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I Shall [Not] Be Released: Wellspring, Director Releases, and the Duty of Loyalty in Restructuring Negotiations

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As we here at Ropes & Gray look back on 2021 and ahead into 2022, we call your attention to the lessons of *Friedman v. Wellspring Capital Mgmt., LLC* (*In re SportCo Holdings, Inc.*), Case No. 20-50554, 2021 WL 4823513 (Bankr. D. Del. Oct. 14, 2021) (Stickles, J.) ("*Wellspring*").

Wellspring is a cautionary tale for the fiduciaries of a distressed or potentially distressed corporation—particularly with respect to negotiations around release and/or indemnification provisions for those same fiduciaries.

In *Wellspring*, the Delaware bankruptcy court held that an alleged duty of loyalty breach could survive a motion to dismiss where:

- the distressed corporation had allegedly reached an agreement in principle on an out-of-court restructuring; and
- allegedly, the distressed corporation's directors (who were all employees of its equity sponsor), refused to approve that restructuring solely because it did not include broad releases and indemnification for those directors and its equity sponsor—which releases and indemnification were demanded at the 11th hour.

Bear in mind that "alleged" is the operative word here. The *Wellspring* court was ruling on a motion to dismiss, and therefore accepted the plaintiff's somewhat barebones and perhaps self serving assertions as true and in the light most favorable to that plaintiff. Accordingly, *Wellspring* did not find that the defendants in fact breached their duties, but rather held that the plaintiff, a litigation trust, had asserted a viable claim that could proceed to a trier of fact.

Regardless, market participants—and equity sponsors in particular—should view *Wellspring* as an important reminder as to how both process and substance matter in restructuring negotiations. Particularly where negotiations may involve releases, indemnification, or similar provisions, be advised that the ever-present tendency for counterparties to exercise "20/20 hindsight" is fully in effect. Accordingly, *Wellspring* reinforces the importance of disinterested governance and arm's length dealing in connection with the restructuring process.

Wellspring's Alleged Facts

Wellspring's facts, as alleged, are fairly straightforward. In Fall 2018, SportCo Holdings, Inc. ("SportCo") was facing severe financial distress. Accordingly, SportCo began negotiations with certain of its lenders around a potential restructuring transaction.

SportCo's negotiations were led by a SportCo director, who was also the managing partner of Wellspring Capital, SportCo's equity sponsor. In this process, SportCo initially exchanged a term sheet with certain of its lenders in early November 2018 and allegedly reached an "agreement in principle" in late December 2018. (Compl. ¶ 19.)[1]

Despite that agreement in principle, it was alleged in relevant part that:

- ***first***, despite exchanging multiple term sheets throughout November and December, no term sheet referenced any release or indemnification provisions until SportCo incorporated such provisions into a term sheet delivered on December 26, 2018—one day before SportCo was set to breach its loan agreements. (*Id.* ¶ 137)

- ***second***, "Wellspring Capital and the D&O Defendants squelched those [restructuring] efforts by refusing, at the last minute, to execute any term sheet that did not include broad release or indemnification language in favor of the D&O Defendants and Wellspring Capital." (*Id*. ¶ 134.)

- ***third***, but for the refusal to accept a term sheet that failed to include the demanded releases and indemnities, an out-of-court transaction would have been promptly entered into and consummated. (*See id*. at ¶ 142.)

Unable to agree on the release and indemnification issue, SportCo's out-of-court restructuring failed, and SportCo defaulted on its funded debt shortly thereafter. SportCo later filed a 'free fall' bankruptcy and liquidated—allegedly causing substantial losses for unsecured creditors that would not have occurred had SportCo accepted that "agreement in principle" allegedly reached in December 2018.

The Alleged Causes of Action

A litigation trust formed through the SportCo bankruptcy then sued, among others, SportCo's former directors and its equity sponsor. Relevant here: the plaintiff/litigation trust alleged that SportCo's directors:

- breached their duty of care, since the directors refused to "reasonably maximize corporate value" by killing the restructuring on account of releases/indemnity (*id*. ¶ 150); and

- breached their duty of loyalty, since they "placed their own self-interests above those of their fiduciaries [*sic*]" for the same reason (*id*. ¶ 168).[2]

Finally, the litigation trust also asserted a variety of other counts in its complaint related to other facts, circumstances, and actions that are not the subject of this Alert.

