When The Door Hits You On The Way Out: The Southern District Of New York Warns Corporate Directors They May Be Liable For The Necessary And Foreseeable Acts Of Their Successors

A great deal of buzz has been generated by the recent decision from the Southern District of New York in *In re: Nine West LBO Securities Litigation*, No. 20 MD 2941 (JSR) 2020 WL 7090277 (S.D.N.Y. Dec. 4, 2020), with some commentators questioning whether the decision places directors who approve a leveraged buyout at risk of liability for the actions of subsequent boards that occur long after they cease to be directors, or expands directors' duties beyond maximizing value for shareholders. *See, e.g.*, Sujeet Indap, Dealmakers warn of chilling effect on buyouts from US court ruling, Financial Times (Dec. 15, 2020), *available at* https://www.ft.com/content/01affe9d-89a7-4c0e-8a15-d6d544d4ce04.

These concerns are overstated. The *Nine West* decision does not impose potential liability on directors for acts of their successors in which they have no involvement, or for acting in shareholders' best interests when the company is solvent. The decision makes clear, however, that corporate directors may not turn a selective blind eye to necessary and foreseeable components of an integrated transaction subject to their approval, regardless of whether those components technically occur under subsequent directors' watch. Moreover, the decision underscores that where directors are on notice that a transaction will render the corporation insolvent, their duties extend not only to shareholders, but to all of the corporation's stakeholders, including creditors who will be left holding the bag if debt incurred to cash-out shareholders leaves the company insolvent.

The Facts in *Nine West*

The *Nine West* case stems from the 2014 sale of the publicly-traded footwear and apparel company Jones Group to private equity firm Sycamore Partners Management, L.P. ("Sycamore"). According to complaints filed by the Litigation Trustee appointed under Nine West's bankruptcy plan, the Jones Group board approved a merger agreement with Sycamore (the "Sycamore Merger") that involved "five integrated components that would 'occur substantially concurrently.'" First, Jones Group would merge with a Sycamore affiliate, and, as the surviving corporation, be renamed Nine West Holdings. Second, Sycamore and another entity would contribute at least $395 million in equity to Nine West. Third, Nine West would increase its debt from $1 billion to $1.2 billion (the "Additional Debt"). Fourth, Jones Group shareholders would be cashed out at $15 a share. And fifth, Jones Group's "crown jewel" assets—the Stuart Weitzman and Kurt Geiger brands (the "Carve-Out Businesses")—would be sold to other Sycamore affiliates for prices alleged to be substantially below their fair market value (the "Carve-Out Transactions").

The complaints allege further that the Jones Group board's approval of the merger agreement purported to exclude the Additional Debt and Carve Out Transactions. The complaints stress, however, that the merger agreement included provisions that obligated Jones Group to assist Sycamore in planning the Carve-Out Transactions and syndicating the Additional Debt, that all of the components of the Sycamore Merger constituted "a single integrated transaction," and that the aspects of the Sycamore Merger that the Jones Group board affirmatively approved "could not have occurred independently of" the aspects that the Jones Group board expressly sought to side-step (*i.e.* the incurrence of the Additional Debt and the Carve-Out Transactions).

Before the deal closed, Sycamore reduced its equity contribution from $395 million to $120 million, and raised the amount of the Additional Debt from $1.2 billion to $1.55 billion. According to the complaints, this meant that the debt to EBITDA ratio for Nine West—which would not include the Stuart Weitzman or Kurt Geiger brands—would exceed the maximum leverage ratio Jones Group's investment banker had previously advised the company could bear in a scenario where it retained the Stuart Weitzman and Kurt Geiger brands. Nevertheless, the Jones Group directors moved forward with the deal, notwithstanding a fiduciary out that permitted them to withdraw their approval if they determined it was no longer in the company's best interests.

Following the close of the merger, Sycamore caused Nine West to sell the Carve-Out Businesses to Sycamore affiliates for $641 million, which the complaints allege was far below their fair market value of at least $1 billion, and more than $150 million less than even the $800 million Jones Group had paid to acquire them less than five years earlier.

Nine West filed for bankruptcy in April 2018. Claims against Sycamore and its affiliated entities and individuals were settled in the bankruptcy, but claims against Jones Group directors and others were transferred to a litigation trust for pursuit by the Litigation Trustee. The Litigation Trustee's complaints allege that the Jones Group directors breached their fiduciary duties by approving the Sycamore Merger, and aided and abetted breaches of fiduciary duty by the Sycamore principals who became Nine West board members following the Sycamore Merger and effectuated the Additional Debt and Carve-Out Transactions.

