Southeast Bankruptcy Workshop

Advising the Board

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CONCURRENT SESSION

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Advising the Board

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Advising the Board

- The Special Committee
- Independent Directors in Bankruptcy (*Mountain Express*)
- Insurance Issues in Bankruptcy
- Considerations for Directors and Management

The Special Committee

The Special Committee

- Directors of a company facing insolvency can promote fair treatment of stakeholders and better navigate the complexities of the insolvency process by forming a special committee of independent directors.
- A special committee can mitigate litigation risk by:
  - Demonstrating a commitment to impartiality and fair decision-making
  - Enhancing transparency and documentation of the board's decision-making process
  - Ensuring diligent evaluation of options available to the company
  - Mitigating conflicts of interest
  - Ensuring compliance with legal and regulatory requirements

A Director's Fiduciary Duties

- At all times and in all functions, corporate directors are subject to uncompromising fiduciary duties to the company and its shareholders.
- Generally comprised of two duties:
  - The Duty of Care
    - Directors must use the care that an ordinarily careful and prudent person would use in similar circumstances, including by informing themselves of all material information reasonably available to them.
  - The Duty of Loyalty
    - Directors must act in the best interest of the corporation and its shareholders.
- These duties are heightened in change in control transactions ("*Revlon*" duties), and when the board is fending off a hostile takeover bid ("*Unocal*" duties).

Special Committees: Legal Framework

- The Basics:
- Business Judgment Rule
  - Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984) (Business Judgment Rule "is a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action was taken in the best interests of the company")
  - Creates a rebuttable presumption. Plaintiff can defeat the presumption by pleading plausible claims that a majority of the board that approved the challenged transaction (1) had a personal interest in the transaction (or were controlled by person with personal interest), (2) were not fully informed (duty of care), or (3) did not act in good faith (duty of loyalty).
- Entire Fairness
  - Burden shifts to defendants to prove that the transaction involved both: fair price and fair dealing (process)

Origins of the Special Committee

- Courts began recognizing special committee device as early as the 1970s.
  - "Prior to the start of negotiations the Christiana and Du Pont boards took" a "basic step[] prompted by the extremely close historical relationship and interlocking directorates of the two companies: The appointment of special negotiating committees composed of persons unconnected with the opposing negotiating party . . . ." *Harriman v. E. I. du Pont De Nemours & Co.*, 411 F. Supp. 133, 142 (D. Del. 1975).
- Two primary types:
  - Special negotiating committee
  - Demand investigation/special litigation committee

The Special Negotiating Committee

- Recognized by the Delaware Supreme Court in *Weinberger v. UOP, Inc.*, 457 A.2d 701, 709 n. 7 (Del. 1983).
  - "Although perfection is not possible, or expected, the result here could have been entirely different if UOP had appointed an independent negotiating committee of its outside directors to deal with [corporation's majority owner] at arm's length."
  - "When directors of a Delaware corporation are on both sides of a transaction, they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain," and bear the "burden of establishing its entire fairness." Weinberger, 457 A.2d at 710.
- *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 938 n.7 (Del. 1985): While not "essential to a finding of fairness," use of an "independent bargaining structure, while not conclusive, is strong evidence of the fairness of the merger ratio."

The Special Negotiating Committee

- In *Kahn v. Lynch Communication Systems, Inc.*, 638 A.2d 1110 (Del. 1994), the Delaware Supreme Court adopted the two-factor test articulated by the Delaware Court of Chancery in *Rabkin v. Olin Corporation* to determine whether the special committee was sufficiently independent and empowered to avoid the burden of establishing entire fairness:
  1. The majority shareholder must not dictate the terms of the merger, and
  2. The special committee must have real bargaining power that it can exercise with the majority shareholder on an arms length basis.
     - "Particular consideration must be given to evidence of whether the special committee was truly independent, fully informed, and had the freedom to negotiate at arm's length"
     - "The power to say no is a significant power."

