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Review of Target Board LBO Practices May Be Warranted Based on the Nine West *Decision–But We Believe the Decision's Impact Has Been Overstated*

Business headlines have warned of a potential "chilling effect on buyouts" as a result of the decision recently issued by the U.S. District Court for the Southern District of New York in *In re: Nine West LBO Securities Litigation* (Dec. 4, 2020). Contrary to the views of some other commentators on the decision, we do not believe that the decision is likely to chill leveraged buyout activity, to upend how LBOs have been conducted, or to significantly increase the potential of liability for target company directors selling the company in an LBO. In our view, the decision is not intended to change the basic ground rules relating to LBOs, but, rather, as discussed below, the court's result principally reflects the unusual aspects of this case.

Nine West involved the acquisition, in an LBO, of The Jones Group, Inc. ("Jones" or the "Company") (a publicly traded fashion retail company) by an affiliate of private equity firm Sycamore Partners Management, L.P. Four years after the LBO closed, Jones (then renamed Nine West Holdings, Inc.) filed for bankruptcy. In a prior Bankruptcy Court proceeding, the court held that the LBO was not a fraudulent conveyance under the federal bankruptcy laws (because it fit within a statutory safe harbor for payments made through a financial institution). In this most recent decision, however, the court held, at the pleading stage, that the former Jones directors (none of whom, according to the court, had engaged in self-dealing or were affiliated with the buyer) may have breached their fiduciary duty to the Company by not having sufficiently evaluated whether the LBO "would lead to insolvency" post-closing. As a result, the court rejected dismissal of the claims brought by the bankruptcy trustees against the former Jones directors.

Key Points

- **The decision highlights that target company directors engaged in selling the company in an LBO should evaluate whether the LBO would be expected to lead to the company's insolvency post-closing–however, in our view, the risk of liability for directors if a post-closing bankruptcy occurs remains remote.** We believe that the court's result in *Nine West* was based on the specific factual context–which, in the court's view, involved both (i) several "red flags" that should have put the target board on notice that the LBO presented a risk of post-closing insolvency and (ii) a board that allegedly did *nothing* to evaluate that risk. The most critical "red flag," as we read the case, was that the private equity firm buyer would be contributing to the post-LBO company an amount far

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lower than the value the buyer would be obtaining immediately post-closing from the planned sale of the target's best assets to the buyer's other affiliates at a discount price.

- **We believe that the potential impact of the decision has been overstated–and that the decision does not require a significant change in practice by boards considering an LBO sale.** Target boards (and their advisors) generally consider the post-insolvency risk insofar as it relates to whether the transaction will actually close (*i.e.*, whether the lenders will be likely to fund their commitments), and may consider whether the transaction will not constitute a fraudulent conveyance under the federal bankruptcy laws. In the usual case, a compelling indication that post-closing insolvency is unlikely is that sophisticated parties (the private equity firm buyer and the bank providing the financing) are contributing equity and lending into the deal. Also, typically, the buyer provides solvency-related representations and warranties in the merger agreement. In our view, these usual considerations and steps continue to be sufficient in most cases–although boards may want to consider taking some additional steps focused on post-closing solvency issues, particularly if they are aware of "red flags" that indicate a particular risk. See "Practice Points" below.

Background. In the years leading up to 2014, Jones was struggling financially, with revenue flat, missed earnings targets, and store counts down. The sole bright spot was the performance of two of its brands (Stuart Weitzman and Kurt Geiger), which were exceeding projections. In July 2012, Jones began to consider selling all or part of the Company. In April 2013, Sycamore, after some negotiation, offered to buy Jones for $15 per share, reflecting an implied enterprise value of roughly $2.2 billion.

The parties entered into a Merger Agreement that provided that: (i) Jones would merge into a newly formed Sycamore affiliate, which would be renamed Nine West (the "Merger"); (ii) Sycamore (with another private equity firm) would contribute $395 million in equity to Nine West (the "Equity Contribution"); (iii) Nine West would increase its debt from $1 billion to $1.2 billion (the "Additional Debt"); (iv) the Jones Group shareholders would be cashed out in the Merger at $15 per share; and (v) the Stuart Weitzman and Kurt Geiger brands and one other business unit (collectively, the "Carve-Out Businesses") would be sold by Sycamore to other Sycamore affiliates for $465 million (which was less than their more than $1 billion fair market value and less even than the $800 million that Jones had paid to acquire them just two years earlier) (the "Carve-Out Transactions"). These are referred to collectively in the opinion as the "2014 Transaction." The Merger Agreement also included a representation and warranty from Sycamore relating to the Company's post-closing solvency after taking all components of the 2014 Transaction into account (although this was not mentioned in the court's opinion).

