Two Important December New York District Court Decisions Highlight Risks in Distressed Company Decision-Making

January 6, 2021

- **Judge Rakoff's *Nine West* decision allowed fiduciary duty claims to proceed against LBO seller directors and officers based on anticipated subsequent transactions by purchaser**
- **Judge Daniels' *Transocean* decision rejected a bondholder challenge to a debt-for-debt liability management transaction, ruling that an internal corporate reorganization did not violate a "successor obligor" provision**

In December 2020, Judges Jed S. Rakoff and George B. Daniels of the United States District Court for the Southern District of New York each issued a decision that, although unrelated, contributes to evolving areas of case law that impact significant issues that distressed companies and their boards of directors often confront: claims of breach of fiduciary duties and opportunities for liability management transactions.

The first decision, by Judge Rakoff, addressed claims of director and officer liability resulting from multi-step, leveraged buyout and spin-off transactions and found that directors of the seller could potentially be liable based on anticipated subsequent transactions approved by the purchaser. The second decision, by Judge Daniels, rejected a challenge to a liability management transaction pursuant to which subordinated bonds were exchanged for new structurally senior bonds, finding that an internal reorganization resulting in a new tier of intermediate holding companies that guaranteed the new bonds, but not existing bonds, did not violate a successor obligor provision in certain existing indentures. Key takeaways from both decisions are discussed below.

District Court Judge Allows LBO-Related Claims Against Former Nine West Directors to Proceed

The litigation arose out of the 2014 LBO of Jones Group, sponsored by a private equity firm. Four years later, the RemainCo—Nine West—filed for bankruptcy. A litigation trustee brought claims on behalf of Nine West asserting breaches of fiduciary duty and aiding and abetting breaches of fiduciary duty against directors and officers of Jones Group (among other claims). We have summarized three lessons directors and officers can take away from this decision.

Takeaway #1: Seller directors and officers may face exposure based on anticipated post-sale transaction steps executed by the buyer, under theories of both breaching their own fiduciary duties and aiding and abetting fiduciary breaches by buyer directors. When considering a complex transaction, seller fiduciaries should evaluate the consequences of all contemplated transaction steps even if they will not be approving those steps directly.

The District Court held that the trustee adequately alleged that seller directors breached their fiduciary duties by failing to evaluate steps of the transaction that occurred following shareholder transfers. The Court held that the litigation trustee sufficiently alleged under Pennsylvania law that the directors failed to conduct a reasonable investigation into whether the LBO would render RemainCo insolvent. There was no allegation that the pre-sale steps the directors directly approved created the insolvency. Rather, the alleged insolvency resulted from a substantially concurrent carve-out transaction that was structured as a later step in the LBO and approved (only) by buyer directors after the seller shares were transferred. The complaint alleged that the seller directors (i) did not evaluate whether that later step of the transaction would be fair to RemainCo and (ii) even expressly disclaimed any evaluation or approval of those steps. Accordingly, the Court wrote, the seller directors were not protected by the business judgment rule because that rule "presupposes that [the] directors made a business judgment." The Court held that the complaints adequately alleged recklessness in disregarding the disputed subsequent transaction steps.

The District Court held that it is possible to aid and abet a future breach of fiduciary duty *even before that duty exists*. The trustee alleged under Delaware law that, prior to the LBO, the seller directors aided and abetted fiduciary breaches that occurred after the LBO, when two of the purchaser's principals became the new and sole directors of Nine West. The Court rejected the argument that any acts taken before the two purchaser principals became directors could not, as a matter of law, aid and abet an alleged subsequent fiduciary breach by those directors. Instead, the Court reasoned that an abettor could lend assistance, prior to the springing of a director's duty, to a scheme that would later breach the director's duty upon its execution.

<u>Takeaway #2</u>: When settling pending or threatened derivative fiduciary duty claims, directors and officers may get valuable protection from including the company as a releasing person under any settlement agreement, in order to more credibly argue that the releases extend to future derivative claims that a bankruptcy litigation trustee may assert.

The District Court also held that settlement of a pre-LBO shareholder suit against the directors and officers did not bar the litigation trustee's post-bankruptcy claims. Prior to the consummation of the LBO, a group of shareholders sued Jones Group's directors and officers, asserting direct and derivative claims for breach of fiduciary duties in connection with the LBO process. In response, the Board formed a special litigation committee under Pennsylvania law that recommended that RemainCo not pursue the derivative shareholder claims. The six named plaintiffs settled and released the claims against the directors and officers on behalf of themselves and a similarly situated class, but by its terms the settlement did not release the derivative claims on behalf of RemainCo.

