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That's What Boards Are For: Corporate Governance Issues in Chapter 11

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The role of a corporation's board of directors in bankruptcy has always been important. Directors' decisions can change the landscape of both a bankruptcy case and the strategic positions that parties take, and actions by management and other insiders at the time leading up to bankruptcy are often challenged. These dynamics raise questions about the duties a director owes and to whom, how non-bankruptcy governance rules align with the Bankruptcy Code, and who is best positioned to investigate and settle claims of insider misbehavior.

Recent litigation and a high-profile academic paper have drawn more attention to the debate about the role or directors in bankruptcy. Below we present summaries and excerpts from recent cases and scholarship.

Recent Bankruptcy Cases on Director Duties

***In re Mountain Express Oil Co.*,** Case No. 23090147 (DRJ)

The Debtors moved to ratify the pre-petition appointment of two independent directors. According to the Debtors, although such an appointment prior to the filing of a bankruptcy petition typically does not require court approval, a motion was filed in an "abundance of caution," given the complicated nature of ownership and capital structure of the Debtors. (Docket No. 283.) Specifically, the Debtors believed that appointment of two qualified, professional, and independent directors would improve the oversight of the Debtors' transition into chapter 11 and assure safeguards for the interest of their creditors and estates. (*Id.*)

Both the United States Trustee (the "Trustee") and the Official Committee of Unsecured Creditors (the "Committee") objected to the motion. The Trustee asserted that the appointment of the independent directors, as well as the approval of their fees, was "accomplished successfully" prior to the bankruptcy filings and that there was "no need . . . for the Court to involve itself in the matters of corporate governance." (Docket No. 370.) According to the Trustee, the court should "not be in the business of blessing pre-petition shareholder actions." (*Id.*) The Trustee further argued:

> An "abundance of caution" . . . is not a basis for relief. The prepetition appointment of directors to a company's board, independent or otherwise, is a matter of corporate governance that does not require this Court's intervention. The Court should not be in the business of ratifying pre-petition corporate governance decision taken by Debtors' shareholders, particularly where the Bankruptcy Code does not contemplate that role. Not only is there no authority but it would set bad precedent for debtors to seek blessings from courts where none are needed.

(*Id.*)

In response, the Debtors argued that the pre-petition appointment of independent directors by a debtor has been "the subject of frequent criticisms, particularly in recent years." (Docket No. 445.) Among these criticisms, the Debtors said, is that such pre-petition appointments fail to allow parties in interest to "consider, probe, or evaluate the propriety, purpose, and terms relating to [the] appointments." (*Id.*) The Debtors explained that their motion was filed to address these concerns by providing parties in interest with the opportunity to understand, evaluate, and respond to the appointments. (*Id.*) The Debtors were "surprised that the watch-dog institutions of the Committee and U.S. Trustee would prefer a closed-door process which would omit the involvement of the Court and forgo transparency for parties in interest, in favor a process which would have excluded their constituents." (*Id.*)

The court ultimately granted the Debtors' motion, noting that it provided transparency and clarity to the appointment process. (Docket No. 459.)

TRU Creditor Litig. Tr. v. Brandon (In re Toys "R" Us), 642 B.R. 727 (Bankr. E.D. Va. 2022)[1]

In this adversary proceeding, the TRU Creditor Litigation Trust (the "Trust") sued former directors, alleging that they breached their fiduciary duties by (1) taking on DIP financing at the start of the bankruptcy case, (2) authorizing pre-petition retention payments to 114 company executives, and (3) authorizing advisory fee payments to the Trust's private equity shareholders from the fourth quarter of 2014 through the first quarter of 2017. *Toys "R" Us*, 642 B.R. at 735–36.