In December 2013, the Jones board (comprised entirely of directors unaffiliated with Sycamore) unanimously approved the Merger and expressly disclaimed any approval of (or view as to) the Additional Debt and the Carve-Out Transactions (although the Merger Agreement required that Jones assist Sycamore with those transactions). Before the closing, Sycamore (unilaterally, as permitted under the Merger Agreement) (i) reduced its Equity Contribution from $395 million to $120 million and (ii) arranged for new Additional Debt that would increase Nine West's total debt from the planned $1.2 billion to $1.55 billion. Because Sycamore planned to sell off the Carve-Out Businesses to other Sycamore affiliates, Sycamore obtained a solvency opinion as to the remaining business following the Carve-Out Transactions ("RemainCo").

The Merger closed in April 2014. Two Sycamore principals became the sole directors of Nine West and caused Nine West to effect the planned post-closing transactions, including incurring the Additional Debt and selling the Carve-out Businesses to Sycamore's other affiliates. Several Jones shareholders sued the

directors for breach of their fiduciary duties in the process leading up to the decision to sell the company, which, they contended, resulted in inadequate consideration being paid to the shareholders in the Merger. This action was settled by the parties. Four years after the Merger closed, Nine West filed for bankruptcy. In the U.S. Bankruptcy Court proceeding, the bankruptcy trustees' claims that the merger consideration paid in the LBO was a fraudulent conveyance were dismissed. The Bankruptcy Court ruled that the payments fell within a safe harbor provision under the federal bankruptcy statute for payments made through a "financial institution." In the bankruptcy, Nine West settled its claims against Sycamore (after Sycamore contributed $120 million to the bankruptcy estate), but did not settle its claims against the former directors and officers of Jones.

The bankruptcy trustees, representing the unsecured creditors and the holders of certain notes issued by Nine West, then brought this litigation, claiming that the former Jones directors and certain officers breached their fiduciary duty to the Company by not investigating, before approving the Merger, whether "the 2014 Transaction–as a whole" would "lead to" the Company becoming insolvent post-closing. They also claimed that these directors aided and abetted fiduciary breaches by the Sycamore-appointed New West directors. The court, at the pleading stage, rejected dismissal of these claims.

Discussion

Target directors face potential challenges if they approve a cash merger financed in substantial part through borrowing and the company declares bankruptcy post-closing. By way of background, we note that there are three main types of actions that may be brought by a bankruptcy trustee in this situation:

- ***Fiduciary Actions.*** A bankruptcy trustee may bring suit for damages against former target directors who approved an LBO sale of the company, on the theory that the directors breached their fiduciary duty to the company by approving a merger that caused the company to become insolvent by putting too much debt on the balance sheet (a "Fiduciary Action"). Even if a valid fiduciary claim is brought, however, directors who approved the LBO would not have liability unless their conduct was so egregious as to meet the standard for non-exculpation of a breach of fiduciary duty. *Nine West* was a Fiduciary Action in which the court found that the former directors may have committed a non-exculpable fiduciary breach by approving the merger, such that the case would proceed past the motion to dismiss stage to pre-trial discovery.

- ***Illegal Dividend Actions.*** A bankruptcy trustee may also bring suit against the former target directors on the basis that, given the substance of the LBO transaction, the merger consideration paid to the target's stockholders was the equivalent of a dividend and, under the state's dividend statute, was impermissible because it caused the company to become insolvent (an "Illegal Dividend Action"). Under, for example, the Delaware statute, directors would be liable for mere "negligent" conduct in authorizing an impermissible distribution. (We note that the Eleventh Circuit has held that an LBO can be challenged as an illegal dividend, while the Fourth Circuit has held that a corporate acquisition structured as a merger is not properly characterized as a dividend.) In *Nine West*, the court's opinion did not address any illegal dividend claim.