The Special Negotiating Committee

- Special Committee in conflict transactions
  - Burden shifts to Plaintiff to show that the transaction was not entirely fair (although under a preponderance of evidence standard, the advantage is "modest" and only determinative in cases that are a close call)
  - Can even shift standard of review to the Business Judgment Rule:
    - Kahn v. M&F Worldwide Corp., 88 F.3d 635, 645 (Del. 2014) and progeny
    - "If a controller agrees up front, before any negotiations begin, that the controller will not proceed with the proposed transaction without both (i) the affirmative recommendation of a sufficiently authorized board committee composed of independent and disinterested directors and (ii) the affirmative vote of a majority of the shares owned by stockholders who are not affiliated with the controller, then the controller has sufficiently disabled itself such that it no longer stands on both sides of the transaction, thereby making the business judgment rule the operative standard of review." In re Ezcorp Inc. Consulting Agreement Derivative Litig., No. CV 9962-VCL, 2016 WL 301245, at *11 (Del. Ch. Jan. 25, 2016) (citing M&F Wordwide)

The Special Negotiation Committee

- To meet the *M & F* standard, the Special Committee must:
  - Be independent;
  - Be empowered to freely select its own advisors and to say no definitively; and
  - Meets its duty of care in negotiating a fair price.

The Special Negotiating Committee: Key Takeaways

- From this line of cases, we can draw the following framework of core principles and best practices for constituting and administering a special negotiating committee to evaluate transactions that pose conflicts of interests:
  - Members of the Special Committee should be disinterested and independent (*i.e.*, free of financial or significant personal connections to the parties involved in the transaction), and possess the necessary expertise, knowledge, and relevant experience.
  - The Special Committee should be empowered with a clear and broad mandate, including the power to engage independent legal and financial advisors, and the "power to say no."
  - The Special Committee should be well-informed and engaged, have free access to all relevant information, and follow a transparent and well-documented decision-making process.

Special Litigation Committees ("SLC")

Overview:

- Arise in context of derivative litigation. Derivative litigation claims require pre-suit demand OR the Plaintiff can plead demand futility
- If Plaintiff chooses to make demand, Board may deny the demand or pursue the claim. If denied, plaintiff has the burden to prove that the decision not to pursue the claim was not a reasonable exercise of the board's business judgment.
- In pleading demand futility: complaint must plead facts that create a "reasonable doubt" that (1) the directors are disinterested and independent; or (2) the decision to approve the transaction was not a reasonable exercise of business judgment. See Aronson v. Lewis, 473 A.2d 805 (Del. 1984)
- SLCs can be formed upon receipt of demand, but in practice, are typically formed after the Plaintiff survives a motion to dismiss based upon failure to properly plead demand futility under Aronson

Special Litigation Committees (Continued)

- Zapata v. Maldonado, 430 A.2d 779 (Del. 1981)
  - Surviving a motion to dismiss on demand futility does not mean that the plaintiff controls the litigation moving forward. Board can still appoint a SLC to determine whether the derivative litigation is in the best interests of the corporation.
  - SLC may seek dismissal. Court will determine (1) whether the SLC acted independently, in good faith, and has shown a reasonable basis for its determination that the action should be dismissed; and (2) whether the Court, exercising its own business judgment, agrees that the action should be dismissed.
- Standard of Independence: London v. Tyrrell, No. CIV.A. 3321-CC, 2010 WL 877528, at *13 (Del. Ch. Mar. 11, 2010)
  - "Unlike a board in the pre-suit demand context, SLC members are not given the benefit of the doubt as to their impartiality and objectivity. They, rather than plaintiffs, bear the burden of proving that there is no material question of fact about their independence. . . . it is conceivable that a court might find a director to be independent in the pre-suit demand context but not independent in the *Zapata* context based on the same set of factual allegations made by the two parties. This is not because the substantive contours of the independence doctrine are different in these two contexts. Rather, it is primarily a function of the shift in the burden of proof from the plaintiff to the corporation when the suit moves from the pre-suit demand zone to the *Zapata* zone.

Special Committees: Post-Bankruptcy Context

- Derivative Claims are property of the estate and can be pursued by the "trustee" (or a debtor-in-possession in chapter 11 with trustee powers under Section 1107(a))

- If debtor-in-possession declines to pursue claim, another party-in-interest can seek standing, which requires 1) colorable claim; 2) trustee's unjustifiable refusal to pursue the claim; and 3) permission of the bankruptcy court.