The court held that the DIP financing claims were precluded by the ruling on the original DIP financing motion. *Id.* at 745–46. Specifically, the court found that there was no "new evidence" that had not been available through discovery and that could have been offered before entry of the final DIP order. *Id.* at 745. Thus, the court reviewed the allegations in the complaint with respect to breach of fiduciary duty in connection with the defendants' authorization of the DIP financing. *Id.* at 746. According to the court, those allegations—of gross negligence, conflicts of interest, bad faith, an abdication of fiduciary duty, and reckless indifference "fell short of claiming that the Defendants committed a fraud on the Court":

> The essential facts necessary to establish a breach of fiduciary duty and associated claims in connection with securing the DIP financing have already been decided in favor of the Defendants. These facts were not changed, nor could they be, by subsequent confirmation orders because they had already become the law of the case as a result of the Final DIP Order.

Id. at 745–46. Accordingly, the Court granted the Defendants' motion for summary judgment as to the count alleging breach of fiduciary duty for authorizing the DIP financing. *Id.* at 746.

As to the claims related to pre-petition bonuses and advisory fees, the court allowed the claims to proceed:

[1] Bankr. Case No. 17-34665 (KLP).

> Unlike the action taken by the Defendants in securing the postpetition DIP financing, the prepetition executive bonus plan was not subject to court approval, for which creditors and interested parties would have been given an opportunity to be heard. The Trust has documented extensive evidence and supporting case law in support of its contention that each of the Defendants breached the duties of loyalty, good faith, and care. It argues that this evidence establishes, *prima facie*, that the Defendants were not disinterested, failed to consider material information reasonably available to them, failed to consider reasonable alternatives, and abdicated the decision-making process to Defendant Brandon, the CEO of TRU, who was the recipient of the largest bonus.

Id. at 747.

***Friedman v. Wellspring Cap. Mgmt., LLC (In re SportCo Holdings, Inc.)**,* Case No. 19-11299 (JKS), 2021 WL 4823513 (Bankr. D. Del. Oct. 14, 2021)

The Plaintiff brought fiduciary duty claims against the directors for a failed out-of-court restructuring that led to a bankruptcy filing. *SportCo Holdings*, 2021 WL 4823513, at *2. The court determined that Delaware law applied to the Plaintiff's claims because, under the "internal affairs doctrine," "matters unique to relationships among the corporation and officers, directors, and shareholders are governed by the law of the state of incorporation." *Id.* at *5.

Under Delaware law, officers and directors owe the corporations that they serve the duties of care and loyalty to "strive in good faith and on an informed basis to maximize the value of the corporation for the benefit of its residual claimants, the ultimate beneficiaries of the firm's value." *Id.* at *6 (internal quotation omitted). When alleging breach of fiduciary duties, a party must "plead around the business judgment rule" in order to survive a 12(b)(6) motion to dismiss. *Id.* (internal quotation omitted). In evaluating breach of fiduciary duty claims, courts must bear in mind that a director does not become "a guarantor of success by choosing to continue a firm's operations when it may be insolvent." *Id.* (internal quotation omitted).

The court described the duties of care and loyalty in this way:

i. The Duty of Care

> The duty of care requires that directors of a Delaware corporation both: (1) use that amount of care which ordinarily careful and prudent men would use in similar circumstances; and (2) consider all material information reasonably available. The duty of care has been described as the duty to act on an informed basis. Duty of care violations are actionable only if the directors acted with gross negligence, which is rarely found. Gross negligence is conduct that constitutes reckless indifference or actions that are without the bounds of reason.

ii. The Duty of Loyalty

> The duty of loyalty mandates that the best interest of the corporation and its shareholders takes precedence over any interest possessed by a director, officer or controlling shareholders and not shared by the stockholders generally. A director is interested in a transaction if he or she will receive a personal financial benefit from a transaction that is not equally shared by the stockholders or if a corporate decision will have a material detrimental impact on a director, but not on the corporation and the stockholders. The private benefit to the director must be of a sufficiently material importance, in the context of the director's economic circumstances, as to have made it improbable that the director could perform her fiduciary duties without being influenced by her overriding personal interest.

Id. (internal citations and quotations omitted).

