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CLIENT ALERT

Sell-Side Directors May Be Liable for Breach of Fiduciary Duty Claims for Failing to Investigate Company's Post-Closing Solvency

DECEMBER 28, 2020

In *In re Nine West LBO Securities Litigation* (Case No. 20-2941) (S.D.N.Y. Dec. 4, 2020), a federal district court denied in part a motion to dismiss claims brought by the Nine West liquidating trustee against former directors (the "Defendants") of The Jones Group, Inc. (the "Company"), Nine West's predecessor, for, among other things, (i) breaches of their fiduciary duties of care and loyalty, and (ii) aiding and abetting breaches of fiduciary duties. The litigation arises from the 2014 LBO of the Company by a private equity sponsor ("Buyer"). The court held that sell-side directors may lose the protection of the business judgment rule and be liable for breach of fiduciary duty if they intentionally do not consider whether post-closing transactions they know about will (or likely will) leave the company insolvent or otherwise harmed. Exculpatory provisions in the Company's bylaws limiting director liability to recklessness were similarly unavailing because the Defendants consciously disregarded the same post-closing transactions despite numerous "red flags" that should have put them on notice that the LBO could leave the Company insolvent.

It is unknown whether other courts will follow this decision. With that said, there are several steps boards can take in any M&A transaction, and particularly in LBOs, to protect themselves, including:

- perform due diligence on the company's expected post-closing financial condition;
- consider the effect on the company's solvency of any known post-closing spin-off or incurrence of additional debt;
- negotiate for a representation from the buyer in the transaction documents that the company will remain solvent post-closing;
- consider retaining professionals to advise on solvency matters; and
- maintain accurate records that reflect all deliberations and actions taken by the directors.

While this decision may initially appear jarring, it is critical to understand that it was made on a motion to dismiss, which requires the court to accept all factual allegations in the complaint and draw all reasonable inferences in the plaintiff's favor. The decision is merely a procedural step in the litigation and is not dispositive of the claims asserted against the Defendants. As the facts continue to develop, the case against the Defendants may weaken.

Further, this case is very fact specific and should not be read as endangering the typical application of the business judgment rule or exculpatory, exoneration or indemnity provisions in company bylaws or applicable organizational documents. It is important to remember that the business judgment rule is intended to protect directors and management from personal liability when they act on an informed basis, in good faith, and in an honest belief that their decision is in the best interests of the business. This means a board's decisions do not have to be right. In fact, a board's judgment can prove mistaken or even stupid and directors can still be protected from personal liability, provided they did not *consciously* disregard their duty to oversee the business. Moreover, most of the holdings in the decision are based on Pennsylvania law (interpreted by a New York federal court), so the decision is likely to have limited precedential value.

Background

In 2013, the Company's board unanimously voted to accept a take-private bid by the Buyer (the "Transaction"). Under the proposed multi-step Transaction: (i) the Company would merge with a newly formed Buyer affiliate with the surviving corporation renamed Nine West Holdings, Inc.; (ii) the Buyer would invest $395 million in Nine West (later reduced prior to closing) in Nine West; (iii) Nine West would increase its debt from $1 billion to $1.2 billion (later increased prior to closing); (iv) Company shareholders would be cashed out at $15 per share; and (v) the two "crown jewels" and another subsidiary (collectively, the "Carve-Out Businesses") would be sold to a newly-formed Buyer affiliate "for substantially less than their fair market value."

Significantly, the Board's authorization "expressly disclaimed" any evaluation of two steps in the Transaction and whether they were fair to the Company: (i) the incurrence of additional debt, and (ii) the post-closing sale of the Carve-Out Businesses. Despite all the Transaction steps occurring substantially concurrently, the board justified not investigating these two steps because the Defendants would be replaced as directors during the Transaction by the Buyer's two principals, who would become Nine West's sole directors (the "Buyer Directors"). The Buyer Directors would authorize those two steps.

In early 2014, prior to the closing of the Transaction, the Company settled a shareholder derivative action that asserted the Company's shareholders were not receiving adequate value from the Transaction.