- What happens to a derivative claim that has been dismissed pre-bankruptcy based upon the SLC review and motion to dismiss process?

  - In re Art Institute of Philadelphia LLC, 2022 WL 18401591 at *12-14 (Bankr. D. Del. Jan. 12, 2022) (Goldblatt, J.) (holding that a state court's granting of an SLC motion to dismiss pre-bankruptcy does not create a claim preclusion defense against a chapter 7 trustee bringing the same breach of fiduciary duty claim in a subsequent bankruptcy, and reasoning that the dismissal is not an adjudication on the merits, but rather is based upon a court's review of the process undertaken by the SLC in determining that pursuing the claim is not in the corporation's best interests)

Independent Directors in Bankruptcy (*Mountain Express*)

Mountain Express – Post-Petition Ratification of Appointment of Independent Directors

- Pre-filing, the debtors' board was controlled by two majority shareholders.
- To address conflict and other concerns, two independent directors added.
- First day motion to ratify independent directors' appointment, fees.
- Gatekeeper provision also approved.

Insurance Issues in Bankruptcy

Identifying, Protecting, and Preserving Potential D&O Claims

Types of D&O Coverage

- **Side A – Insured Person Coverage**
  - Directly covers directors and officers against personal liability in the absence of indemnification by the entit
- **Side B – Indemnification Coverage**
  - Reimburses the entity when it indemnifies its directors and officers
- **Side C – Entity Coverage**
  - Directly covers the entity for its own exposure, but frequently to the limited extent of securities claims

Important Insurance Considerations – Timeliness of the Trustee's Claim

A newly-appointed Trustee must immediately assess the operative policy period and assert a claim within that window

But, there are other avenues to coverage even if this is not possible:

(1) Tail coverage or extended reporting periods: Lengthens the period of time to assert a claim *after* the policy period has expired

(2) Relation back provisions: Provide that multiple claims involving related wrongful acts constitute a single claim

Important Insurance Considerations – Protecting the Policy Proceeds

Trustees can protect the asset they're seeking to monetize for the estate's benefit

Where Trustees or third parties sue the directors and officers, the payment of defense costs will "waste" or "burn" the policy proceeds.

Because the policy is property of the estate where the debtor is the named insured, carriers frequently seek relief from the automatic stay to advance defense costs.

Trustees should seek an agreed order that provides this relief with certain protections for the estate:

Consider, *e.g.*, the advancement of defense costs in limited tranches and periodic updates on defense costs incurred

Important Insurance Considerations/Issues – Frequently-Raised D&O Insurance Exclusions

- **Insured v. Insured Exclusion**
  - **Intended to prevent collusion and claims by companies against their directors and officers for imprudent business decisions. But, many policies expressly exempt bankruptcy trustees from this exclusion. For example:**
    - "The Insurer shall not be liable for Loss arising out of, based upon, or attributable to any Claim which is brought by or on behalf of any . . . Company. This exclusion shall not apply to . . . any Claim against any Insured Person . . . pursued by an insolvency administrator, receiver, trustee or liquidator of any Company or Outside Entity either directly or derivatively on behalf of a Company or Outside Entity."
  - **Some policies also contain exceptions to this exclusion when a claim is asserted by a debtor-in-possession. For example:**
    - "This exclusion shall not apply to any Claim brought by the Organization as a debtor-in-possession against an Insured Person that is no longer acting in his or her capacity as an Insured Person at the time that such Claim is brought . . ."

Enforceability of a Bankruptcy and Insolvency Exclusion Under Section 541(c) of the Code

In *Yessenow v. Executive Risk Indemnity Inc.*, 953 N.E.2d 433 (Ill. Ct. App. 2011), the Court held that a bankruptcy exclusion was unenforceable under Section 541(c). In this case, former directors of a bankrupt entity asserted that they were entitled to coverage for claims brought by the bankruptcy trustee. The D&O carrier argued that coverage was barred by the policy's bankruptcy exclusion.

