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SDNY Denies Motion to Dismiss Breach of Fiduciary Duty Claims Against Former Directors Based on Allegations That Approval of Leveraged Buyout Was Reckless

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On December 4, 2020, Judge Rakoff of the Southern District of New York denied a motion to dismiss breach of fiduciary duty claims against former directors of Jones Group (the predecessor to Nine West).[1] The lawsuit arises from the board of directors' approval of a buyout transaction that distributed $1.2 billion to Jones Group shareholders, while allegedly rendering the company insolvent. The Court allowed the claims to proceed, finding that the directors, by their own admission, failed to conduct a reasonable investigation into whether the transaction as a whole was beneficial to the company or would render the company insolvent. The Court concluded that the director defendants were not exempt from responsibility for the steps of the integrated transaction that were implemented after they resigned from the board because they allegedly knew that those steps were part of an integrated multi-step transaction and would be completed substantially concurrently with their resignation. The directors were not entitled to the protections of the business judgment rule because they expressly avoided any investigation regarding two key steps in the transaction; they allegedly turned a blind eye to the intention to complete those steps after the initial merger.

This preliminary decision merits discussion, but it does not represent a watershed expansion of exposure for directors or expansion of their fiduciary duties. Instead, it reinforces the simple rule that in order to obtain the protection of the business judgment rule the board must in fact make an informed business judgment, and declining to review key components of an integrated multi-step transaction is reckless. Ordinarily, the business judgment rule and the exculpatory provisions in a company's bylaws offer a significant shield against liability for directors, except in the most egregious of circumstances. However, those protections only operate when the directors make a reasonable investigation and a business judgment, which the Jones Group directors expressly chose not to do when they opted not to approve or disapprove the key elements of the multi-step transaction that allegedly rendered the company insolvent. As the Court very aptly noted, "the business judgment rule presupposes that directors made a business judgment."[2]

Facts of the Case

In the years leading up to the 2014 leverage buyout transaction, Jones Group—a publicly traded global footwear and apparel company—was suffering financially. The only bright spot was the performance of two brands, Stuart Weitzman and Kurt Geiger, that Jones Group had purchased for $800 million just a few years earlier.

In July of 2012, the board began considering a sale of the company and retained Citigroup Global Markets to act as its advisor. Citigroup advised the board, in relevant part, that in a transaction where Jones Group retained all of its businesses (including the successful Stuart Weitzman and Kurt Geiger brands), the company could support a maximum debt to EBITDA ratio of 5.1. The following year, the private equity firm Sycamore Partners Management reached a deal to purchase Jones Group for $15 per share, representing a $2.15 billion implied enterprise value for the company.

The merger agreement between Jones Group and Sycamore Partners originally involved five allegedly integrated components:

1. Jones Group would merge with a Sycamore affiliate;
2. Sycamore would contribute at least $385 million in equity to the post-merger surviving entity ("Nine West");
3. Nine West would increase its total debt burden from $1 billion to $1.2 billion;
4. Jones Group shareholders would be cashed out at $15 per share (for a total of $1.2 billion); and
5. the successful Stuart Weitzman and Kurt Geiger brands, along with one additional business unit, would be sold to another Sycamore affiliate for substantially less than fair market value.

The board unanimously approved the merger agreement on December 19, 2013 but excluded from its approval the 3rd and 5th steps (the debt increase and the carve-out transaction of the Stuart Weitzman and Kurt Geiger brands). The merger agreement included provisions that obligated Jones Group to assist Sycamore in both planning the carve-out transaction and syndicating the additional debt. The directors allegedly knew that these were parts of an integrated transaction, that all steps would occur substantially concurrently, and that their affirmative vote was putting the wheels in motion to strip the most valuable assets out of the merged company and burden it with unsustainable debt. They allegedly chose to approve parts of the multi-step transaction and turn a blind-eye to the harmful steps they allegedly knew they were facilitating.

Prior to the closing, Sycamore reduced its equity contribution from $395 million to $120 million, and increased the total amount of new debt from $1.2 billion to $1.55 billion. This raised the company's post-transaction debt to EBITDA ratio to between 6.6 and 7.8.—well above the 5.1 maximum ratio that Citigroup initially indicated was sustainable. Although the merger agreement contained a fiduciary out clause, the directors did not reconsider their approval even after the initial transaction was modified in ways detrimental to the company.

