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USA: Trends and Developments

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Young Conway Stargatt & Taylor, LLP and Latham & Watkins LLP

Trends and Developments

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Young Conaway Stargatt & Taylor, LLP is Delaware's second-largest firm, with more than 130 attorneys experienced in a wide range of practice areas important for business clientele throughout the state and around the world. Young Conaway attorneys advise companies of all sizes and regularly appear on behalf of client's in Delaware's Chancery Court, Bankruptcy Court and District Court, as well as court's around the country.

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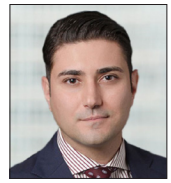
George Davis is the global chair of Latham & Watkins' Restructuring & Special Situations group. He helps public and private companies, sponsors, and investors navigate their highest-stakes restructurings, including some of the most complex matters of the past three decades. Widely recognised as a top restructuring lawyer, Mr Davis combines shrewd negotiating skills and creative problem solving to achieve positive outcomes for clients. He offers particular experience in large-scale restructurings involving prominent multinational and domestic companies across diverse industries, including the energy, chemicals, metals, manufacturing, real estate, gaming, financial services, retail, telecommunications, airline, and healthcare sectors.



George Klidonas is a partner in the Restructuring and Special Situations group of Latham & Watkins. George assists privately and publicly held companies, creditors, distressed investors, and public and private equity holders in navigating complex issues in the context of financially troubled situations, with a particular focus on corporate restructurings, liquidity and liability management, recapitalisations, in- and out-of-court restructurings, and special situations. He also advises boards of directors, board committees, and senior management of financially-troubled companies on a range of issues, including fiduciary duties and corporate governance.

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Michael Nestor is vice-chair of Young Conaway, a member of the firm's management committee, and co-head of the firm's portfolio company management group. With more than 25 years of corporate restructuring and governance experience, Michael regularly advises companies in distress and works with management, boards and stakeholders to develop a strategy that provides both certainty and maximum value.

James Hughes is a partner at Young Conaway. Under Delaware law, the set of deal protection provisions that lay out the consequences of an abandoned transaction places a large fiduciary burden on the directors of target companies. Many such directors and their lawyers turn to James to help them define their fiduciary duties in a defensible manner, so as to avoid subsequent litigation by stockholders and other interested parties.

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Governance in Distress and Conflict: Maximising Value and Ensuring Deal Certainty

In the late 1990s and early 2000s, private equity firms began to take a more active role in restructuring, generally, and chapter 11 cases, specifically. While prior to that time it was not uncommon for cases to enter chapter 11 in a "free-fall" and for the exit strategy to be sorted out post-filing, many cases quickly assumed a more proactive tempo, with a focus on pre-filing considerations that saw distressed investors (i) acquire debt in companies to use as post-filing capital or credit; (ii) negotiate in advance the exit strategy with stakeholders; and (iii) substantially shorten the time that companies spent in chapter 11 (with a corresponding material decrease in cost). The active involvement of such investors in the management of the process and the capital structure of distressed opportunities naturally led to the placement of investor representatives on company boards of directors.

When presented with a transaction or situation that involves any prospect of distress, self-dealing or control, adhering to appropriate governance best advances a company's objective to maximising value of the corporate enterprise. However, since appropriate governance in those instances will necessarily require a release of a certain (or, at times, total) degree of control, it can be difficult for sponsors to cede material decision-making authority to an independent person or entity. In those instances where independence is required but not implemented, the company, including the board, risks litigation, uncertainty and liability.

Recent decisions by the United States Bankruptcy Court for the District of Delaware in Furniture Factory, Pipeline Foods and Sportco Holdings (discussed in greater detail below), underscore the need for portfolio company directors, sponsors and professionals to be particularly vigilant in satisfying traditional fiduciary duties and, where appropriate, to consider engaging independent directors and special committees to insure an unbiased authority at the board, preserve process integrity, and ensure deference to the decisions of a board pursuant to the business judgment rule.