Acts "taken in bad faith" also "breach the duty of loyalty" under Delaware state law. *Id.* at *7 (internal quotation omitted). To establish a bad-faith claim, "a plaintiff must show either an extreme set of facts to establish that disinterested directors were intentionally disregarding their duties, or that the decision under attack is so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith." *Id.* (internal quotation omitted). A claim for breach of the duty of loyalty can be dismissed if it "is devoid entirely of factual support to establish that the transaction was self-interested." *Id.* (internal quotation omitted).

In the complaint, the Plaintiff alleged that the director and officer defendants (the "D&O Defendants) breached their fiduciary duty of loyalty by failing to restructure SportCo's debt out of court. *Id.* at *10. According to the complaint, the D&O Defendants refused to execute any debt restructuring agreement unless it included broad release and indemnification language in favor of the D&O Defendants and defendant Wellspring Capital, "because they, and not the Debtors' creditors, stood to receive substantial value if the Debtors' debt restructuring agreement included such provisions." *Id.* (citing ¶ 166 of Compl.). In doing so, the Plaintiff alleges, the D&O Defendants "placed their own self-interests above those of their fiduciaries—specifically, the Debtors—and permitted the Debtors to breach their loan covenants instead of entering into a restructuring agreement that did not provide the D&O Defendants or Wellspring Capital with releases and the benefit of indemnification." *Id.* (citing ¶ 168 of Compl.).

In response, the D&O Defendants argued that it is not necessarily a breach of a director's fiduciary duty of care or loyalty under Delaware law to negotiate for release or indemnification by a creditor based on fear of subsequent litigation. *Id.* According to the D&O Defendants, individual releases would not have been a "private interest" under the circumstances, because the benefit would have been shared with restructured SportCo." *Id.*

The court found that the extent to which individual releases might have benefitted SportCo was, in part, a factual question involving the nature and extent of the D&O Defendants' entitlements to indemnification and other matters that the court could not resolve at that time. *Id.* Ultimately, the court held that the complaint contained sufficient allegations to reasonably infer that the D&O Defendants breached their duty of loyalty with respect to the failed out-of-court restructuring and,

thus, denied the motion to dismiss as to that claim, but granted the Plaintiff leave to amend and replead. *Id.; see also In re OPP Liquidating Co., Inc.*, Case No. 19-10729 (MFW), 2022 WL 774063, at *11 (Bankr. D. Del. Mar. 14, 2022) (allowing fiduciary duty claims to survive a motion to dismiss).

Halperin v. Morgan Stanley Inv. Mgmt., Inc. (In re Tops Holding II Corp.), 646 B.R. 617 (Bankr. S.D.N.Y. 2022)

The Plaintiff, as litigation trustee for the Tops Holding Litigation Trust, brought an adversary proceeding to challenge transfers that were made to private equity investors and the Debtor's directors. In the complaint, the Plaintiff alleged that the Director Defendants were "not truly 'independent' directors, but in fact were beholden to, and controlled by, Morgan Stanley, [the lead private equity investor,] and acted at Morgan Stanley's direction to advance Morgan Stanley's interest in approving . . . [d]ividends." *Tops Holding II Corp.*, 646 B.R. at 710 (quoting ¶¶ 44 & 137 of Compl.). In support of these allegations, the Plaintiff pleaded that Morgan Stanley placed all of the Director Defendants on the Debtor's board and had "sole and absolute direction to remove them if they failed to follow Morgan Stanley's directives." *Id.* at 710–11 (quoting ¶ 137 of Compl.). The Plaintiff also pleaded that careers of two of the Director Defendants were "solely focused on serving on Boards, and meeting Morgan Stanley's needs on the Tops' Board would mean the possibility of Morgan Stanley appointing them to other Boards." *Id.* at 711 (quoting ¶ 137 of Compl.).