The Jones Group Directors' Motion to Dismiss

The Jones Group directors moved to dismiss the breach of fiduciary duty claims, arguing, among other things, that (i) the dismissal of a shareholder action challenging the Sycamore Merger as a breach of fiduciary duty prior to the close of the transaction barred the claims on the basis of res judicata, and (ii) the Litigation Trustee could not overcome the business judgment rule applied under Pennsylvania law (where Jones Group was incorporated), or the exculpatory provisions in the Jones Group's by-laws. Under Pennsylvania law, the business judgment rule insulates a disinterested director from liability for decisions made in good faith, on a reasonably informed basis, and with the rational belief that the decision is in the best interests of the corporation. Pennsylvania law affords additional deference to directors in the context of mergers and acquisitions, applying a presumption that approval by a majority of disinterested directors satisfies the business judgment standard "unless it is proven by clear and convincing evidence that the disinterested directors did not assent to such act in good faith after reasonable investigation." And Pennsylvania law permits shareholders to further protect directors by adopting by-laws limiting director liability to instances where the breach constitutes "self-dealing, willful misconduct, or recklessness." The Jones Group by-laws incorporated these limitations.

The Jones Group directors also moved to dismiss the aiding and abetting claims, arguing that (i) acts taken before the Sycamore principals became directors could not form the basis for such a claim, and (ii) even if they could, the complaints failed to adequately allege that the Jones Group directors "knowingly participated" in the Sycamore principals' breaches, which is a necessary element of an aiding and abetting claim.

The *Nine West* Decision

The court denied the Jones Group directors' motion to dismiss. On the question of res judicata, the court held that the shareholder action could bar the Litigation Trustee's claims only if the Litigation Trustee was adequately represented by the shareholder plaintiffs in that action. That was not the case, the court held, because "[w]hereas the shareholder plaintiffs argued that the directors … breached their fiduciary duty by failing to generate enough money for the shareholders, the Litigation Trustee now argues that the directors … breached their fiduciary duty by distributing too much money to shareholders, thereby rendering the Company insolvent."

Though not expressly addressed by the court, implicit in this holding is that under Pennsylvania law, "when an entity is insolvent, [directors' fiduciary] duties extend to creditors of the corporation." *See, e.g., In re Zambrano Corp*., 478 B.R. 670, 684 (Bankr. W.D. Pa. 2012). The law of Delaware—where the majority of Fortune 500 corporations and newly formed corporations are incorporated—is stated differently, but directors of an insolvent corporation must similarly discharge their fiduciary duties by maximizing the value of the insolvent entity for the benefit of all stakeholders, including creditors. *See, e.g., Quadrant Structured Prods v. Vertin,* 115 A.3d 535, 544 (Del. Ch. 2015).

With respect to the business judgment rule, the court rejected the Litigation Trustee's allegations that the Jones Group directors were not disinterested because they financially benefitted from the Sycamore Merger through accelerated vesting and cashing out of their Jones Group shares. The court held that the business judgment rule still did not apply, however, because the complaints adequately alleged that the Jones Group directors failed to "investigate whether the Additional Debt and Carve-Out Transactions would render the Company insolvent." In so holding, the court rejected the Jones Group directors' assertion that they had no obligation to consider those transactions because they "were effectuated after they ceased to be directors of the Company."

Suggestions that this portion of the decision may be read to saddle corporate directors who approve a leveraged buyout with potential liability for unforeseen actions taken by their successors years after the leveraged buyout closes are not well founded, however. As the court explained, "[m]ultistep transactions can be treated as one integrated transaction where … the plaintiff pleads that the transaction 'reasonably collapses into a single integrated plan …'" In *Nine West,* such collapsing was supported by the complaints' allegations that (i) the components of the Sycamore Merger that the Jones Group directors affirmatively approved (*i.e.* the cash-out of Jones Group shareholders) were dependent on the Additional Debt and Carve-Out Transactions, (ii) all of these components occurred effectively contemporaneously, and (iii) the merger agreement that the Jones Group directors approved required Jones Group to assist in effectuating the Additional Debt and Carve-Out Transactions.

The remainder of the court's denial of the Jones Group directors' motion is primarily predicated on its finding that the complaints adequately alleged that the Jones Group directors were on notice that the Sycamore Merger would render Nine West insolvent. The Jones Group directors acted with recklessness that could not be exculpated, the court held, because they consciously disregarded "'red flags' that should have put [them] on notice that the Additional Debt and Carve-Out Transactions would leave the Company insolvent." These included (i) that subtracting the $800 million purchase price Jones Group had paid to acquire the Stuart Weitzman and Kurt Geiger

brands from the $2.2 billion valuation the company received in the Sycamore Merger yielded a value that was $150 million less than the amount of debt Nine West would be left with after incurring the Additional Debt, and (ii) Nine West's leverage ratio after incurring the Additional Debt would be higher than the maximum leverage ratio the Jones Group directors had previously been advised the entire company could withstand. The court concluded: "In spite of these red flags, the Board did not make any inquiry into Remainco's solvency; to the contrary, the Board expressly disclaimed any view of the Additional Debt and Carve Out Transactions. This, the Court holds, was reckless."

