The Nine West Decision: A New Twist on an Old Cause of Action

*By: Kenneth A. Rosen, Esq. and Michael Savetsky, Esq., Lowenstein Sandler LLP**

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As originally published in the Credit Research Foundation's publication, Perspective by CRF (Q2 2021)

Trustees pursuing recoveries for unsecured creditors in Chapter 11 cases may have another arrow in their quiver under the right set of facts. Board of director members may have something new to worry about when considering their fiduciary duties in approving a merger or sale.

A Chapter 11 plan of reorganization under which trade claims are unimpaired and where secured debt and/or bondholder debt are the only restructured debt is quite common. The norm in plans of reorganization is to provide broad releases to as many parties as possible, including members of a debtor's board of directors, senior management, professional advisors, plan sponsors and proponents, and secured lenders. Trade creditors whose claims are unimpaired do not have the right to vote on a plan of reorganization, and where trade creditors are being paid in full and a creditors committee is not appointed, such releases may go unchallenged. A leveraged buyout ("LBO") where liability for trade debt is assumed also is common. But what happens when the reorganized company or highly-levered company after an LBO winds up in bankruptcy and unsecured creditors are left holding the proverbial bag?

A recent decision by the United States District Court for the Southern District of New York in *In re Nine West LBO Securities Litigation*[1] sent shock waves through the legal and financial communities. Although the case has drawn the most attention in the world of leveraged buyouts and private equity, it should also be on the radar screen of trade credit executives.

The very short version of this tale is that the directors of the selling company approved a leveraged buyout transaction that they knew would burden the company, renamed Nine West, with more debt than its own bankers had said it could sustain while resulting in the sale of its crown jewel businesses for less than their fair market value to an affiliate of the purchaser shortly after the closing. They also sat by as the purchaser, Sycamore, modified the deal pre-closing to decrease its equity contribution and load additional debt on the acquisition, despite having a "fiduciary out" clause that it could have tried to invoke. Several years later, Nine West commenced a Chapter 11 bankruptcy case and suit was commenced by a litigation trust created under Nine West's Chapter 11 plan against the former board members of the selling entity who authorized the sale transaction, alleging that they breached their fiduciary duties in connection with the leveraged buyout.

Why is this case potentially relevant to vendors and to a debtor's board of directors? The court ruled in *Nine West* that directors of a selling corporation may forfeit the protection of the business judgment rule and be held liable, under a breach of fiduciary duty theory, for not undertaking a reasonable investigation into the company's *post-closing solvency* and the propriety and effect of any contemplated *post-closing transactions* that could be considered part of the same overall transaction when such transactions may affect the post-closing solvency of the company. In other words, a director may be liable for not taking into account transactions expected to occur *after* the sale closes. The decision has been interpreted as sending a warning that directors cannot ignore what might happen to the company *post-closing*, especially if they are aware of contemplated actions that might cause the company to become insolvent in the near future.[2]

The Court rejected the former directors' argument that they could not be liable for actions effectuated *after* they ceased to be in control of the company, explaining that, accepting the allegations in the complaint as true for purposes of the motion to dismiss the complaint, the multi-step transaction "reasonably collapses into a

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1 In re Nine W. LBO Sec. Litig., No. 20 MD. 2941 (JSR), 2020 WL 7090277 (S.D.N.Y. Dec. 4, 2020).

2 Warning to Directors of Selling Companies: Breach of Fiduciary Duty Liability May Exist for Failure to Investigate and Ensure Solvency of Company Post-Closing and Propriety and Effect of All Related Transactions (But You Can Protect Yourself). Ronit Berkovich, Teddy Cohan, Weil, Gotshal & Manges LLP, December 18, 2020.

single integrated plan." The Court found it significant that the directors allegedly knew about the post-merger steps and, further, that those post-merger steps were certain to occur upon approval of the transaction. The Court found that the complaint sufficiently alleged that the directors failed to conduct a reasonable investigation into whether the transaction *as a whole* (including the additional debt burden and the subsequent sale of the crown jewel businesses) would render the company insolvent. The complaint alleged that the directors had excluded from their approval the two steps in the multi-step transaction that rendered Nine West insolvent, even after Sycamore substantially increased the debt burden and decreased its equity contribution.[3]

Lesson number 1: In leveraged buyouts that result in later Chapter 11 bankruptcy filings, an unsecured creditors committee should investigate whether the board of directors that approved the leveraged buyout considered all known and available information about the likely solvency of the post-sale company, including information about any contemplated post-sale transactions, in deciding whether a potential transaction presented unacceptable risks of insolvency. If not, then there may be a viable cause of action against the prior board of directors.

Lesson number 2: The fact that trade creditors may be unimpaired under a Chapter 11 reorganization, does not always mean releases are appropriate or automatically approved. In addition, plan release provisions typically include a "carve out" for acts that constitute "gross negligence." In a "Chapter 22" case, the *Nine West* decision should serve as a reminder that the creditors committee should investigate post-confirmation transactions of the previously reorganized debtor that may have caused the subsequent bankruptcy filing (the "Chapter 22") and whether the previous board was aware of the likelihood of, and adequately considered, those transactions and their potential impact on the company's solvency. If not, and depending on whether the prior board members were granted releases in the first Chapter 11 case and the scope of those releases, the estate and its creditors in the Chapter 22 may have a valuable cause of action against the prior board.

Of course, the viability of such a cause of action depends, among other things, upon whether the debtor's insolvency is traceable to a transaction that can be collapsed into the original transaction approved by the board, similar to the transactions in *Nine West*, and not a result of subsequent events unrelated to the original transaction.

3 SDNY Denies Motion to Dismiss Breach of Fiduciary Duty Claims Against Former Directors Based on Allegations that Approval of Leveraged Buyout was Reckless. Gibson Dunn & Crutcher LLP, December 30, 2020.

About the Authors

Kenneth A. Rosen, Esq is Partner, Chair, Bankruptcy, Financial Reorganization & Creditors' Rights of Lowenstein Sandler. Mr. Rosen advises on the full spectrum of restructuring solutions, including Chapter 11 reorganizations, out-of-court workouts, financial restructurings, and litigation.

In his spare time, Mr. Rosen serves on several philanthropy and nonprofit boards primarily devoted to health care and education.

Michael Savetsky's practice focuses primarily on creditors' rights in the context of complex Chapter 11 bankruptcies, including representing creditors' committees, secured and unsecured creditors, and other parties in interest in Chapter 11 cases. He also has experience representing debtors, asset purchasers, and liquidating trustees, and prosecuting and defending preference actions and other bankruptcy-related litigation.