- ***Fraudulent Conveyance Actions.*** A bankruptcy trustee may assert that the merger consideration constituted a fraudulent conveyance under the federal bankruptcy laws (a "Fraudulent Conveyance Action"). In a Fraudulent Conveyance Action, the remedy is a clawback from the target stockholders of the merger consideration they received. In *Nine West*, a

Fraudulent Conveyance Action had previously been brought and was dismissed on the basis that the paying agent for the merger consideration was a "financial institution" within the meaning of a safe harbor under the federal Bankruptcy Code.

In *Nine West*, the court held that the former Jones directors may have committed an unexculpable breach of their fiduciary duty to the Company by approving the Merger without *any* evaluation as to whether the LBO would lead to insolvency post-closing. The court found, at the pleading stage, that the bankruptcy trustee-plaintiffs had validly claimed that the Jones directors, when they approved the Merger, did not act on an informed basis because they had "consciously disregarded whether the Additional Debt and Carve-Out Transactions were in the interest of the Company"; "did nothing to investigate the Additional Debt and the Carve-Out Transactions"; "expressly disclaimed any view of the Additional Debt and Carve-Out Transactions"; and "did not make any inquiry into Remainco's solvency."

Under Pennsylvania law (which applied), directors are required by statute to act based on a "reasonable investigation" and fiduciary breaches are non-exculpable if the directors' conduct was "reckless." As defined under Pennsylvania case law, "recklessness" means that "the directors knew, or had a reason to know, of facts that created a risk that the 2014 Transaction would harm the Company, and that they deliberately acted or failed to act in disregard of the risk." (We note that under Delaware law, directors are not subject to a statutory duty to investigate but are subject to a fiduciary duty of care. Under Delaware law, the standard for non-exculpation for independent directors is "bad faith," which has been defined to include a "conscious disregard of duties.") Doing *nothing* to evaluate the post-closing insolvency risk, especially in the face of "red flags" that there may have been a risk, "is reckless," the court wrote. Because the directors made "no investigation whatsoever" into the post-closing solvency of the company, they could not "take cover behind the business judgment rule." The court expressly rejected the defendant directors' argument that they had no duty to evaluate the risks associated with the Additional Debt and the Carve-Out Transactions because they did not approve those transactions and the transactions were to be effected after the Company was under the control of a new board. The court reasoned that, (i) although the directors had not "formally approved" the Additional Debt and the Carve-Out Transactions, the 2014 Transaction, as reflected in the Merger Agreement, was a "single integrated plan," and (ii) the harm from the plan (*i.e.*, insolvency) may have been "foreseeable."

The court viewed the buyout (specifically, the Additional Debt and Carve-out Transactions) as presenting a risk of post-closing insolvency based on the following "red flags" that, in the court's view, were known to the former Jones directors:

- ***RemainCo's value as compared to debt.*** The court wrote: "The $2.2 billion valuation the Company received in the 2014 Transaction, less the Company's $800 million historical purchase price for the Carve-Out Businesses, implied that RemainCo was worth no more than $1.4 billion. That knowledge should have alerted the director defendants that they needed to investigate RemainCo's solvency, given that Sycamore arranged, with their knowledge, for RemainCo's debt to be increased to $1.55 billion." It would appear that the calculation should have been the following: The $2.2 billion valuation the Company received in the 2014 Transaction, less the *$1 billion (or more) fair market value* of the Carve-Out Businesses, *plus the $465 million the buyer's affiliates paid RemainCo for the Carve-Out Businesses*, implied that RemainCo was worth no more than *$1.6 billion*. Under this revised calculation, we would observe, the result was above the $1.55 debt level (albeit only slightly so). We note also that, according to the proxy statement relating to the transaction, Sycamore had informed Jones that the Company would have debt at closing of approximately $1.2 billion; and, although the directors may have subsequently become

aware that Sycamore determined to increase the debt level to $1.55 billion, the Company did not have the right under the Merger Agreement to prevent Sycamore from increasing the Additional Debt or to terminate the Merger Agreement if Sycamore did so.

- ***EBITDA multiple and prior banker advice.*** Sycamore's pre-closing decrease of the Equity Contribution and increase in the Additional Debt led to RemainCo's debt being 7.8 times Adjusted EBITDA calculated by the Company's management, and 6.6 times the Adjusted EBITDA figure produced by Sycamore. Both of these were higher than the 5.1 multiple that Jones' financial advisor had advised the Board that the Company could sustain in a scenario where it retained all of its businesses (including the high-performing Carve-Out Businesses). We note that Sycamore's unilateral post-signing, pre-closing changes to the level of planned equity and debt were permitted under the Merger Agreement (as would be usual); and, while the court suggested that the Jones board could have terminated the Merger Agreement under the "fiduciary out" clause of the Agreement based on these changes, the clause appears to permit termination only if an alternative superior bid has been made for the Company (as also would be usual).