The directors and officers argued that the 2014 settlement agreement barred the new claims by the litigation trustee because the settling shareholders had previously sought to bring derivative claims on behalf of RemainCo and they and RemainCo entered that 2014 settlement. The Court rejected this argument, reasoning that the plain terms of the 2014 settlement included as "releasing persons" only the six named plaintiffs and the shareholder class they represented, but not RemainCo itself. The Court also held that *res judicata* did not bar the claims because the interests of the pre-petition shareholders and the post-bankruptcy litigation trustee differed fundamentally: the shareholders had argued that the LBO paid them too little while the trustee argued (on behalf of creditors) that the LBO paid shareholders too much.

<u>Takeaway #3</u>: This *Nine West* decision was a denial of a motion to dismiss, so it did not reach a finding of liability for directors or officers. But it still shows that it is possible as a matter of law for directors or officers of a Pennsylvania company to have liability for subsequent transaction steps they did not directly approve. The decision also leaves two important areas for further development.

First, Judge Rakoff's reasoning for finding potential liability for seller directors and officers focused on the allegation that the problematic post-sale carve-out was an integrated component of the overall transaction that was directly contemplated by the seller board and deemed to occur substantially concurrently with other transaction steps that the seller board approved. In future cases, potential liability for seller directors and officers could turn on the degree of foreseeability of subsequent steps a buyer may take to render a remaining company insolvent, or the degree of integration of those future steps with earlier, non-controversial steps that a seller board approves directly.

Second, the Nine West RemainCo directors' and officers' fiduciary duties were analyzed under Pennsylvania law. Delaware and New York state fiduciary duty laws, which apply more frequently because many corporations are organized in those states, differ from Pennsylvania law in some respects. It remains to be seen whether differences would lead to a different analysis of this issue, including how courts will reconcile these post-transaction considerations with directors' duties to maximize value to the pre-closing shareholders in the context of change of control transactions.

District Court Judge Rejects Challenge to Transocean's Liability Management Transaction Based on Successor Obligor Provision

This important decision granted summary judgment in favor of Transocean in litigation arising from an exchange transaction proposed by Transocean, a Swiss-based offshore drilling contractor, pursuant to which near-dated unsecured notes were exchanged for new, structurally senior "New Guarantee Notes." The exchange transaction was made possible after Transocean consummated an internal reorganization pursuant to which a new tier of holding companies was interposed between the guarantors (the "Upper Tier Notes Guarantors") of certain of Transocean's existing unsecured notes (the "2027 Notes") and Transocean's operating subsidiaries. The new tier of holding companies—known as the "Lower Tier Notes Guarantors"—guaranteed the New Guarantee Notes. Certain holders of the 2027 Notes argued that Transocean's internal reorganization constituted a transfer of "all or substantially all" of the 2027 Notes guarantors' assets in violation of a standard successor obligor provision in the 2027 Notes' indenture.

Judge Daniels rejected the 2027 noteholders' argument as "literalist" and "reductive," finding instead that, under New York state law, when a parent holding company transfers its ownership of subsidiary holding companies to new wholly-owned intermediate holding subsidiaries, there is not a transfer of "all or substantially all" of the parent holding company's assets because the parent holding company continues to own an indirect interest in the same operating assets.

Transocean's internal reorganization and exchange offer was structured and effectuated as follows:

- *First*, Transocean created three new intermediate holding companies wholly owned by the Upper Tier Notes Guarantors;
- *Second*, the Upper Tier Notes Guarantors transferred all of their equity interests in wholly-owned holding companies (the "Asset Holding Companies") that held equity interests in Transocean's operating subsidiaries to the Lower Tier Notes Guarantors; and
- *Third*, the new Lower Tier Notes Guarantors guaranteed the New Guarantee Notes, rendering the New Guarantee Notes structurally senior to the 2027 Notes.

Certain holders of 2027 Notes alleged that Transocean breached Section 11.03 of the existing 2027 Notes' indenture (the successor obligor provision) because the Lower Tier Notes Guarantors were allegedly required to, but did not, guarantee the existing 2027 Notes upon the transfer of the Upper Tier

Notes Guarantors' 100% ownership of the Asset Holding Companies to the Lower Tier Notes Guarantors. Section 11.03 reads as follows:

> [An Upper Tier Notes Guarantor] may … dispose of all or substantially all of its assets to any Person … provided however, that in the case of the ... disposal of all or substantially all of the assets of such [Upper Tier Notes Guarantor] … if such other Person is not [Transocean Ltd.], [Transocean Inc.] or another [Upper Tier Notes Guarantor], such [Upper Tier Notes Guarantor's] obligations under its Securities Guarantee must be expressly assumed by such other Person . . . .