Four years later, Nine West filed for bankruptcy. Nine West confirmed a chapter 11 plan that settled its claims against the Buyer but did not settle its claims against the Defendants.

The Decision

On December 4, 2020, the court issued its decision. Notably, the court held the following:

> 1. The Defendants' Acted Recklessly by Failing to Investigate the Entire Transaction, including the Company's Post-Closing Solvency. The court held that multi-step LBO transactions can be treated as one integrated transaction when the transaction (i) reasonably collapses into a single integrated plan and (ii) there is a foreseeable harm. Here, the Defendants knew each step was essential to the Transaction. Therefore, the Defendants had a duty to evaluate the entire Transaction because they were the fiduciaries charged with deciding whether the Transaction would even occur.
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> Further, the court noted there were numerous "red flags" that should have put the Defendants on notice that the Transaction would harm the Company and, very likely, leave it insolvent (*e.g.*, (i) once the Carve-Out Businesses were sold, Nine West's $1.4 billion valuation would be less than the $1.55 billion in debt it was incurring, and (ii) Nine West's adjusted EBITDA would far exceed the multiple that the Company's investment banker had advised the Company could sustain if it retained *all* of its businesses, which it was not doing).
>
> While the Company bylaws limited director liability, the exculpatory provisions were inapplicable here because the Defendants acted recklessly by intentionally disregarding aspects of the Transaction that could harm the Company.

2. The Defendants May Be Liable for Aiding and Abetting Breaches by the Buyer Directors of Their Fiduciary Duties to the New Board. The Defendants knew that the Buyer Directors would incur additional debt and sell the Carve-Out Businesses, which would likely leave the Company insolvent. Because the Defendants approved the Transaction anyway, the complaint adequately alleged that the Defendants aided and abetted the Buyer Directors' breach of their fiduciary duties.

3. Settlement of the Shareholder Derivative Action Did Not Bar the Litigation Trustee's Breach of Fiduciary Duty Claims. The pre-closing settlement of the derivative action was with the former shareholders, who asserted the Company's directors breached their fiduciary duty by failing to generate *enough* money for the shareholders. Here, the litigation trustee asserted that the Defendants breached their fiduciary duty by distributing too *much* money to shareholders, thereby rendering the Company insolvent. Moreover, the litigation trustee represents the unsecured creditors of Nine West's bankruptcy estate, a different constituency. Therefore, the court held that the shareholder plaintiffs did not adequately represent the litigation trustee's interests.

Takeaways

There is no blueprint to structure an LBO transaction, which is why it is critical for directors and purchasers to work closely with competent counsel and other transaction advisors early in the process. In addition to the considerations listed above, boards should consider the following:

1. When a multi-step LBO transaction will occur substantially concurrently, assume that a court may collapse the transaction, including the post-closing incurrence of new debt or the sale of subsidiaries. Even if the LBO transaction contemplates replacing a director before all the transaction steps are completed, that director must still consider the whole transaction.

2. If the deal's terms change, the board should re-evaluate its approval of the transaction, particularly if there is a fiduciary out.

3. While directors have a duty to maximize the value of the company for its equity holders, in an LBO they cannot ignore the post-sale impact on the company's stakeholders.

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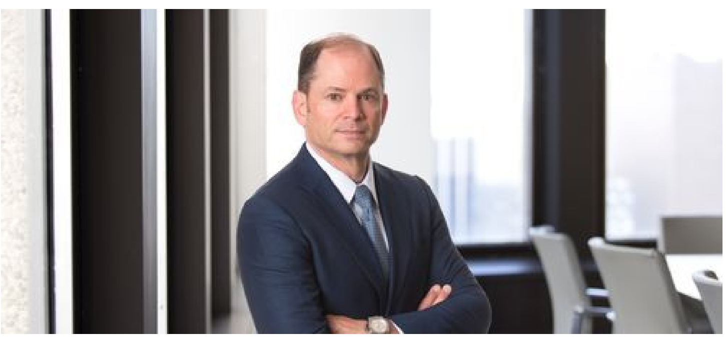

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