

Fiduciary Crossroads: Director Duties in the Zone of Insolvency



IWIRC@ABI
Washington, DC

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Fact Pattern

IWIRC Brands, Inc. Case Background

IWIRC Brands, Inc. is a premium athleisure company incorporated in 1993 the State of Delaware and headquartered in New York City. IWIRC Brands has 30 leased stores throughout the Northeast Region and a warehouse in Newark, New Jersey, which also houses its direct consumer operations.

Following several years of elevated demand for premium athleisure products, consumer purchasing behavior shifted in mid-2021.

In 2022, IWIRC Brands was acquired by **PowerSuit Capital** (private equity firm) and invested heavily in marketing, locked in retail pop ups and flagship leases, increased product drops and limited editions, and levered up to fund expansion.



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Fact Pattern (cont.)

IWIRC Brands, Inc. – Equity / Debt Structure

IWIRC Brands is 70% owned by PowerSuit Capital; 20% owned by the Founder and Chief Executive Officer (CEO), **Brooke Balance** and 10% owned by minority co-investors.

IWIRC Brands has a \$325 million asset-backed revolver (ABL) with **Connecting Women Worldwide (CWW) Bank**, with a first lien on inventory and accounts receivable.

IWIRC Brands also has a \$450 million first lien term loan with **Be Inspired Partners**, secured by substantially all other assets, \$200 million in unsecured notes held by its 58 network members, and \$150 million in accounts payable.



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Fact Pattern (cont.)

IWIRC Brands, Inc. – Board / Triggering Event

IWIRC Brands' Board of Directors is comprised of six (6) members:

- One (1) of the members is Brooke Balance, the CEO.
- Two (2) of the members are representatives from PowerSuit Capital.
- The remaining three (3) members are independent directors.

In 2024, IWIRC Brands implemented a micro-fulfillment logistics strategy in three cities (NYC, Philadelphia, and Baltimore), but due to supply chain disruptions from overseas suppliers over the holiday season, the hubs operated materially below capacity.

As a result, IWIRC Brands experienced accelerated cash burn during a period of already slow sales and tightening credit availability.



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Fact Pattern (cont.)

Scenario One: The PostHoliday Board Meeting

IWIRC Brands has just closed the holiday season.

- Revenue is significantly below forecast due to micro-fulfillment rollout issues, excess seasonal inventory is sitting in the warehouse, the borrowing base is shrinking, and vendor pressure is rising.
- The CEO believes spring inventory and a marketing push will rightsize operations.
- The CFO does not dispute that supply chain interruptions played a role in financial performance. However, she raises several concerns that extend beyond timing issues.

What are the Board's fiduciary duties at this moment assuming (1) IWIRC Brands is solvent, but (2) insolvency is reasonably foreseeable?



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Zone of Insolvency

- Company can no longer meet its financial obligations as they become due;
- Company's total liabilities exceed the total value of its assets;
- Failure of proposed transaction (or entry of impending judgment) is reasonably likely to cause insolvency.
- **How does this impact the Ds & Os' fiduciary duties?**
 - Fiduciary duties of Ds & Os will extend to creditors.
 - Focus is on whether parties acted in a manner that benefits the *corporate enterprise*



Fact Pattern (cont.)

Scenario Two: The Timeline Shift (600 Days Later)

Unfortunately, holiday markdowns were steeper than expected and spring demand remains soft. IWIRC Brands has missed rent payments on a handful of store leases, fallen behind in payments to a small number of vendors, and the liquidity runway is 8-10 weeks under the current forecast.

Is the Board now operating in the “zone of insolvency”? If so, how does this impact the Board's decision-making process?



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Fiduciary Duties

Directors and officers of a solvent corporation owe their fiduciary duties *to the corporation and its stockholders*

Decisions are afforded deference under the “business judgment rule.”



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Fact Pattern (cont.)

Scenario Two: Additional Factors

CWW Bank is starting to worry about its collateral and schedules a field audit. During CWW Bank's field audit, it uncovers that inventory was overstated, returns were not properly reserved, and borrowing base certificates were inaccurate.

Considering the field audit findings, what steps must the Board take to satisfy its fiduciary duties? How does the Board's response differ if the inaccuracies were the result of error versus intentional misrepresentation?



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Fact Pattern (cont.)

Scenario Two: Additional Factors

The Board asks PowerSuit Capital for additional capital while it explores strategic alternatives. PowerSuit Capital agrees to provide rescue financing in the form of a short-term insider bridge loan, with a super-priority lien, and high payment-in-kind (PIK) interest.

Does this proposal create a conflict? What process must the Board follow in evaluating this option?



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Fact Pattern (cont.)

Scenario Two: Additional Factors

Forecasts now show a potential inability to meet payroll within 30-45 days if sales continue to underperform.

Does looming payroll risk change the Board's obligation to act, and if so, how? Are there circumstances where Directors face personal exposure related to unpaid wages?



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Fact Pattern (cont.)

Scenario Three: The Situation Further Unravels

Concerned about the company's financial position, Ms. Balance reaches out to The Workout Women, LLP, which has provided general corporate guidance to IWIRC Brands and certain of its officers for several years. Ms. Balance asks a corporate partner and a bankruptcy partner from the Firm to join board meetings going forward and be available for advice on strategy.