In dismissing the Plaintiff's complaint, the court provided a comprehensive analysis on director independence. Specifically, the court explained that a director's decision is deemed independent if it is based on the corporate merits of the transaction at issue rather than extraneous influences or considerations. *Id.* at 708. To demonstrate a lack of independence, the court said, a plaintiff must allege facts raising "sufficient doubt that a director's decision was based on extraneous considerations or influences, and not on the corporate merits of the transaction." *Id.* (internal quotations omitted). A lack of independence can be shown if a complaint offers facts which "create a reasonable doubt that through personal or other relationships the directors are beholden to the controlling person [or entity] or so under their influence that their discretion would be sterilized." *Id.* (internal quotations omitted). The court noted, however, that:

> [Allegations] of mere personal friendship or a mere outside business relationship, standing alone, are insufficient to raise a reasonable doubt about a director's independence. Conclusory references to dominated and controlled directors also are insufficient. It is the care, attention and sense of individual responsibility to the performance of one's duties, not the method of election, that generally touches on independence. Thus, that a director was nominated by or elected at the behest of those controlling the outcome of a corporate election adds no support to the plaintiff's claims, because that is the usual way a person becomes a corporate director. More is required, such as situations involving family, employment prospects, and long-standing business relationships, before a complaint will have alleged sufficient facts to support an inference that the director could not act independently of an interested party. Delaware courts have long held that

> one should not assume directors are influenced by a controller due to a concern about potentially losing their directorships, unless the controller has actually made retributive threats. But more recently, the Court of Chancery acknowledged scholarly work on the topic of director independence to suggest: (1) gaining or losing a directorship is generally material to an individual director, and (2) directors could be particularly influenced by entities that regularly are in a position to appoint and reappoint directors, sometimes to multiple boards. . . .

Id. at 708–09 (internal citations and quotations omitted).

As for the independence of directors based on their ability to continue to receive directors' fees, some courts have focused on whether the fees exceed those that are usual and customary. *Id.* at 709–10. Other courts have suggested that directors' fees are more likely to be material to an individual whose primary profession is serving as director. *Id.* at 710. "As with interestedness, analysis of independence is based on a subjective "actual person" standard rather than an objective "reasonable director" standard. So, too, materiality comes into showing a lack of independence." *Id.* (internal citation and quotations omitted).

The court concluded its analysis by explaining as follows:

> The plaintiff must allege that the director in question had ties to the person whose proposal or actions he or she is evaluating that are sufficiently substantial that he or she could not objectively discharge his or her fiduciary duties. In other words, the question is whether, applying a subjective standard, those ties were material, in the sense that the alleged ties could have affected the impartiality of the individual director. [Delaware] law requires that all the pled facts regarding a director's relationship to the interested party be considered in full context in making the, admittedly imprecise, pleading stage determination of independence.
>
> Put differently, the Court begins with the presumption that all directors are independent, such that the allegations must be sufficient to demonstrate a *substantial reason* to find that a director cannot make a decision with only the best interests of the corporation in mind.

Id. at 708–10 (internal citations and quotations omitted).

Based on the foregoing caselaw, the court found that the limited allegations in the complaint were insufficient to prove that the two directors at issue lacked independence. *Id.* at 711.

The court also adopted Delaware's approach to exculpation provisions in connection with motions seeking dismissal, explaining that courts can consider such provisions in the context of a motion to dismiss claims for breach of fiduciary duty because directors' fiduciary duties may be set forth in or amended by the corporate charter or operating agreement, and, thus, the agreement "should be a point of departure for a [t]rustee claiming breaches of fiduciary duties" and considered integral

to the complaint. *Id.* at 700 (internal quotation omitted). This is in contrast to other courts that have treated exculpation as an affirmative defense. For example, one court observed that "[t]he Defendants also argue[d] that they ha[d] an exculpation clause which relieve[d] them of any responsibility. The Court [explained that it did not need to] consider this argument because it is an affirmative defense which should not be considered at the motion to dismiss stage." *Buchwald Cap. Advisors LLC v. Schoen (In re OPP Liquidating Co.)*, Case No. 19-10729 (MFW), 2022 WL 774063, at *11 n.95 (Bankr. D. Del. Mar. 14, 2022).