The court also denied the Jones Group directors' motion to dismiss the Litigation Trustee's claims against them for aiding and abetting breach of fiduciary duty. Rejecting as "senseless" the directors' contention that acts taken before a person becomes a director cannot form the basis for an aiding and abetting claim, the court held that the complaints adequately alleged the Jones Group directors' "knowing participation" in the Sycamore principals' breaches, by alleging that the Jones Group directors approved the Sycamore Merger with "actual or constructive knowledge" that the Sycamore principals "would execute the Carve-Out Transactions and leave the Company insolvent."

Distinctions between Pennsylvania and Delaware Law

A distinction between Pennsylvania and Delaware law may have resulted in a different outcome had the breach of fiduciary duty claims against the Jones Group directors been decided under Delaware law. Unlike Pennsylvania law, Delaware law permits corporate by-laws to exculpate directors for recklessness. *See* 8 Del. C. § 102(b)(7) (permitting exculpation for breaches of fiduciary duty other than breaches of the duty of loyalty, acts or omissions not in good faith or involving intentional misconduct, authorization of illegal dividends, and transactions resulting in improper personal benefit); *Norfolk County Ret. Sys. v. Jos. A. Bank Clothiers Inc.*, No. CIV.A 3443-VCP, 2009 WL 353746, at *12 (Del. Ch. Feb. 12, 2009) ("recklessness by itself only amounts to gross negligence, which is not sufficient to demonstrate the state of mind necessary for finding a breach of the duty of loyalty"). Thus, the court's finding that the directors acted recklessly by consciously disregarding red flags showing that Nine West would be rendered insolvent by the Additional Debt and Carve-Out Transactions likely would not have been sufficient to overcome the exculpatory provisions found in the by-laws of many Delaware corporations.

Nevertheless, the court still may have reached the same conclusion under Delaware law, albeit on a different basis. Delaware law does not permit exculpation for actions that are not undertaken in good faith. *See* 8 Del. C. § 102(b)(7). An absence of good faith is adequately stated where it is alleged that a "fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties." *Lyondell Chemical Co. v. Ryan*, 970 A.2d 235, 239-40 (Del. Sup. Ct. 2009). Had the *Nine West* court been confronted with this issue, it may have held that the Jones Group directors' failure to consider the impact of the Additional Debt and Carve-Out Transactions on the company satisfied the lack of good faith standard. The imposition of liability on this basis, however, "requires a showing that the directors knew that they were not discharging their fiduciary obligations." *Id.* It is unclear whether the *Nine West* Litigation Trustee would have been able to meet this standard.

Further, under Delaware law, a complaint sufficiently pleads a breach of the duty of loyalty—which cannot be exculpated by a corporation's by-laws—if it alleges that the directors were interested in the transaction at issue. *See Crescent/Mach I Partners, L.P. v. Turner*, 846 A.2d 963, 981

(Del. Ch. 2000). Pennsylvania law states expressly that a director shall not be deemed interested solely because he owns shares of the corporation, or receives distributions on account of such shares that are made to all shareholders. 15 Pa. Cons. Stat. § 1715(e)(2)(i), (ii). A court applying Delaware law, however, may find that where a corporation is insolvent, directors were rendered interested in a transaction that conferred material benefits on them in their capacity as shareholders that were not shared equally by creditors. *See, e.g.*, *In re Healthco Intern., Inc.*, 208 B.R. 288, 303 (Bankr. D. Mass. 1997) (applying Delaware law). Had Delaware law applied in *Nine West*, the Litigation Trustee may have been able to state a non-exculpable claim for breach of the duty of loyalty based on the accelerated vesting and cash-out payments the Jones Group directors received in the Sycamore Merger.

Additionally, the Delaware statute that permits corporate by-laws to limit directors' liability applies only to personal liability "for monetary damages for breach of fiduciary duty as a director." 8 Del. C. § 102(b)(7). It is thus possible that even if the court had found that the direct claims for breach of fiduciary duty were barred by exculpatory provisions in the Jones Group by-laws, the aiding and abetting breach of fiduciary duty claims still would have survived.

Key Takeaways

The *Nine West* decision does not alter existing law regarding corporate director liability. It should serve as an important reminder to directors, however, that they should consider all of the necessary and foreseeable aspects of a transaction they are asked to approve, even if some of those aspects will not technically close until after they step down. Additionally, where the transaction poses a risk of insolvency, directors should consider the impact it will have on all of the corporation's stakeholders—including creditors—even if shareholders are being cashed out at a fair price.

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If you have any questions about the issues addressed in this Client Alert, or if you would like a copy of any of the materials we reference, please do not hesitate to contact us:

Deborah Newman
Email: deborahnewman@quinnemanuel.com
Phone: + 212 849 7481

Corey Worcester
Email: coreyworcester@quinnemanuel.com
Phone: + 212 849 7471

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