Fiduciary Duties

Traditionally, directors and officers of a Delaware corporation owe fiduciary duties of loyalty and care to the corporation and its stockholders. The charter of a Delaware corporation can eliminate liability for duty of care violations. The managers and/or directors of a Delaware limited liability company can also have such duties removed or limited if expressly provided for in the limited liability company agreement of an LLC, although they are still subject to the implied covenant of good faith and fair dealing. Great care must be exercised in drafting such limiting provisions in an LLC Agreement or a Delaware court will otherwise find the managers/directors of the LLC subject to fiduciary duties.

Duty of loyalty

A claim that a director or officer breached the duty of loyalty requires proving that the director or officer: "harbored self-interest adverse to the stockholders' interests, acted to advance the self-interest of an interested party from whom they could not be presumed to act independently, or acted in bad faith." (In re Orbit/FR, Inc. S 'holders Litig., 2023 WL 371640, at *5 (Del. Ch. Jan. 24, 2023)). "Bad faith" is generally understood by courts to be "where the fiduciary intentionally acts with a purpose other than advancing the best interests of the corporation[,] acts with the intent to violate applicable positive law[, or] intentionally fails to act in the face of a

known duty to act, demonstrating a conscious disregard for his duties." (In re Walt Disney Co. Derivative Litigation, 906 A.2d 27, 67 (Del. 2006)).

A plaintiff alleging a breach of the duty of loyalty must establish that (i) a majority of the board was materially conflicted or acted in bad faith; (ii) the board was dominated by the conflicted/bad faith director(s); or (iii) the conflicts were material and not disclosed to other board members (Cinerama, Inc. v Technicolor, Inc., 663 A.2d 1156, 1168 (Del. 1995)).

Because private equity sponsors often appoint their own officers and principals to be directors of companies they acquire or control, such directors may be susceptible to allegations of divided loyalty. Indeed, the decisions in Furniture, Pipeline and Sportco all make this point, alleging that the sponsor directors were motivated to engage in transactions, acquisitions, or agreements that primarily benefitted the sponsor to the detriment of other investors.

One way to hedge against such claims is to install independent directors on the board, and, if appropriate, have such directors serve on special committees for purposes of reviewing and/or approving transactions. Delaware does not adhere to a specific formula for director independence, but Delaware courts have endorsed NASDAQ's test for director independence as a useful barometer in determining independence. That test considers the following:

- Has the director received compensation in excess of USD120,000 in any 12-month period during the prior three years from the company (not counting director fees)?
- Was the director employed by the company during the prior three years?
- Is the director related to any individuals who are employed as executive officers at the company?
- Is the director affiliated with any other companies that had received payments for services to the company that were more than 5% of the revenues for such other company during each of the prior three years?
- Does the director serve as an executive officer at any other companies where executives at the company in question make compensation determinations on behalf of those other companies?
- Does the director have any affiliation with the company's outside auditors?
- Is the director personal or social friends with any of the other company directors (Delaware courts have described such personal or social friends as, among other things, sharing a vacation home with someone, having been college roommates, being in a person's wedding party)?
- Is the director receiving any additional or special benefits as a result of a transaction under consideration, other than in respect of the pro rata consideration for their shares of stock?

Duty of care

The fiduciary duty of care requires that: "in making business decisions, directors must consider all material information reasonably available, and that the directors' process is actionable only if grossly negligent... [T]he standard for judging the informational component of the directors' decision-making does not mean that the Board must be informed of every fact. The Board is responsible for considering only material facts that are reasonably available, not those that are immaterial or out of the Board's reasonable reach." (San Antonio Fire & Police Pension Fund

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v Amylin Pharms., Inc., 983 A.2d 304, 318 (Del. Ch.), aff 'd, 981 A.2d 1173 (Del. 2009)).