Judge Daniels held that the transfer of the Upper Tier Notes Guarantors' 100% interest in the Asset Holding Companies to the Lower Tier Notes Guarantors did not constitute a transfer of "all or substantially all" of the assets of the Upper Tier Notes Guarantors. The Court explicitly rejected the argument that "'all' means all"—namely, that because the Upper Tier Notes Guarantors transferred their sole asset, the 100% interest in the Asset Holding Companies, as part of the internal reorganization, the Upper Tier Notes Guarantors *de facto* transferred "all" of their assets. Judge Daniels eschewed a "literalist" interpretation of the indenture and instead, relying on Second Circuit precedent, analyzed the effect of the internal reorganization to determine whether the successor obligor provision applied.

When determining whether a company has transferred "all or substantially all" of its assets, New York courts consider both qualitative and quantitative factors. *Roseton OL, LLC v. Dynegy Holdings Inc.*, No. CIV.A. 6689-VCP, 2011 WL 3275965, at *13 (Del. Ch. July 29, 2011). While the quantitative factors focus on the economic value or number of assets being transferred, the qualitative factors focus on the overall effect the transaction has on the company.

Starting with the qualitative factors, the Court held that the new layer of Lower Tier Notes Guarantors created by the internal reorganization did not have any effect on the Upper Tier Notes Guarantors. The Upper Tier Notes Guarantors held indirect interests in Transocean's operating assets before the reorganization, and continued to hold indirect interests in them after the reorganization. Turning to the quantitative factors, the Court held that the Upper Tier Notes Guarantors were not adversely impacted economically by the creation of the Lower Tier Notes Guarantors. Both before and after the internal reorganization, the Upper Tier Notes Guarantors' economic value remained constant because they continued to indirectly own the same operating assets of Transocean. Accordingly, the Court ruled for Transocean and held that the internal reorganization did not violate Section 11.03.

<u>Takeaway #1</u>: While the substance of a transaction is crucial in evaluating whether it violates a successor obligor provision, in light of seemingly conflicting case law, consideration of the form of the transaction should not be ignored, and companies should endeavor to structure and document a transaction in a manner that strictly complies with the letter of its agreements when pursuing an internal reorganization.

The Court's ruling stands in contrast to the approach taken by the District of Delaware in *Oaktree Capital Mgmt., LLC v. Spectrasite Holdings, Inc.*, No. Civ.A. 02-548, 2002 WL 32173072 (D. Del. June 25, 2002). In *Spectrasite*, the defendants consummated a series of transactions by which the operating company, formerly directly owned by a parent holding company, merged into a newly created "Mergerco." Mergerco was wholly owned by a new intermediate holding company that, in turn, was wholly owned by the parent holding company. Similar to the *Transocean* internal reorganization, the *Spectrasite* transactions created a new wholly-owned intermediate holding company between the operating assets and the parent holding company. Holders of notes issued by the parent holding company alleged that the transactions constituted a "transfer" of "all or substantially all" of the parent holding company's assets in violation of a successor obligor provision. While the transactions in *Spectrasite* and *Transocean* resulted in substantively similar effects on the assets held by the parent company, the court in *Spectrasite* accepted that the merger at issue involved "all or substantially all" of the parent holding company's assets.

<u>Takeaway #2</u>: When faced with the potential of an adverse ruling in bet-the-company litigation, companies may want to reconsider alternative options and take curative measures that may moot or substantially weaken arguments attacking a transaction

Prior to the entry of Judge Daniels' decision, Transocean consummated a second internal reorganization that was intended to resolve the alleged breach of Section 11.03 of the 2027 Notes' indenture. As part of this second internal reorganization:

- The Lower Tier Notes Guarantors merged into the Upper Tier Notes Guarantors, eliminating the "transfer" at issue in the litigation;
- The Asset Holding Companies guaranteed the New Guarantee Notes, preserving the New Guarantee Notes' structural seniority over the 2027 Notes; and
- A new layer of "Sub Asset Holding Companies" was created below the Asset Holding Companies.

After the second internal reorganization was consummated, both parties to the litigation urged Judge Daniels not to dismiss the case as moot for varying reasons, and Judge Daniels saw no reason to dismiss the action in light of the challenging noteholders' refusal to withdraw their original notice of default under the 2027 Notes' indenture.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your usual Davis Polk contact.

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