- ***Solvency opinion's "manipulated" projections.*** The court also viewed as a "red flag" that Sycamore allegedly "created unreasonable and unjustified" EBITDA projections for RemainCo and instructed Duff & Phelps to use those numbers for its analysis in rendering a solvency opinion to Sycamore (which, allegedly, Sycamore did to make the value of RemainCo look higher in order to justify the lower price for the sale of the Carve-Out Businesses to its other affiliates). Sycamore "settled on" a $1.58 billion valuation of RemainCo–a number just above the $1.55 billion in debt RemainCo would take on. The Jones directors were not "directly aware" that Sycamore had "manipulated" the projections for RemainCo; however, they received updated reports and projections from management on a monthly basis, and therefore, according to the court, "were aware of" the decline in the actual and projected performance of the RemainCo businesses and the "glowing" projections for the Carve-Out Businesses. We note that it is not clear that the solvency opinion could have been a red flag upon which the Jones board should have acted given that the Jones directors did not have the ability to terminate the deal after signing, other than to accept a superior alternative transaction.

The Jones board allegedly "made no investigation whatsoever" to evaluate whether the LBO might lead to the company's insolvency post-closing, notwithstanding the "red flags." First, the former Jones directors "specifically exclud[ed] [the Additional Debt and Carve-Out Transactions] from their consideration" and "expressly disclaimed any view of…those elements of the 2014 Transaction" (and thus "consciously disregarded whether the Additional Debt and the Carve-Out Transactions were in the interest of the Company"). Second, the directors took no action, including considering whether to terminate the Merger Agreement, when (after the Jones directors approved the Merger but before the closing) (i) Sycamore decreased the Equity Contribution and increased the Additional Debt and (ii) Sycamore obtained a solvency opinion that (as the Jones board allegedly had reason to know) was based on unreasonable projections. (As we note above, the court stated that the Jones directors had the right to terminate the Merger Agreement under the "fiduciary out" clause; however, the clause permitted termination only if a superior alternative transaction had been proposed by another party.)

The court also held that the former Jones directors may have aided and abetted the Nine West directors' breaches of their fiduciary duties to the post-LBO company. The Merger Agreement provided that Jones would cooperate with Sycamore in its efforts to syndicate the Additional Debt and to effect the Carve-Out Transactions; and certain officers of Jones allegedly participated in rating agency

presentations, the preparation of offering memoranda, and the like. The court held that the complaint adequately alleged that the former Jones directors may have aided and abetted the fiduciary breaches of the two Sycamore principals who became the sole directors of Nine West, as the Jones directors had "approv[ed] the Merger and substantially assist[ed] in carrying out the remaining elements of the 2014 Transaction." The court held with respect to the Jones officers, however, that their participation was not sufficient to support an aiding and abetting claim against them.

Would the result have been different if Delaware law had applied? There are differences between Pennsylvania law and Delaware law. It is not clear whether these differences would compel a different legal result. Nonetheless, it is uncertain whether Delaware courts would be likely to follow the New York federal district court's reasoning in *Nine West*. Although Pennsylvania law generally is even more deferential toward directors' business judgment than Delaware law is, with respect to the application of the business judgment rule, the standard for non-exculpation, and the elements of aiding and abetting, under Delaware law there may be an emphasis on what directors actually *knew* and *intended* (*i.e.*, whether they *knew* they were breaching, and *intended* to breach, their fiduciary duties by not conducting any evaluation of the post-insolvency risk; and whether they *knew* they were aiding and abetting, and *intended* to aid and abet, a fiduciary breach by others). We note that the Delaware courts have characterized non-exculpation and aiding and abetting as among the most difficult theories of recovery under Delaware law.

