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With Economic Headwinds Blowing, the Time Is Now for Legal Housekeeping

By Ronald Camhi

Soaring costs and the specter of a recession lay bare the fact that businesses across industries face significant challenges.

Of course, economic headwinds are nothing new—in recent memory, the U.S. has endured the Great Recession and the financial fallout from the COVID-19 pandemic. Nevertheless, it's readily apparent that a confluence of circumstances today places us in uncharted territory—even if the severity of the macro downturn is subject to interpretation or debate (many are asking, are we in a recession?).

What we do know is how critical it is in uncertain times to tap into trusted counsel, financial and legal included. In terms of the latter, prior dips in the economy have shined a light on particular legal risks that can come to a head in down cycles—lessons that inform what businesses and their stakeholders should now prioritize.

What Companies Can and Should Do When the Economy Falters

Experience teaches us that there are upticks in many types of litigation when the economy weakens. For instance, during periods of economic distress, transactions inevitably fail or otherwise stall and loan and contract default rates rise. When those things happen, companies and their directors, officers and other executives become targets of claims.

For this reason, businesses—no matter the sector—would be wise to pay heed to corporate governance, legal risk management and commercial law protections given the virtual certainty of increased company and executive exposure in times like these.

Corporate Governance

Again, history dictates that when the economy is in peril and businesses are struggling, litigation spikes—a reality that should serve as a clarion call to stakeholders to tend to corporate housekeeping.

By their very nature, corporations, limited liability companies and like entities provide the benefit of limited liability to their owners, officers and directors. To maintain this critical protection, certain formalities must be followed (read: ensuring that organizational documents—articles of incorporation, bylaws, initial minutes, records of stock ownership and resolutions, to name a few—are current and in place). Additionally, operating entities must properly document actions taken and major decisions made. Doing so is crucial to maintain built-in corporate protections, especially given the propensity of claims alleging that parties failed to follow corporate formalities, which is a basis for "piercing the corporate veil," all in hopes of holding key individuals liable for the debts of a company.

Company directors should be especially hypervigilant given the basic fiduciary duties of care and loyalty that govern their conduct. That being said, the business judgment rule—a long-standing protection in corporate law—affords directors a set of presumptions that their decisions won't be second-guessed by courts—even if those decisions turn out to be unwise—so long as a majority of directors have no conflicting interests in the decisions being made and that those choices are undertaken with due care and in good faith. With this in mind, directors should be careful to properly document their actions and remain diligent and informed when making decisions. This often requires guidance from lawyers, financial advisors and, if relevant, outside marketing advertising agencies and real estate professionals when it comes to buying, selling or leasing commercial property.

Claims and Risk of Litigation

As mentioned, downturns in the economy are often met with an increase in legal claims. Be it a SPAC deal or other investment gone bad or a client unhappy with goods sold or services rendered, parties suffering a loss will be primed for recompense.

The possibility of litigation is also created by a company's operational practices, including hiring and firing and financial controls. Aggrieved employees, investors, clients, lenders and vendors will line up to seek recoupment of claimed losses. To the extent lawsuits filed by desperate plaintiffs may be on the horizon and claims against owners, directors and officers become more likely, it's crucial that these stakeholders consider (1) reviewing director and officer indemnification agreements to ensure protection against third-party claims; (2) consulting with legal and insurance experts to obtain (or confirm) adequate insurance coverage for directors, officers and other executives; (3) making sure all corporate actions are properly authorized and documented in written minutes; and (4) having proper employment-related documents in place, including employee handbooks and policies, arbitration agreements, confidentiality and work-for-hire agreements and the like.

These steps will not only protect a company itself but will also help to shield parent companies, sister companies and individuals from alter-ego liability.

Commercial Risks

A common refrain is that in a great economy, boilerplate clauses in contracts never need review. The opposite is true in the worst of times, which means service providers should scrutinize their agreements and verify that they set forth clear and concise terms and conditions that incorporate the latest laws related to limitations of liability, indemnification, waiver, reliance, force majeure, venue and governing law.

To mitigate potential commercial risks, companies should also do what they can to know exactly who they're dealing with. This is done by way of due diligence to determine if any given customer or vendor is in good standing or involved in pending litigation.

During difficult economic times, bankruptcy filings increase and, with them, so-called "claw back" actions (formally known as avoidance actions). Common among these are preference actions, used by trustees or creditors' committees to recoup transfers to creditors made in the 90 days (or longer under certain circumstances) prior to the filing of a given bankruptcy case.

The rationale behind a preference action is that a company's transfer of assets during this 90-day window is made when the entity was insolvent, and one creditor should not be preferred (or paid to the exclusion of others). Companies must be aware that these kinds of cases, which notoriously catch creditors off guard, can result in unpaid receivables and sometimes require the return of money received. The good news is that there are several defenses to attempted claw backs. There are also steps companies can take in advance to minimize the risk of being sued in a claw back action, which is why businesses dealing with financially troubled clients or customers should seek counsel early in order to best insulate themselves.

Looking Forward

On the plus side, the economic slowdown now making headlines is sure to be temporary. Even so, the near-term outlook appears to be more of the same and the Fed seems prone to keep increasing interest rates at least through early 2023 in its quest to curb inflation.

As those in power work to turn our economic headwinds into tailwinds, companies and their GCs should take every opportunity, with the assistance of able counsel, to "button things up." This starts with a deep dive into corporate governance, legal risk management and commercial law protections.

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