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Caveat Venditor: Sellers (and their Directors) Beware *Nine West* Has an Important Message for Boards Considering an Exit

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The United States District Court for the Southern District of New York has delivered a sobering punctuation mark to a sobering year through *In re Nine West LBO Securities Litigation*, Case No. 20-2941 (S.D.N.Y. Dec. 4, 2020) (Rakoff, J.).

Under *Nine West*, directors of a *selling* corporation face a serious risk of personal liability where they do not assess a *buyer*'s post-transaction viability.

Given its potentially drastic implications, *Nine West* should be carefully reviewed by corporate directors and market participants.

Nine West holds that directors approving the *sale* of a company as part of a leveraged buyout can be liable for breach of fiduciary duties in the seller's subsequent, post-sale bankruptcy where those directors failed to adequately assess the seller's post-sale solvency. In particular, *Nine West* determined that:

- ***the business judgment rule does not even apply*** where directors fail to adequately assess the selling company's post-sale solvency;
- directors may be deemed to have ***acted recklessly*** by failing to adequately assess the selling company's post-sale solvency; and
- selling directors can also be held liable on an "aiding and abetting" theory for subsequent but related post-sale asset dispositions undertaken by the ***buyer***.

Nine West should be viewed as a serious warning for corporate decision-makers. Although they may be exiting, the directors of a corporate seller cannot ignore the selling company's post-transaction balance sheet without also risking their protections under business judgment rule.

Admittedly, *Nine West*'s direction to corporate decision-makers is seemingly at odds with their concurrent duty to maximize value for corporate stakeholders—typically satisfied by obtaining the highest possible price from a putative buyer. But, rightly or wrongly, *Nine West*'s message is that directors should prudently assess the post-transaction capitalization of the selling company and related transactions taken (or proposed to be taken) by the buyer, regardless of the fact that the seller in question will be "under new management."

As *Nine West* shows, failure to conduct such a review, and to document that process accordingly, can result in serious risk of personal liability for corporate decision-makers.

Background

Nine West is part of the ongoing saga of the Jones Group, a process that began with a 2014 LBO, was quickly followed by a series of related party asset transfers, and ultimately landed in a famously contentious chapter 11 that consumed the better part of 2018. The *Nine West* facts relevant here are summarized as follows:

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- In 2014, Jones Group, a then-publicly traded footwear and apparel company organized under Pennsylvania law, was considering a take-private cash bid from Sycamore Group, a private equity sponsor.
- The Jones Group board had previously been advised that, under then-current projections, the Jones Group could support a debt-to-EBITDA ratio of 5.1x one year forward EBITDA.
- As part of the Sycamore bid ultimately accepted by the Jones Group board, Sycamore was proposing to, among other things:
  - transfer certain "crown jewel" assets of Jones Group to a Sycamore-controlled vehicle for what was subsequently alleged to be "substantially less than fair market value," *Nine West*, slip op. at 4; and
  - cause post-transaction Jones Group to be levered at approximately 7.8x management's projected EBITDA.
- Additionally, Jones Group directors and officers were allegedly aware that company projections were continuing to decline in the face of what would be, post-transaction, a more highly levered balance sheet.
- Post-transaction, the "RemainCo" Jones Group business was re-branded as Nine West; Nine West filed chapter 11 approximately four years later in 2018.

A litigation trust formed through the bankruptcy process brought suit against certain Jones Group directors for, among other things breaches of fiduciary duty and aiding and abetting breaches of fiduciary duty in conjunction with the 2014 Sycamore LBO.

The *Nine West* Ruling

The *Nine West* opinion ruled on certain of the defendants' motion to dismiss breach-of-fiduciary duty and aiding-and-abetting claims. In this regard, one should bear in mind that the *Nine West* court thus accepted as true the plaintiff-litigation trust's allegations regarding the defendants' conduct.

The *Nine West* court determined that the directors in question could be liable for their failure to adequately investigate Jones Group's post-sale solvency. In particular, the court rejected the directors' arguments that they could not be held liable for failure to investigate the solvency of the post-sale company after giving effect to post-sale asset dispositions they did not even approve. Instead, the court held that the pre- and post-sale transactions could be "collapsed" for purposes of assessing fiduciary duties where the alleged harm of the post-sale transactions was foreseeable. The court found that the business judgment rule ***would not even apply*** in light of the director defendants' allegedly complete failure to even consider post-transaction solvency:

- "[T]he complaints allege that the director defendants failed to conduct an investigation even after Sycamore made the deal less favorable to the Company . . . ." *Id.* at 29.
- "Because the director defendants made no investigation whatsoever into the propriety of the Additional Debt and Carve Out Transactions, they cannot take cover behind the business judgment rule with respect to those components of the 2014 Transaction." *Id.* at 31.

The court further determined that this alleged failure to investigate also meant the plaintiff-litigation trust had adequately pled "recklessness"—the effect being to eliminate any exculpatory protections that might have otherwise arisen under the Jones Group bylaws and governance documents:

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- "[B]ecause the director defendants failed to make a reasonable investigation (or any investigation for that matter) into the Additional Debt and Carve-Out Transactions even in the face of red flags suggesting the 2014 Transaction would render the Company insolvent, ***they are not entitled to the protections of the business judgment rule or the Company's exculpatory bylaws***." *Id.* at 36 (emphasis added).

And, finally, the *Nine West* court determined that a valid claim for "aiding and abetting" liability could survive a motion to dismiss since the defendant-directors had approved a transaction that left Jones Group insolvent through, among other things, the subsequent carve-outs undertaken by Sycamore. *See id*. at 38.

Key Takeaways from *Nine West*

To be sure, *Nine West* only addressed various motions to dismiss and was not an actual finding of liability. Certain portions of the *Nine West* opinion also focused on operative provisions of Pennsylvania law and, thus, the court's opinion might be cabined on that basis.

But *Nine West* has a serious message for corporate decision-makers, regardless of procedural posture or questions of Pennsylvania law. Namely, the directors of a selling company may find themselves being held responsible for wrongs (or alleged wrongs) inflicted by the LBO buyer on its creditors. *Nine West*'s message is that directors cannot ignore the selling company's post-transaction balance sheet or foreseeable carve-out transactions or subsequent dispositions to be undertaken by the buyer.

Without question, this ruling creates tension between directors' broader duty to maximize stakeholder value when asked to consider a potential sale—which ordinarily translates into trying to extract the highest possible price from a particular buyer. But *Nine West*'s determination that the business judgment rule does not even apply where directors have not adequately considered post-transaction solvency suggests that directors cannot focus only on obtaining the highest possible price for their stakeholders. Under *Nine West*, directors must also carefully assess the post-transaction risks facing the business in question—even where (or particularly where) the business is "under new management."

These steps may include:

- solvency or debt capacity analyses with respect to the post-sale company;
- retaining appropriate professional advice on questions of solvency and debt capacity;
- diligencing a buyer's plans for asset dispositions or transfers;
- obtaining reps or covenants from the buyer regarding post-sale transactions; and
- establishing and then documenting a record of thorough consideration, analysis, and decisionmaking on these topics.

At the same time, there can be no "one size fits all" approach for any board asked to consider a change of control sale. Much will depend on the facts on the ground. But, as *Nine West* makes clear, the board of directors for a selling company may be the decision-makers ultimately held responsible for the balance sheet created, or bad acts taken (or allegedly taken), by the erstwhile buyer.

We encourage you to contact your Ropes & Gray team to discuss these matters more fully.

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