A violation of the duty of care occurs only when a fiduciary's process is grossly negligent, which is said to be evidenced by a "devil-may-care attitude or indifference to duty amounting to recklessness." (Albert v. Alex. Brown Mgmt. Servs., Inc., 2005 WL 2130607, at *4 (Del.Ch. Aug. 26, 2005)).

In the corporate context, gross negligence is the traditional standard for pleading and later proving a breach of the fiduciary duty of care when the standard of review is the business judgment rule. But proving such a breach of the duty of care – by establishing gross negligence – often becomes a meaningless exercise, because such conduct, including gross negligence, is then typically exculpated through a Section 102(b)(7) provision in the corporate charter of the subject corporation. ("Because section 102(b)(7) immunizes directors against liability for breaches of duty of care, in reality these claims would fall out at trial, since proving breaches of the duty of care would result in no damages for the stockholders. Therefore, trial on these issues is unlikely.") (Cf. Koehler v. NetSpend Holdings Inc., 2013 WL 2181518 at (Del. Ch. May 21, 2013)).

Although duty of care obligations are typically exculpated or eliminated in corporate charters and LLC agreements, courts have demonstrated a reluctance to dismiss such claims on a motion to dismiss, particularly in the face of allegations that directors had failed to conduct adequate due diligence around transactions that eventually went south. Generally speaking, the following types of conduct have been historically cited in duty of care claims:

- acting too quickly;
- utilising advisers that are not independent and disinterested or are inexperienced;
- delegating key negotiations or due diligence to management;
- failure to negotiate aggressively;
- failure to understand key documents or fundamental aspects of a transaction;
- failure to review reasonably available information;
- failure to ask questions;
- failure to consider reasonable alternatives;
- failure to document key decisions; and
- falling victim to a controlled mindset and allowing a controlling party to dictate alternatives or terms

Although there is no precise script for directors to follow in satisfying the duty of care, the following procedural and process steps can significantly reduce the risk of such claims being sustained. Some of those steps include:

- having adequate time for the board to consider and vote upon the final version of the transactional documents(s);
- receiving and reviewing all pertinent information about a transaction, agreement or proposal sufficiently in advance of a meeting;
- active participation at board meetings, with questioning of management and outside advisers;
- maintaining contemporaneous and accurate minutes of board meetings, with sufficient detail to reflect an active and engaged board; and
- analysing alternatives under consideration and challenging the assumptions upon which the alternatives have been formulated and based.

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Board oversight

A consistent theme running through Pipeline and other cases is the alleged failure of the board to properly oversee the operations of the company. Oversight claims have become increasingly prevalent because, although not constituting a classic duty of loyalty claim, the failure to properly oversee is considered evidence of "bad faith," which, if sustained, will move a claim out of the exculpable duty of care realm and into a duty of loyalty standard. Such claims have received particular attention in the Court of Chancery, which has found such bad faith claims sustainable in such cases as In re Boeing, 2021 WL 4059934 (Del. Ch. Sept. 7, 2021), and which has discussed the nature of such claims at length in Construction Industry v Bingle, 2022 WL 4102492 (Del. Ch. Sept. 6, 2022).

In those cases, the Court of Chancery has emphasised that oversight claims, sometimes referred to as Caremark claims, are difficult for a plaintiff to sustain on a motion to dismiss, and that, at a minimum, a plaintiff must allege that the directors either (i) utterly failed to establish any system for board-level reporting of risk or (ii) failed to act in the face of known "red flags."

In Bingle, the Court of Chancery held that directors had not breached an oversight duty in respect of cyberattacks against the company because a special committee of the board had been specifically created to address such attacks, and that even though the committee was not especially active (it did not report to the board for over two years at one point), the committee was sufficiently active and robust to overcome the claim. By contrast, in Boeing, despite two crashes of its signature 737 MAX airplane, the designated board committee responsible for overseeing the plane's development failed to initiate reforms after the first crash, and failed to actively address the company's legal and regulatory requirements, resulting in a denial of a motion to dismiss oversight claims against the directors.