The bankruptcy exclusion provided, in relevant part, that:

(1) In the event that a bankruptcy or equivalent proceeding is commenced by or against the Company, no coverage will be available under the Policy for any Claim brought by or on behalf of:

(a) the bankruptcy estate or the Company in its capacity as a Debtor in Possession; or

(b) any trustee, examiner, receiver, liquidator, rehabilitator, conservator, or similar official appointed to take control of, supervise, manage or liquidate the Company, or any assignee of any such official (including, but not limited to, any committee or creditors or committee of equity security holders).

After finding that plaintiffs had standing to challenge the bankruptcy exclusion — reasoning that the policy was property of the estate and the benefit of that interest would be realized only if plaintiffs could seek coverage under the policy — the appellate court agreed that the bankruptcy exclusion was unenforceable under Section 541(c).

The court found that this section invalidates contractual provisions conditioned on the debtor's insolvency or the commencement of a bankruptcy case; and because the bankruptcy exclusion applied if the company went bankrupt, it was precluded by the Bankruptcy Code.

In summary, the court in *Yessenow* essentially found that since the policy was property of the estate, any provision therein conditioned on the bankruptcy or insolvency of the debtor was prohibited by Section 541(c).

Section 365(e)(1) also Applies

The threshold question with respect to the applicability of this provision, however, is whether a D&O policy constitutes an executory contract, which was the focus of the U.S. District Court for the Eastern District of Michigan's 2019 decision in *In re: Community Memorial Hospital*, 2019 WL 3296994 (E.D. Mich. July 23, 2019) where the court held that an insurance policy that was renewed post-petition was still an executory contract. Thus, a provision denying coverage for acts leading to bankruptcy was a prohibited ipso facto clause.

In this case, the federal district court began by analyzing whether the insurance policy should be deemed an executory contract. The insurer, National Union Fire Insurance Company, argued that "because the tail coverage did not exist pre-petition, it could not possibly constitute an executory contract against which ipso facto provisions are unenforceable."

The trust for the debtor argued that the court should focus on the contractual relationship between the parties in order to determine whether the tail coverage was continuous and essentially unchanged from the pre-petition period through the post-petition period, such that the same contractual relationship and the same contract can and should be deemed to have been extant pre-petition.

Note: the relevant portion of the bankruptcy exclusion provided that the insurer "shall not be liable to make any payment of Loss in connection with any Claim against any Insured: (1) alleging, arising out of, based upon, attributable to, or in any way involving, directly or indirectly: (1) any Wrongful Act which alleged to have led to or caused, directly or indirectly, wholly or in part, the bankruptcy or insolvency of the Organization."

The court agreed with the trust, explaining that, except for the time frames and the premium amounts, the policies in effect pre- and post-petition were "functionally the same." Further, the court found that the tail coverage was not a separate policy but an endorsement on an existing, pre-petition contract.

Therefore, the court held that National Union's declination of coverage impeded an executory contract and violated the Bankruptcy Code's prohibition on enforcement of ipso facto provisions.

One potential issue with the court's decision *in Community Memorial* is that the parties did not seem to dispute that the policy that existed pre-petition was an executory contract.

But see, Daileader v. Certain Underwriters at Lloyd's London, 2023 WL 3026597 (S.D. N.Y. April 20, 2023) .

Considerations for Directors and Management

Is There Any Danger to Limiting Director or Officer Liability to Available Insurance?

The short answer is yes. See *U.S. Bank Nat'l Association v. Federal Insurance Co.*, 664 F.3d 693 (8th Cir. 2011)

Compare "Legally obligated to pay" with definitions of "Loss" that exclude amounts "for which the Insured Person is absolved from payment by reason of any covenant, agreement or court order."

For example, some policies may provide that a "Loss" does not include any amounts for which an Insured is not financially liable or which are without legal recourse to an Insured.

