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Guidance for Directors of LBO Sellers Based on the Nine West Decision

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The bankruptcy of companies that previously were the subject of leveraged buyouts (LBO) often results in bankruptcy plan trustees asserting litigation claims against the companies' directors, officers and equity holders. These litigations commonly include breach of fiduciary duty claims against the pre-sale directors and officers on the theory that the LBO transactions were not in the best interest of the companies or the theory that the companies' insolvency resulted from the transaction. Bankruptcy plan trustees are also likely to assert fraudulent conveyance claims against the equity holders, because the purchase of their equity in the LBO transaction was funded by acquisition financing secured by liens on the assets of the acquired companies, allegedly rendering them insolvent. To limit LBO litigation risk, directors and officers rely on a variety of safeguards, including valuations, fairness and/or solvency opinions, requiring solvency representations from buyers, and careful consideration of the impact of proposed transactions on the selling entity's relevant constituents, especially its creditors. A recent decision arising out of the bankruptcy of Nine West Holdings highlights what can happen when directors on the selling side fail to exercise appropriate care in vetting and approving an LBO.

The Nine West Holdings Case

The case is *In re Nine West LBO Securities Litigation*, 505 F. Supp. 3d 292 (S.D.N.Y. 2020), which was decided by U.S. District Court Judge Jed S. Rakoff for the Southern District of New York on Dec. 4, 2020. In his decision (the Nine West decision), Judge Rakoff ruled on motions filed by director and officer defendants seeking to dismiss breach of fiduciary duty, aiding and abetting, and fraudulent conveyance claims arising out of the leveraged buyout of the Jones Group, later known as Nine West Holdings (Nine West). Nine West had filed for bankruptcy in 2018, and the bankruptcy plan Litigation Trustee, together with the indenture trustee of certain notes (together the Trustees), brought the claims. Judge Rakoff determined not to dismiss certain claims against the directors. His opinion has raised concerns in many circles about the risks faced by directors of companies considering leverage buyout proposals.

Background

In 2014, Sycamore Partners Management, L.P., a private equity company, acquired the Jones Group (the 2014 Transaction). Jones Group was a publicly-traded global footwear and apparel company, which sold its products under marquee brand names.

The Jones Group board retained Citigroup Global Markets as its advisor. Citigroup advised the board that, in a transaction where Jones Group retained all of its businesses—including the Stuart Weitzman and Kurt Geiger brands, referred to in the decision as Jones Group's "crown jewels," along with another business unit (collectively, the Carve-out Businesses)—the company could support a debt ratio of 5.1 times its estimated 2013 EBIDTA.

After the Jones Group board approved the agreement, Sycamore changed the deal terms, reducing its equity contribution from $395 million to $120 million. In addition, Sycamore arranged for additional new debt that would increase the Jones Group's total post-transaction debt from $1.2 billion to $1.55 billion. These changes raised the debt to EBITDA ratio to a 7.8 multiple, which was well above the 5.1 multiple that Citigroup had advised that the company could sustain.

Following the closing, Sycamore renamed the entity Nine West and sold the Carve-out Businesses to its own affiliates for a price of $641 million, which, per the decision, "was a price substantially below their fair market value of at least $1 billion." Because the merger agreement contemplated the sale of the Carve-out Businesses to Sycamore affiliates, Sycamore obtained a solvency opinion from Duff & Phelps. Ultimately, Sycamore settled on a $1.58 billion valuation for Nine West, which was slightly above the $1.55 billion in debt that Nine West would take on. However, it appears that the projections provided by Sycamore to Duff & Phelps may have been unreasonable, resulting in an inflated value for Nine West, compounded by an apparently low price for the Carve-out Businesses.

As part of the bankruptcy plan, Nine West settled its claims against Sycamore. In addition the bankruptcy plan established a litigation trust and authorized Marc Kirschner, as Litigation Trustee, to pursue "all claims and Causes of Action arising under state or federal law owned by, or asserted by or on behalf of, or that may be asserted by or on behalf of, the Debtors or their Estates, in respect of matters arising out of or relating to the 2014 Transaction against, [inter alia], directors, officers, or managers of Jones Group and its subsidiaries and affiliates."

The Holding

The central holding of the Nine West decision is that directors of a selling entity cannot ignore foreseeable consequences to that entity of contemplated post-transaction dispositions of assets. Absent both a "reasonable investigation" and a good faith evaluation by the directors of the impact of such dispositions on the solvency of the entity, the directors will not be protected by the business judgment rule in approving an LBO.

The Nine West decision was in the context of a motion to dismiss. To survive a motion to dismiss, a plaintiff must state a claim that is plausible on its face, and the court is required to accept the factual allegations in the Complaint, drawing all reasonable inferences in favor of the plaintiff. Thus, a decision on a motion to dismiss is not a determination of the merits. Nevertheless, on the facially bad facts alleged, the Nine West directors ignored foreseeable red flags and foreseeable adverse solvency consequences. The revised deal terms called for the Jones Group's post transaction debt to be in excess of the ratio that Citigroup had advised was supportable if the Carve-out Businesses were retained. As noted, those revised terms called for the sale of the Carve-out Businesses to Sycamore's own affiliates at a price apparently below their fair market value. Moreover, the merger agreement obligated Nine West to assist Sycamore in planning that sale of the Carve-out Businesses.

Notwithstanding the views of some that the Nine West decision breaks new ground, it does not signal a quantum shift in how courts view the fiduciary duties of directors in an LBO. See, e.g., *In re Hechinger Investment Co. of Delaware*, 274 B.R. 71 (D. Del. 2002), cited in the decision. Rather, the decision serves to emphasize that directors must carefully consider the entire context in evaluating the post-transaction solvency of a target company, including the impact of actions contemplated by the acquirer to take place after the closing.

The Guidance

In practical terms, directors of LBO sellers, at a minimum, should make sure that they obtain representations from buyers regarding the anticipated solvency of the acquired entity after the transaction. They should also conduct a reasonable investigation and evaluation of material contemplated post-closing transactions, including the amount of debt to be incurred, the use of the proceeds of such debt, the extent to which material assets or businesses are to be spun off, and the use of the proceeds of such spin-offs, including analyzing valuations and projections (including, to the extent available, the buyer's valuations and projections and the accuracy of the assumptions therein), all focusing on how the contemplated transactions will impact the solvency of the selling entity. While nothing can protect directors from the assertion of claims by an aggressive trustee, LBO seller directors can limit their exposure to breach of fiduciary liability claims by being vigilant in satisfying their duty of care.