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Exercising Independence In Restructuring: The Path to Better Governance

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A rising number of distressed companies are appointing independent directors or managers (Independents) prior to filing for bankruptcy. Independents—who may act as part of special committees—when properly used add governance credibility and may mitigate creditor scrutiny of restructuring-related transactions or settlements. While the use of Independents can aid a process, they can also hinder or delay the restructuring if used improperly. The key is appointing a disinterested person who acts on the advice of appropriate professionals.

Director Fiduciary Duties, Generally

Directors are responsible for managing the company's policies and objectives, overseeing company officers and authorizing significant business decisions. They must act in an informed manner that they reasonably believe is in the best interests of shareholders. See *N. Am. Catholic Educ. Programming Found. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007). Under Delaware law, for example, directors owe the corporation duties of care and loyalty. The duty of care requires that directors act with the care of a reasonably prudent person in similar circumstances and consider all pertinent information reasonably available. See, e.g., *In re Walt Disney Co. Derivative Litigation*, 907 A.2d 693, 749 (Del. Ch. 2005). Delaware law insulates disinterested directors who reasonably and "in good faith" rely on legal,

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financial or other expert advisors in fulfilling their duty of care. See, e.g., DGCL §141(e). The duty of loyalty, which includes a duty to act in good faith, requires that directors put the interests of the corporation ahead of their own. See, e.g., *Quadrant Structured Prods. Co. v. Vertin*, 115 A.3d 535, 549 (Del. Ch. 2015). A plaintiff can challenge a director's loyalty by showing that the director is interested or not independent of someone who was interested. Id. To establish a lack of independence, plaintiffs must show that the directors are beholden to or under the influence of a controlling shareholder such that their discretion would be sterilized. See, e.g., *Rales v. Blasband*, 634 A.2d 927, 936 (Del. 1993). Some states have expanded a director's fiduciary duties to creditors when the corporation is insolvent. See generally *Gheewalla,* 930 A.2d at 101.

Directors acting on an informed basis and consistent with the duties of care and loyalty are entitled to deference under the business judgment rule. See *Quadrant Structured Prods. Co. v. Vertin*, 102 A.3d 155, 182-83 (Del. Ch. 2014). Courts defer to the directors' business judgment by not examining the merits of the decision or by substituting the court's judgment for the directors' judgment. See *Sinclair Oil v. Levien*, 280 A.2d 717, 720 (Del. 1971). Plaintiffs may rebut the business judgment presumption only by showing that the fiduciary's actions rise to a level of gross negligence, defined as "reckless indifference to or a deliberate disregard of the whole body of stockholders or actions which are without the bounds of reason." See, e.g., *Benihana of Tokyo v. Benihana*, 891 A.2d 150, 192 (Del. Ch. 2005).

Appointment of Independent Directors

Independents play an important role in the restructuring process, aiding creditor and court analysis of whether the board has met its fiduciary duties. Independents are non-management directors not employed by the company, who derive no company income other than customary director compensation. See *Selectica v. Versata Enter.*, No. 4241-VCN, 2010 WL 703062, at *13 (Del. Ch. Feb. 26, 2010), aff'd, 5 A.3d 586 (Del. 2010). Independents lack personal interests or relationships that prevent them from acting in the best interests of the company. See *In re Oracle Corp Derivative Litig.*, 824 A.2d 917, 920 (Del. Ch. 2003). Independents may be appointed to "special committees" delegated certain specific decision-making authority.

> Independents do not replace the role of a creditors' committee in the restructuring process, but when properly used, **Independents can aid the restructuring** by providing enhanced governance oversight and proactively addressing creditor concerns.