The *Wellspring* Ruling

The *Wellspring* court dismissed the litigation trust's claim for breach of the fiduciary duty of care, holding that it was not adequately pled. In particular, the bankruptcy court held that the allegations failed to support a conclusion that the SportCo directors were somehow acting on an uninformed basis or that the rejection of the out-of-court restructuring was grossly negligent. *Wellspring*, 2021 WL 4823513, at *10.

Importantly, however, the *Wellspring* court declined to dismiss the litigation trust's duty of loyalty claim, stating on a cursory basis that "Drawing all inferences in favor of the Trustee, the Complaint contains sufficient allegations that the D&O Defendants breached their duty of loyalty regarding the Failed Out of Court Restructuring." *Id*.

The court's analysis of the duty of loyalty claim can be fairly characterized as "limited," consisting of four short paragraphs that largely restate or simply quote the complaint. *Id*. *Wellspring* also rejected in cursory fashion the defendants' argument that "it is not necessarily a breach . . . to negotiate for release or indemnification," with the defendants arguing that such releases "may have saved the post-restructuring company the expense of indemnifying the D&O Defendants" in subsequent litigation. *Id*. In *Wellspring*'s view, the extent to which releases might have benefitted SportCo (as opposed to benefiting the directors alone) was at least in part a question of fact that could not be resolved on a motion to dismiss. *Id*.

The *Wellspring* ruling was not appealed, nor has any trial occurred on this matter.

Takeaways from *Wellspring*

Many of the facts underlying the *Wellspring* decision are neither unique nor unusual. It is not unusual for an entity facing distress to engage with their stakeholders and to negotiate any number of transaction alternatives and terms.
But *Wellspring* would arguably undermine the ability to negotiate for what are customary and, indeed, necessary protections for corporate decisionmakers in those same transactions, such as releases, indemnity, or exculpation. After

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all, corporate decisionmakers are often tasked with choosing a path where outcomes are at best uncertain. Frustrated stakeholders can be further inclined, and incentivized, to view all corporate decisions with an eye towards 'litigation first' through a 20/20 hindsight lens.

To this end, *Wellspring* reinforces two key principles in particular:

- ***Disinterested Governance***: As alleged, it does not appear that SportCo, the portfolio company in question, had any independent directors involved in the restructuring negotiations. Thus, the plaintiff could allege that governance was entirely conflicted on the release and indemnification issue, and that the equity sponsor sought only to protect itself.
    - *Wellspring* may have reached a very different conclusions if negotiations were undertaken by a disinterested decision making body.
- ***Importance of Arm's Length Dealing***: As alleged, (i) SportCo's restructuring negotiations were personally led by Wellspring Capital's managing partner, as opposed to advisors or an independent director, and (ii) Wellspring Capital's managing partner was "front and center" in all dealings with SportCo's stakeholders.
    - As with the plaintiff's assertions around disinterested governance, such allegations may (or may not) bear any semblance to the actual facts.
    - But *Wellspring* is an important reminder that arm's length negotiations between a distressed corporation and its stakeholders remain a key facet of ensuring that corporate decision makers will remain appropriately insulated from potential liability.

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

1. The operative complaint may be accessed here.
2. The plaintiff/litigation trust also asserted claims directly against Wellspring Capital under an aiding and abetting theory—i.e., asserting that Wellspring Capital itself aided and abetted the SportCo Board's alleged fiduciary duty breaches.
   The *Wellspring* court ultimately dismissed this count on somewhat technical grounds, holding that insufficient facts had been pled to support an aiding and abetting theory. *Wellspring*, 2021 WL 4823513, at *13. However, the Bankruptcy Court also gave the plaintiff the ability to amend its complaint in this regard. To date, no amended complaint has been filed.

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