These decisions and others suggest that, particularly where a sponsor is operating its business or considering a transaction, the board should rely on independent directors to run committees of the board that are tasked with oversight and transaction analysis. Even poorly functioning, independent committees will receive a certain level of deference from the courts that will not necessarily be forthcoming where a board is controlled exclusively by a sponsor that attempts to manage all aspects of the company's operations and acquisitions.

Furniture Factory, Pipeline Foods, Sportco Holdings

Despite decades of precedent regarding when and how to implement governance mandates that appropriately address potential conflicts or distress, the willingness to cede control to third parties is oftentimes too uncertain for controllers to accept. Furniture Factory, Pipeline Foods and Sportco Holdings provide examples of what the Bankruptcy Court may consider in the context of conflict or distress, and each decision reinforces important considerations for boards, sponsors and professionals.

Furniture Factory

In In re Furniture Factory Ultimate Holding, L.P, Ch. 7 Case No. 20-12816, Adv. No. 22-50390, slip op. (Bankr. D. Del. Aug. 31, 2023), the sponsor owned a majority stake in the company, held substantial secured debt, sponsor representatives made up a super-majority of the board, the sponsor injected additional liquidity (in the form of additional debt) when the company was in distress, and

the sponsor had a management agreement with the company, pursuant to which the sponsor provided resources and received the opportunity to be actively involved in the management of the company. The chapter 11 plan provided the court-appointed plan trustee with authority to pursue causes of action on behalf of the company. Vested with such authority, the trustee filed a complaint against the directors and sponsor alleging breaches of fiduciary duties.

The trustee's claims fell into three general categories. First, the trustee alleged that the sponsor appointees to the board breached their duty of care obligations in connection with the acquisition of another business by failing to seek the advice of third-party consultants, ignoring the synergies of the current and acquired business and the industry generally, and grossly misjudging the time, resources and costs of the acquisition. Second, the trustee asserted a claim for the board's breach of its duty of loyalty due to the sponsor directors' approval of certain transfers in favour of the sponsors and insider debt facilities provided by the sponsor that the trustee alleged should, in fact, have been characterised as equity. Third, the trustee alleged that the sponsor aided and abetted the sponsor directors in the breach of their fiduciary duties.

Upon consideration of the defendants' motion to dismiss the claims filed by the trustee, the bankruptcy court held that the trustee had alleged facts to support a reasonable inference that the director defendants had breached their fiduciary duties and that the sponsor had aided and abetted such breaches. Specifically, the court ruled that the trustee had alleged the following facts to support its claims:

- the board was dominated by the sponsor;
- the board did not utilise the input of a third-party consultant;
- the projections were grossly offset from the ultimate result;
- decisions regarding transactions and distributions in favour of the sponsor were made by a board that was controlled by the sponsor; and
- the documents supporting such transactions had been signed by the sponsor "standing on both sides of the transaction".

As such, the sponsor and sponsor directors' motions to dismiss were denied.

Pipeline foods

The facts alleged in In re Pipeline Foods, LLC, Ch. 11 Case No. 21-11002, Adv. No. 22-50399, slip op. (Bankr. D. Del. Oct. 10, 2023) were similar in many respects to those in Furniture Factory. Pipeline Foods involved a three-member board of managers, two of whom were representatives of the sponsor. The core of the alleged fiduciary duty claims relied upon the trustee's allegation that the company utilised and failed to account for incompatible accounting software programs that "would yield fake numbers" and "values [that] just didn't make sense." The trustee alleged that the board, including the conflicted directors, failed to replace the system and knowingly continued to produce false reporting to the company's lenders who had no knowledge of the system malfunctions. When the lenders ultimately refused to continue to lend, the company engaged restructuring professionals "who quickly discovered that the inventory data was untrustworthy and refused to sign any document relying on it."