In distressed situations, Independents often diligence the reasonableness of related party transactions or analyze settlements of disputed claims involving related parties (such as sponsors) that, in turn, provide a basis for the restructuring. For example, the board of Southcross Holdings LP (Southcross) appointed Independents to review a pre-bankruptcy transaction that was integral to its prepackaged plan. Case No. 16-2016 [D.N. 7] (Bankr. S.D. Tex. March 28, 2016). The Independents reviewed and approved a proposed restructuring of the company involving the release of certain claims against the equity sponsors coupled with a new equity investment by the existing equity to fund the reorganization. Id. The Independents, with the assistance of separate counsel, evaluated disputed claims over alleged breaches by the equity sponsors to fund prepetition operations and evaluated alternatives to the proposed prepackaged plan. By the Independents concluding that the plan settlements and transaction were appropriate, Southcross obtained approval of its prepackaged plan within two weeks of its bankruptcy filing. [D.N. 182]. Other recent distressed companies have utilized Independents to assist with restructuring efforts—especially in multi-debtor cases with intercompany transactions. See *In re Toys "R" Us*, Case No. 17-34665 [D.N. 192] (Bankr. E.D. Va. Sept. 17, 2017) (appointed 11 Independents involving six affiliated entities, all of which held different types of assets and maintained diverse debt structures). Other recent examples include *In re BCBG Max Azria Global Holdings*, Case No. 17-10466 [D.N. 3] (Bankr. S.D.N.Y. March 1, 2017) (appointed

Independents to assist with restructuring negotiations, including an analysis of the proposed debtor-in-possession financing and plan) and *In re The Gymboree Corporation*, Case No. 17-32986 [D.N. 30] (Bankr. E.D. Va. June 12, 2017) (appointed Independents to review and approve pre-petition merger and acquisition). In cases where creditors are focused on potential litigation claims, a special committee of Independents can facilitate a successful reorganization through its own review processes. Recent examples include *VER Technologies HoldCo*, Case No. 18-10834 [D.N. 19] (Bankr. D. Del. April 5, 2016), where a special committee consisting of one Independent investigated certain causes of action, including a pre-petition leveraged buyout, and *Sabine Oil & Gas*, Case No. 15-11835 [D.N. 650] (Bankr. S.D.N.Y. Dec. 22, 2015), where a special investigation committee consisting of two Independents analyzed various litigation claims against insiders and non-insiders arising from a pre-petition merger. Importantly, while Independents do not supplant the role of the creditors committee in bankruptcy, they can provide a relevant diligence source in any investigation by creditors.

Independents may not be effective, however, where independence of the director or special committee is called into question. A recent example is *In re Claire's Stores*, Case No. 18-10584 [D.N. 325] (Bankr. D. Del. April 27, 2018), where creditors filed a motion seeking to modify the debtors' plan and marketing process based upon factors including the lack of independence by the oversight finance committee. Creditors called into question the effectiveness of a two-member finance committee, consisting of: (1) the chief executive officer, who was appointed by the equity sponsor that was expected to benefit from the contemplated restructuring support agreement, and (2) an independent director. Id. Creditors pointed out that (1) the finance committee did not retain separate independent counsel or financial advisors for advice even though the corporate resolutions allowed it to do so, (2) the finance committee delegated the CEO with the authority to review potential causes of action against the sponsor, and (3) the finance committee could only take action with the affirmative vote of the insider CEO. Id.; D.N. 484. Although the debtors argued the sponsor's role in the restructuring process was minor, the court expressed concern that the debtors, its professionals and the finance committee were too close to the sponsor. [D.N. 509]. In response, the debtors removed the CEO from the finance committee. [D.N. 625]. In addition to delay and cost of litigation, criticisms of the finance committee continue to impact the bankruptcy, including approval of the disclosure statement and the debtors' request to extend the plan exclusivity period.

These examples provide some guidance on best practices to properly utilize Independents. Independents need to be disinterested, with no financial stake or personal interest in the matter being analyzed. (Customary director's compensation is okay). The person should have relevant legal or business experience to perform the role. But, having the right person is just the start. Corporate resolutions should expressly delegate authority to Independents to act and effectuate their decisions and that authority should not be dependent upon approval by interested parties. This is key where Independents analyze transactions or claims involving interested parties. Independents should proactively suggest appropriate changes to shape the outcome for the benefit of stakeholders and obtain advice from separate legal or financial advisors where warranted.

Conclusion

Independents do not replace the role of a creditors' committee in the restructuring process, but when properly used, Independents can aid the restructuring by providing enhanced governance oversight and proactively addressing creditor concerns. As demonstrated above, careful selection of truly disinterested persons that have the express delegated authority to act based upon reasoned advice facilitates obtaining creditor support. This support, in turn, can expedite the restructuring process to enhance recoveries for creditors. Failure to follow prudent practices, however, can cause delays and costly litigation, defeating the purpose of using Independents in the restructuring process.