On certain of the board meetings, the two board members from PowerSuit Capital discuss the terms of a potential DIP Facility, at which time the Board asks counsel for advice as to the reasonableness of the terms. When asked to recuse themselves from the meeting, the PowerSuit members refuse.

**Does the presence of counsel at these meetings render meeting discussions confidential?
What fiduciary obligations should the Board consider as it evaluates its options and considers the PowerSuit proposal?**



Legal Privileges

Attorney-Client Privilege:

- Any (1) communication (2) between client and attorney (or agents) (3) in confidence (4) to obtain / provide legal assistance to client.

Attorney Work Product:

- Protects documents prepared by attorney (or agents) reflecting counsel's mental impressions in anticipation of litigation.

Joint Defense and Common Interest

- Extends umbrella of attorney-client privilege to parties with shared legal interest against common adversary.

Corporate Entity as a Client

- Counsel for company does not represent individual employees, but employee interviews in internal investigation are privileged.
- Company holds privilege and may waive it.



Confidentiality

Model Rule 1.6: Confidentiality of Information

- (a) A lawyer shall not reveal information relating to the representation of a client unless the client gives informed consent, the disclosure is impliedly authorized in order to carry out the representation or the disclosure is permitted by paragraph (b).



Fact Pattern (cont.)

Scenario Three: Additional Factors

During a separate meeting, board members raise the prior audit issues and suggest that conduct of certain of the officers previously represented by The Workout Women exacerbated the company's distress.

How should counsel at the Workout Firm respond?

Frustrated with the company's trajectory, on her calls with counsel, Ms. Balance states that she is fed up, has foregone certain salary and bonuses, and signals that she may abruptly resign and pursue a claim for amounts owed.

How would you respond to Ms. Balance?



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Conflicts of Interest

Model Rules of Professional Conduct

Rule 1.7(a)- Conflict of Interest (Current Clients)

(a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves **a concurrent conflict of interest**.

A **concurrent conflict of interest** exists if:

- (1) the representation of one client will be **directly adverse** to another client; or
- (2) there is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer.



Conflicts of Interest (cont'd)

Rule 1.8– Current Clients – Specific Rules

(b) A lawyer shall not use information relating to representation of a client to the disadvantage of the client unless the client gives informed consent, except as permitted or required by these Rules.

(g) A lawyer who represents two or more clients shall not participate in making an aggregate settlement of the claims of or against the clients, . . . unless each client gives informed consent, in a writing signed by the client. The lawyer's disclosure shall include the existence and nature of all the claims . . . involved and of the participation of each person in the settlement.

(k) While lawyers are associated in a firm, a prohibition in the foregoing paragraphs (a) through (i) that applies to any one of them shall apply to all of them.



Conflicts of Interest (cont'd)

Rule 1.9(a) : Former Clients

(a) A lawyer who has formerly represented a client in a matter shall not thereafter represent another person in the same or a substantially related matter in which that person's interests are materially adverse to the interests of the former client *unless the former client gives informed consent, confirmed in writing* .

Rule 1.9(c)- Duties to Former Clients

(c) A lawyer who has formerly represented a client in a matter or whose present or former firm has formerly represented a client in a matter shall not thereafter:

(1) use information relating to the representation to the disadvantage of the former client except as these Rules would permit or require with respect to a client, or when the information has become generally known; or

(2) reveal information relating to the representation except as these Rules would permit or require with respect to a client.



Fact Pattern (cont.)

Scenario Four: The Board Knows It's Filing

The Board is no longer discussing alternatives – it is preparing for a Chapter 11.

What must the Board do before authorizing a Chapter 11 filing to ensure the decision withstands scrutiny from creditors and the court?

What happens if the Board deadlocks – 3-3 in a vote to approve the filing with the PowerSuit financing?



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D&O Policy Considerations*

- What are the policy limits?
- Evaluate potential retentions and deductibles
- Is “insured” defined to include a “debtor in possession”?
- Evaluate exclusions:
 - Are there bankruptcy or insolvency exclusions?
 - Is there an *insured versus insured* exclusion (which may impact coverage for claims later asserted by a Committee, equity holders or other similar constituents)?
 - Are exclusions limited by “final adjudication” language?
- Runoff/Tail Coverage
 - Preserves the ability to report claims for an extended period beyond expiration or termination of policy.
- Ensure Side A Coverage is available
 - “Side A” proceeds are available solely for individual Ds & Os, and thus not impacted by a company’s insolvency.
 - Ensure that policies have a “priority of payments” provision—prioritizes Side A payouts.

*List is not exhaustive.



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Fact Pattern (cont.)

Scenario Five: Fiduciary Duties in Bankruptcy

IWIRC Brands files a Chapter 11 bankruptcy, with The Workout Women as its counsel. A DIP facility is approved on an interim basis. A creditors' committee is formed and begins investigating prepetition conduct, including the conduct of certain officers allegedly responsible for inaccurate borrowing base certificates. The committee also argues that The Workout Women has a conflict because it represented certain of the officers in the past.

How do the board's fiduciary duties change once the company is a debtor-in-possession?



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