The View for the Academy

In a paper entitled "The Rise of Bankruptcy Directors," Professors Jared A. Ellias, Ehud Kamar, and Kobi Kastiel presented evidence about the characteristics and performance of directors appointed to serve in bankruptcy cases. They argued that these directors suffer from structural bias because they are repeat players who are appointed by a small community of private equity sponsors and law firms. Jared A. Ellias, Ehud Kamar & Kobi Kastiel, *The Rise of Bankruptcy Directors*, 95 S. CAL. L. REV. 1083 (2022).

In summarizing their data findings, the authors noted that the percentage of companies in chapter 11 cases claiming to have an independent director rose from 3.7% in 2004 to 48.3% in 2019. *Id.* at 1087. More than 60% of the firms that appointed bankruptcy directors had a controlling shareholder and approximately half were under the control of private equity funds. *Id.* The authors further summarized their findings as follows:

> After controlling for firm and bankruptcy characteristics, we find that the recovery rate for unsecured creditors, whose claims are typically most at risk in bankruptcy, is on average 20% lower in the presence of bankruptcy directors. We cannot rule out the possibility that the firms appointing bankruptcy directors are more insolvent and that this explains their negative association with creditor recoveries. Still, this finding at least shifts the burden of proof to those claiming that bankruptcy directors improve the governance of distressed companies to present evidence supporting their view in this emerging debate.
>
> We also examine a mechanism through which bankruptcy directors may reduce creditor recoveries. In about half of the cases, these directors investigate claims against insiders, negotiate a quick settlement, and argue that the court should approve it to save the company and the jobs of its employees. We supplement these statistics with two in-depth studies of cases in which bankruptcy directors defused creditor claims against controlling shareholders: Neiman Marcus and Payless Holdings.
>
> Finally, we consider possible sources of pro-shareholder bias among bankruptcy directors. Shareholders usually appoint bankruptcy directors without consulting creditors. These directors may therefore prefer to facilitate a graceful exit for the shareholders. Moreover, bankruptcy directorships are short-term positions, and the world of corporate

> bankruptcy is small, with private equity sponsors and a handful of law firms generating most of the demand. Bankruptcy directors depend on this clientele for future engagements and may exhibit what we call "auditioning bias."
>
> In our data, we observe several individuals appointed to these directorships repeatedly. These "super-repeaters" had a median of 13 directorships and about 44% of them were in companies that went into bankruptcy when they served on the board or up to a year before their appointment. Our data also show that super-repeaters have strong ties to two leading bankruptcy law firms. Putting these pieces together, our data reveal an ecosystem of a small number of individuals who specialize in sitting on the boards of companies that are going into or emerging from bankruptcy, often with private equity controllers and the same law firms.

Id. at 1087–88 (internal citations omitted).

The authors argue that their findings support the claim that "bankruptcy directors are a new weapon in the private equity playbook." *Id.* at 1088. According to the authors, bankruptcy directors effectively help with "shielding self-dealing transactions from judicial intervention. Private equity sponsors know that if the portfolio firm fails, they [can] appoint bankruptcy directors to handle creditor claims, file for bankruptcy, and force the creditors to accept a cheap settlement. Importantly, the ease of handling self-dealing claims in the bankruptcy court may fuel more aggressive self-dealing in the future." *Id.* at 1088–89 (internal citations omitted).

The authors also assert that their findings have significant policy implications:

> Bankruptcy law strives to protect businesses while also protecting creditors. These goals can clash when creditors bring suits that threaten to delay the emergence from bankruptcy. While bankruptcy directors may aim for speedy resolution of these suits, their independence may be questionable because the defendants in these suits are often the ones who appoint them. Moreover, bankruptcy directors often bypass the checks and balances that Congress built into Chapter 11 when they seek to replace the role of the official committee of unsecured creditors ("UCC") as the primary check on management's use of the powers of a Chapter 11 debtor.

Id. at 1089.