Faculty

James D. Decker, CIRA is the founder of JDecker & Company, Inc. in Atlanta, which is focused on corporate governance, transactional advisory and litigation support. As an independent director, he serves on the boards of middle-market private companies typically undergoing transformational events. Mr. Decker's board service has included the capacities of board chairman and chair of special committees and restructuring committees. He is qualified as an Audit Committee Financial Expert. In addition, he has also served as an arbitrator, testifying expert and liquidating trustee, and is well versed in the fiduciary obligations of directors. For the 30 years prior to founding JDecker & Company in 2019, Mr. Decker was an investment banker and advisor in the U.S. middle market, with a focus on advising clients in complex corporate finance transactions, mergers & acquisitions, recapitalizations and restructurings. He advised owners, boards, special committees, management teams and creditors across a wide range of industries and circumstances. In the course of his investment banking career, Mr. Decker originated and completed hundreds of transactions worth in excess of $30 billion. These included restructurings, exclusive sales, acquisitions, special-situation financings, leveraged buyouts, loan placements, recapitalizations and valuations. He also recruited, developed and managed large teams of professionals at a variety of prominent institutions, including Guggenheim Securities, Morgan Joseph, Alvarez & Marsal and Houlihan Lokey. Mr. Decker is a Fellow in the American College of Bankruptcy and has twice received Turnaround of the Year Awards from The M&A Advisor. He is also a past director of the Association of Insolvency and Restructuring Advisors (AIRA), a former co-chair of ABI's Investment Banking Committee and a former director of the Turnaround Management Association (TMA). Mr. Decker enjoys teaching and is a frequent speaker on corporate finance, mergers and acquisitions, capital markets and financial restructuring. He maintains Series 7, 24 and 63 FINRA licenses. Mr. Decker received his B.A. in economics and geology from Vanderbilt University and his M.B.A. in business administration with a concentration in finance from the Wharton School of the University of Pennsylvania.

J. Cory Falgowski is a partner with Burr & Forman LLP in Wilmington, Del., in the firm's Creditors' Rights & Bankruptcy Practice group, where his practice focuses on representing secured creditors, corporate debtors, purchasers, trustees, vendors, consultants and other stakeholders in complex corporate bankruptcy cases and insolvency-related matters. He regularly handles high-stakes litigation, including fraudulent transfer and other avoidance actions, asset-sale disputes, stay-relief litigation, plan-confirmation objections, and receivership actions and other commercial and corporate disputes. His practice also spans transactional matters, including negotiating and documenting credit transactions and asset purchase agreements, as well as bankruptcy appeals. Mr. Falgowski has been listed in *The Best Lawyers in America* for Litigation-Bankruptcy (2022-23), named in *Chambers USA* for Bankruptcy/Restructuring (2014-23), and as one of *The Best Lawyers in America*'s "Ones to Watch" for Bankruptcy and Creditor/Debtor Rights/Insolvency and Reorganization Law (2021). He received his B.A. with honors in 2001 from Johns Hopkins University and his J.D. in 2004 from Wake Forest University School of Law.

Robert J. Feinstein is the managing partner of the New York office of Pachulski Stang Ziehl & Jones LLP, which he opened in 2011. He represents debtors, creditors' committees, equity committees, acquirers and examiners in business reorganizations and related litigation. He also has experience representing

various constituencies in cross-border chapter 11 and chapter 15 cases. Mr. Feinstein's recent engagements include lead counsel to the official creditors' committees appointed in the chapter 11 cases of J. Crew, Whiting Petroleum, Ascena Retail Group, Ditech, Jevic Transportation, The Weinstein Company, Open Road Films, Cobalt International Energy, Bon-Ton Stores, A&P, Sports Authority, Aeropostale, AMF Bowling Worldwide, Reddy Ice Corporation, Coach Transportation and Circuit City Stores, and conflicts counsel to the creditors' committees appointed in the ResCap and Chrysler LLC cases. On the debtor side, he has represented Digital Domain Media Group, former world heavyweight champion Mike Tyson, and *Penthouse* magazine publisher General Media, Inc. in their chapter 11 cases. His cross-border representations include the Canadian receiver for Blockbuster Canada in its chapter 15 case and the Canadian monitor in the *Essar Steel* case. Mr. Feinstein is an adjunct professor in the St. Johns University LL.M. in Bankruptcy Program and an associate editor of the *Norton Journal of Bankruptcy Law and Practice*, as well as a contributing editor of *Norton Bankruptcy Law and Practice 2d*. He has authored numerous articles, and frequently lectures on bankruptcy topics. Mr. Feinstein is rated AV-Preeminent by Martindale-Hubbell, and is ranked among Bankruptcy/Restructuring attorneys by *Chambers USA*. He also has been listed in *The Best Lawyers in America* for Bankruptcy and Creditor/Debtor Rights/Insolvency and Reorganization Law every year since 2018, and he was listed by *Lawdragon* as one of the 2022 "500 Leading U.S. Bankruptcy & Restructuring Lawyers" and one of the 2020 "500 Leading Global Restructuring & Insolvency Lawyers." Mr. Feinstein received his B.A. from Lafayette College and his J.D. *magna cum laude* from Boston University School of Law.

