnification obligations under its organizational documents may be unavailable, ensure that the policy covers the company's indemnification obligations.

NO. 2: HOW SOLVENT IS OUR D&O CARRIER?

Obtain watch list of troubled financial institutions for distribution at meeting

NO. 1: WHAT PROACTIVE ACTIONS SHOULD BE TAKEN TO REDUCE LITIGATION RISK?

- Should the decision be made to create an independent special committee, the special committee should obtain independent financial and legal advice without the influence of any interested person. The special committee, rather than the entire board, should choose its financial and legal advisors.

- If entrenchment of current management is a concern, independent analysis of a proposed transaction that might affect current management's tenure (or promise or hints of continued tenure) should be conducted by the outside legal and financial advisor. Management should not be allowed to handle negotiations solo or even participate in the deal if significant possibility exists of management's self interest in entrenchment or retention by the buyer.[12]

[12] IN RE LEAR CORP. SHAREHOLDER LITIG., 926 A. 2d 94 (Del. Ch. 2007).

- Documentation of decision making is essential. Commentators have opined that NETSMART is essentially a "failure of documentation" case by noting that you never want a court to say about the board's decision making process: "From there, things get fuzzy."[13]

- The special committee or the full board must be actively involved in exploring available strategic alternatives for the corporation.

- Consider a range of strategic alternatives, including bankruptcy alternatives. It is often prudent for a distressed company to pursue a dual track reorganization strategy that includes an out-of-court sale, joint venture, equity or debt financing, restructuring strategy and a prepackaged chapter 11 plan and disclosure statement (which can be used to effectuate the restructuring should the out-of-court strategy fail).

- Demonstrate affirmative director action by clearly documenting the board and committee's use of outside financial advisor and counsel to advise them during their deliberations. Given the financial crisis, dynamic changes in valuation are present:

    - Buyers and sellers find it challenging to value a seller in distress
    - Metrics and multiples are in flux
    - Financial models for healthy companies may not be accurate and as such both going concern and liquidation valuation analysis should be prepared by the outside financial advisor

WHAT ELSE SHOULD WE ANTICIPATE?

Anticipating attacks by activist hedge funds seeking management, structural or strategy changes to boost short-term stock prices at the expense of long-term value, and developing business, financial and legal strategies to avoid or counter them.

CONCLUSION

The global financial crisis has presented corporate directors with increasingly challenging and perilous waters to navigate. Shareholders of household brands like Lehman, AIG and Merrill Lynch have learned that their stockholdings have little or no value. Inaction can lead to a rapid decline of enterprise value. In these times, directors of potentially distressed companies could face heightened fiduciary obligations. Inaction in these troubled times could unnecessarily expose directors to personal liability. In distressed

[13] NETSMART, slip op. at p. 16.

situations, it is more important than ever for independent directors to rely upon independent, experienced and qualified financial and legal advisors to help navigate these troubled waters.

ABOUT JD FORD & COMPANY:
JD Ford & Company is a specialized Investment Bank offering sophisticated solutions to both private and publicly-held companies in a variety of industries, including consumer products, specialty retail, building products, and specialized services throughout the United States. Since the Firm's founding in 1996, JD Ford & Company has consistently provided clients, operating throughout all phases of the business cycle, with a wide variety of professional services, including: Strategic & Financial Advisory Services, M&A Transaction Services, Business Valuation Services, and a wide array of Financing Solutions.

***Joe Durnford*,** Senior Managing Director and CEO of JD Ford & Company, Investment Bankers and its affiliated companies. Mr. Durnford has over twenty years experience in corporate finance and has structured, negotiated and completed in excess of $1 billion in mergers, acquisitions, divestitures and financing transactions. Mr. Durnford is also the founder and chairman of numerous private companies, and has served as audit and finance committee chairman for publicly listed corporations. Prior to founding JD Ford & Company in 1996, Mr. Durnford was a corporate finance and business consultant at the predecessor firms of Pricewaterhouse Coopers and Deloitte. Mr. Durnford earned a BSBA (Accounting) at the University of Colorado Leeds School of Business, is a Certified Public Accountant, a Certified Valuation Analyst, a Certified Merger & Acquisition Advisor, and holds Series 24, 27, 7 & 63 securities licenses.

***Jakes Jordaan*,** a Managing Director of JD Ford & Company, has structured, negotiated, managed, and consummated nearly every form of corporate transaction, including corporate reorganizations, leveraged and management buyouts, mergers-of-equals, tender offers, leveraged recapitalizations, joint ventures, going private acquisitions, venture capital transactions, hedge fund formations, and public offerings of debt and equity securities. He has represented numerous middle and lower-middle market companies in corporate restructurings, mergers and acquisitions, corporate finance, banking and corporate control transactions. On the institutional side, he has represented leading and boutique investment banks, private equity funds, venture capital investors and hedge funds in public and private transactions. Jakes is the former Chairman of the Securities Section of the Dallas Bar Association. He graduated from SMU, where he earned his BA in Economics (Cum Laude) and BBA in Accounting (Cum Laude) degrees. He received his JD degree from the SMU School of Law, where he served as Editor of the law review.

Any questions, inquiries or requests for additional information relating to this article should be directed to the following individuals at JD Ford & Company:

Joe Durnford
JD Ford & Company
www.jdford.com
303.333.3673
durnford@jdford.com

Jakes Jordaan
JD Ford & Company
www.jdford.com
303.333.3673
jakes.jordaan@jdford.com