The authors contend that the contribution of bankruptcy directors "to streamlining bankruptcies should not come at the expense of creditors." *Id.* Addressing the issue, they propose a procedure that can be implemented by bankruptcy judges without new legislation: "the bankruptcy court should treat as independent only bankruptcy directors who, in an early court hearing, earn overwhelming support of the creditors whose claims are at risk, such as unsecured creditors or secured creditors whom the debtor may not be able to pay in full." *Id.* Bankruptcy directors who do not have such support, the authors say, should not be treated as independent and thus should

not prevent creditors from investigating and pursuing claims. *Id.* Elaborating on their proposal, the authors explain as follows:

> The creditors will likely need information on the bankruptcy directors to form their opinion, and bankruptcy judges can rule on what information requests are reasonable. This will create standardization and predictability. However, disclosure is no substitute for creditor support. Requiring disclosure without heeding creditors on the selection of bankruptcy directors will not cure bankruptcy directors' structural biases.
>
> Some might argue that our solution is impractical or otherwise lacking. We answer these claims. More importantly, our solution is the only way to ensure that bankruptcy directors are truly independent. If it cannot be made to work, bankruptcy law should revert to the way it was before the invention of bankruptcy directors, where federal bankruptcy judges were the only impartial actors in most large Chapter 11 cases. In such a scenario, debtors will be free to hire whomever they want to help them navigate financial distress, but the court will regard these bankruptcy directors as ordinary professionals retained by the debtor. The court should weigh the bankruptcy directors' position against the creditors', allow the creditors to conduct their own investigation and sue over the bankruptcy directors' objections, and not approve settlements merely because the bankruptcy directors endorse them.

Id. at 1089–90.

The authors further argue that their study supports restrictions on the control that debtors exert over claims against insiders. Specifically, they assert that their findings lend support to a bill recently introduced by Senator Elizabeth Warren to prevent debtors from prosecuting and settling claims against insiders. *Id.* at 1090 (citing Alexander Saeedy, *Elizabeth Warren Floats Expanded Powers for Bankruptcy Creditors Against Private* Equity, WALL ST. J. (Oct. 20, 2021, 1:17 p.m. ET), available at https://www.wsj.com/articles/elizabeth-warren-floats-expanded-powers-for-bankruptcy-creditors-against-private-equity-11634750237 [https://perma.cc/P3XE-U24Y]). Like the author's proposal, this bill would restore the traditional checks and balances of the bankruptcy process while allowing distressed firms to appoint directors of their choice." *Id.* The authors maintain, however, that their proposal has many advantages. *Id.* Among them, the proposal "does not require new legislation, it preserves greater flexibility for the bankruptcy court and, by requiring that bankruptcy directors be acceptable to creditors, it ensures that all board decisions in bankruptcy, not just decisions regarding claims against insiders, advance creditor interests. *Id.*

Professor Vincent Buccola, another bankruptcy scholar, reached a similar conclusion:

> In practice, . . . neither the threat of litigation nor the interposition of (nominally) independent directors has much bite. By design, judicial enforcement of directors' fiduciary duties aims to target only the most egregious decisions. Delaware courts, at least, have made clear that their

> review is no more searching while a corporation is insolvent than while it is solvent. In both situations, the business-judgment rule insulates the vast majority of decisions for which directors can articulate a plausible rationale. Independent directors often seem to be appointed only when a bankruptcy, with its concomitant scrutiny of conflicted transactions, is inevitable. Their prosecution of claims against former directors and controlling sponsors in that forum does not always appear to be as vigorous as it could be. Indeed, the appearance of a number of "bankruptcy directors" hired repeatedly by sponsored companies has led some to question whether the real function of independence isn't precisely to enforce fiduciary law's laxity. The essential weakness of fiduciary law thus has ensured that sponsor-backed distressed businesses today use the flexibility they now have under their loan contracts to the advantage of their private equity owners.

Vincent S.J. Buccola, *Sponsor Control: A New Paradigm for Corporate Reorganization*, 90 U. Chi. L. Rev. 1, 24 (2023) (internal citations omitted).

Scholarship on this topic has been one sided, with several articles agreeing with the above sentiments and little being written in defense of current practices.