Brienne M. Letourneau is a partner in White & Case LLP's Global Commercial Litigation Practice in Chicago, where she strategically partners with businesses and institutions to help them achieve favorable outcomes in their most complex and high-stakes matters. She has experience representing clients in a variety of disputes, including fiduciary litigation (asset-management claims, director and officer liability and other corporate governance issues), class actions, contract disputes, business torts and professional liability. Ms. Letourneau has represented a wide array of public and private companies, including leading wealth-management and financial-services companies and multinational consumer-facing businesses, as well as prominent higher-education institutions, directors, officers, trustees, and other individual and corporate fiduciaries. She has broad experience representing clients as plaintiffs and defendants before state and federal courts and arbitral tribunals throughout the country, from pre-litigation dispute resolution and early dispositive motion practice to trial and appeal. She also has advised and defended clients in connection with government subpoenas and investigative demands. In 2022, *The Chicago Daily Law Bulletin* and *Chicago Lawyer* named Ms. Letourneau among the "40 Illinois Attorneys Under Forty to Watch." In 2021, she was recognized by *Crain's Chicago Business* as a "Rising Star in Law," and was named to *The American Lawyer*'s list of 2021 Midwest Trailblazers. Ms. Letourneau maintains a *pro bono* practice representing indigent clients and nonprofit organizations in civil actions, and advising and counseling nonprofit organizations on legal issues that impact their institutional missions. She is a member of the Chicago Bar Association and the National Association of College and University Attorneys (NACUA). Ms. Letourneau received her B.A. from the University of North Carolina and her J.D. from Harvard Law School.

Jason S. Mazer is a founding shareholder with Cimo Mazer Mark PLLC in Miami, where he regularly represents individual, corporate and municipal policyholders, as well as third-party claimants in all manner of disputes with insurance carriers. Having tried insurance coverage and bad-faith cases to policyholder verdicts, he also routinely negotiates with insurance carriers to achieve cost-effective and client-focused outcomes. Mr. Mazer's industry experience includes financial, professional, health

care, hospitality, manufacturing, retail, aviation, food services, construction, agriculture, media, entertainment and technology. Experienced in policyholder insurance recovery, insurance coverage litigation, insurer bad faith and unfair insurance practices, he also represents bankruptcy trustees, receivers and court-appointed fiduciaries in complex business litigation involving director and officer, error and omission, and commercial general liability insurers. Additionally, Mr. Mazer represents health care providers and hospitals in reimbursement disputes with commercial payors. In addition, he is a frequent teacher, accomplished author and media consultant on insurance law and unfair insurer practices. Mr. Mazer previously served as a volunteer in the Department of Justice Civil Rights Division, prosecuting pattern or practice employment discrimination cases. He then joined the Miami office of Morgan, Lewis & Bockius, LLP, briefly representing management in labor and employment disputes. In October 1999, Mr. Mazer joined the newly-formed Ver Ploeg & Lumpkin, P.A. and was elected a shareholder in 2004. In 2018, he joined forces with longtime collaborators David C. Cimo and Marilee A. Mark to form Cimo Mazer Mark PLLC. Mr. Mazer received his B.A. from Tufts University in 1994 and his J.D. from Washington University School of Law in 1998, where he was admitted to the Order of the Coif.