The trustee in Pipeline Foods followed a playbook analogous to Furniture Factory. With respect to the sponsor-related directors, the complaint

alleged breaches of the duties of loyalty and care for "acting in bad faith and behaving in a reckless and grossly negligent manner" by failing "to implement proper reporting systems and internal controls" and permitting, causing and encouraging "the Debtors to make known material misrepresentations and omissions" to the company's lenders. With respect to the sponsor, the trustee asserted direct claims for breach of fiduciary duties based upon the allegation that the sponsor "exercised control over the Debtors."

Upon review of the "amended complaint as a whole", the bankruptcy court concluded that the trustee "stated a plausible claim" for breaches of fiduciary duties due to director "bad faith" and "gross negligence." With respect to the fiduciary duty claims against the sponsor, the court ruled that the trustee controlled the board through its appointed board representatives, which the court found sufficient to support moving forward with a breach of fiduciary duty claim against the sponsor.

SportCo holdings

The court in In re Sportco Holdings, Inc., Ch. 11 Case No. 19-11299, Adv. No. 20-50554, slip op. (Bankr. D. Del. Oct. 14, 2021) also addressed allegations from a plan trustee that the directors of the company breached their duties of care and loyalty. In Sportco, the facts centred on two factual circumstances. First, the trustee alleged that in connection with the board's approval of an asset acquisition, the defendant board members projected a value (USD14 million) that was far in excess of the value actually received (USD139,000) with "no incremental increase in sales" and vastly underestimated the unanticipated costs of such acquisition (by millions). Unable to overcome the economic consequences of the business decisions or to reach agreement on an out-of-court restructuring with its lenders, the company commenced a voluntary chapter 11 proceeding.

With respect to the duty of care claims, the director defendants sought dismissal on the basis that they conducted appropriate diligence, the board properly deliberated, and the transaction was approved by the company's secured lender. At this stage in the pleading process, however, the court found that the complaint stated "a plausible claim for a breach of the duty of care" due to the magnitude of the negative disparity between the director defendants' anticipated and actual gain, and material costs that were not anticipated by the directors that were directly attributable to the transaction (by millions).

The trustee's duty of loyalty claim relied upon allegations that throughout the negotiations between the company and the lenders regarding potential out-of-court restructuring alternatives, the director defendants were unwilling to consider any proposal that did not provide them with broad release and indemnification rights. While the trustee asserted that the director requests benefitted only the subject directors and, as such, were properly characterised as a loyalty breach, the directors asserted that the company also benefited from such exculpatory relief as it would avoid the need to indemnify the directors for any litigation that may be commenced going forward. Tipping the balance in favour of the trustee, the court determined that whether the company would have benefitted from the release and indemnity provisions was a factual issue that precluded dismissal of the claim at that time in the proceedings.

Governance Lessons

As with so many governance scenarios that result in litigation, hindsight is 20/20. Nevertheless,

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Furniture Factory, Pipeline Foods and SportCo Holdings present litigation cost and risk that could have been mitigated with traditional Delaware corporate law solutions that should be proactively utilised by boards and sponsors. First, to avoid any potential allegation (or risk of liability) for the breach of duty of loyalty, it is helpful for sponsors and conflicted (or potentially conflicted) directors to engage independent fiduciaries at the outset of discussions relating to distress and/or any proposed acquisitions. Those directors can also become part of a special committee with authority to negotiate a transaction, thereby demonstrably lessening or even eliminating the influence of sponsor-appointed directors.

Further, engagement by the special committee of respected third-party professionals will serve as an important signifier of a well-functioning board, both with respect to day-to-day oversight and in connection with any material transactions.

Lastly, as one Delaware court memorably stated, "There's no such thing as being a dummy director in Delaware, a shill, someone who just puts themselves up and represents to the investing public that they're a monitor." In other words, directors agreeing to serve on Delaware boards should not take on the role lightly; they need to be vigilant, engaged, sceptical, and confident that there are adequate reporting systems in place to ensure they are receiving a clear, real-time picture regarding the operations and management of the company. An engaged independent board will mitigate potential liability for directors and sponsors, and will best serve the board's goal of maximising value and preserving deal certainty.

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