Practice Points

- **Based on *Nine West*, the target board involved in an LBO should evaluate the likelihood of post-closing solvency of the company.** The extent and scope of the evaluation will depend in each case on the facts and circumstances. It is to be emphasized that the board in *Nine West* did *nothing* to evaluate the risk, according to the court. In the usual case, where there are no "red flags" with respect to post-closing insolvency, we believe that a board should be able to take comfort from the fundamental fact that LBO transactions, although leveraged, are designed by the buyer and financing institutions to be financially *viable*. A conclusion that the transaction would not be likely to lead to insolvency post-closing would, in our view, be well-supported by factors such as the following:

  - ***The equity and debt being provided for the deal are being provided by sophisticated parties who have negotiating leverage and access to all relevant information.*** Obviously, for both financial and reputational reasons, the buyer and the financing institutions would not be participating in the deal if they believed the company would become insolvent post-closing. Their good reputation and track record, therefore, would be strong evidence of financial viability of the transaction.

  - ***The equity being contributed meaningfully exceeds any value to be distributed to the buyer or its affiliates shortly following closing.*** In *Nine West*, the buyer was contributing $125 million and was receiving immediately after the closing net value of roughly $550 million through the Carve-Out Transactions. The buyer thus appears to have had significantly *negative* net equity in the deal (after it decreased the Equity Contribution and increased the Additional Debt, and, as had been contemplated, sold the Carve-Out Businesses immediately post-closing to its other affiliates at a significantly discounted price).

- ***There was more than one bid for the company, with pricing and a capital structure roughly similar to that in the approved transaction.*** This would indicate that other parties considered similar transactions to be not likely to lead to post-closing insolvency.

- ***The buyer provides representations and warranties in the merger agreement relating to the post-closing solvency of the company.***

We do not believe that in the usual case a board would have to go beyond the kind of steps outlined above–and, thus, generally, in our view, a board would not have to, for example, obtain an opinion on solvency. A board may want to consider requesting relevant analyses from its chief financial officer or other financial experts that would bear on post-closing solvency; and, of course, a board may choose to obtain a solvency opinion.

- **If there are "red flags" as to a risk of insolvency post-closing, a broader evaluation may be warranted.** A target board should consider a broader inquiry if there are red flags as to the post-closing insolvency risk or if there are significant changes in the deal terms (such as a substantial decrease in the equity contribution or substantial increase in the anticipated post-closing debt). "Red flags" generally would be those factors that would tend to reduce the risk the deal represents to the buyer and the lenders, whose judgment to participate in the deal otherwise provides a strong indication of a likelihood of financial viability of the transaction. The red flags identified by the court in *Nine West* were the buyer's decrease in equity, increase in debt, and sale of the Carve-Out Businesses to the buyer's affiliates at a significantly discounted price (which, we note, resulted in a net significantly *negative* equity contribution). The court also identified as a red flag that the EBITDA multiple significantly exceeded recent banker advice the company allegedly received as to the multiple that would be sustainable.

- **The following merger agreement changes could be considered based on the *Nine* W*est* decision:**

  - Consider circumscribing the target directors' and officers' obligations to assist pre-closing with the buyer's planned post-closing actions (although, as a practical matter, it may be difficult to do this to any meaningful extent).

  - If in connection with the merger, the buyer will be effecting a sale of the company's assets to an affiliate of the buyer, consider requiring the buyer to obtain a fairness opinion on the sale price (upon which the target board may rely).

  - Consider providing limitations on the extent to which the buyer may reduce the amount of equity and increase the amount of debt used by the buyer to complete the transaction. For example, the merger agreement could provide that a change to the amount of debt and equity beyond specified levels could only be implemented if a solvency opinion (upon which the target board can rely) is obtained.

  - Consider requiring that the buyer update any solvency-related representations if significant changes are made to the deal terms. Although this would not lead to a right of the target to terminate (other than the right that would exist anyway at closing if the closing condition as to accuracy of the representations is not satisfied), the requirement for the update would mean that, at the time the buyer makes significant changes to the deal terms, the buyer and its advisors

would have to focus on and undertake steps to evaluate the solvency issues that might arise as a result of the changes.

- Review carefully the boilerplate provisions relating to indemnification (as well as the target company's D&O insurance and "tail" policies) to ensure that the target directors are appropriately covered.

- **The target company could consider seeking to limit its potential liability in connection with a post-closing bankruptcy by seeking agreement from the buyer and its affiliates that, if fiduciary claims are made against the former target directors based on post-closing insolvency, the buyer and its affiliates will not agree to any settlement that does not release the former target directors from such fiduciary claims.**

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