In anticipation of the carve-out transaction, Sycamore hired valuation advisors to provide a solvency opinion for Jones Group as it would exist after the transfer of the successful Stuart Weitzman and Kurt Geiger brands (Jones Group without the successful brands, "RemainCo"). Sycamore allegedly created and provided to their advisors "unreasonable and unjustified" EBITDA projections for RemainCo to inflate its value and justify the below-market price for the Stuart Weitzman and Kurt Geiger brands. Sycamore ultimately settled on a $1.58 billion valuation of RemainCo, just above the $1.55 billion total debt burden that was planned by Sycamore. The directors of Jones Group were not, according to the complaint, directly aware of the fact that Sycamore had manipulated the projections of RemainCo in order to achieve the $1.58 billion valuation. However, the complaint alleged that the directors received updated reports and projections from Jones Group management on a monthly basis and were therefore aware of the poor performance of Jones Group overall, as well as the comparatively stellar performance of the Stuart Weitzman and Kurt Geiger brands.

The merger closed on April 8, 2014, at which point Jones Group directors were replaced by two Sycamore principals. As part of the closing of the merger, the new directors caused

Nine West to sell the Stuart Weitzman and Kurt Geiger brands to a newly formed Sycamore affiliate for just $641 million. This number was far less than the $800 million that Jones Group had paid to acquire these brands just a few years earlier, even though these brands had been very successful during the interim. The complaint alleged that the fair market value of these brands was $1 billion. In April of 2018, about four years after the merger closed, Nine West filed for bankruptcy.

Allegations

The Court found that the following allegations justified denial of the motion to dismiss and refusal to apply the deferential business judgment standard of review to the actions of the directors:

1. The directors chose not to review or approve two of the major steps of the merger transaction—the issuance of additional debt and a carve-out transaction that sold off the most successful parts of the company post-merger, even though they knew their approval of the merger would lead to the completion of these additional steps in the intended multi-step transaction. Both steps were crucially important in causing the overleveraging that eventually led to the bankruptcy of the company.
2. The directors allegedly ignored certain “red flags” that should have caused them to investigate potential solvency issues related to the transaction. The failure to investigate these red flags when the directors could have withdrawn support for the transaction was, according to the Court, reckless.

Breach of Fiduciary Duty Claim

The director defendants moved to dismiss the breach of fiduciary duty claims on two grounds. First, they argued that their approval of the transaction was protected by the business judgment rule, and second, that even if the business judgment rule did not apply, they were protected by exculpatory provisions in Jones Group’s bylaws. The Court rejected both arguments based on the same fundamental allegations: the directors had not in fact exercised any business judgment because they expressly avoided approving the two key steps of the multi-step transaction, and the directors were responsible for those steps because they knew the entire multi-step transaction would be consummated substantially concurrently. The directors’ failure to review the merits of each step of the transaction was reckless.

Under Pennsylvania law, which is especially deferential towards directors in the merger context, adherence to the business judgment standard is presumed so long as a majority of the disinterested directors approve the merger unless the disinterested directors did not assent to such act in good faith ***after reasonable investigation***.

The Court found that the complaint sufficiently alleged that the directors failed to conduct a reasonable investigation into whether the transaction as whole (including the additional debt burden and the carve-out transaction) would render the company insolvent. The complaint alleged that the directors had excluded from their approval the two steps in the multi-step transaction that rendered RemainCo insolvent, even after Sycamore substantially increased the debt burden and decreased its equity contribution. The Court concluded that the business judgment rule did not apply because the rule, even under the deferential merger standard, only protects decisions undertaken after reasonable investigation and the complaint alleged there was no investigation (reasonable or otherwise).

Furthermore, the Court rejected the directors’ argument that they could not be liable for actions effectuated after they ceased to be in control of the company, explaining that, accepting the allegation in the complaint as true for purposes of the motion to dismiss, the multi-step transaction “reasonably collapses into a single integrated plan.”[3] In making this determination, the Court found it significant that the directors allegedly knew about the post-merger steps and, further, that those post-merger steps were certain to occur upon approval of the transaction. In a different recent decision in the Southern District of New York, *In re Tribune Co. Fraudulent Conveyance Litigation*, 2018 WL 6329139 (S.D.N.Y. Nov. 30, 2018), the court declined to collapse a two-step LBO transaction where the second step occurred more than six months after the first and its occurrence was subject to various preconditions including regulatory approval and the issuance of a second solvency opinion.[4] Contrasted to the facts here, where all five steps of the transaction were certain to occur substantially concurrently, the second step in *Tribune* was subject to conditions precedent that might not be satisfied and, therefore, was not certain to occur when the first step occurred or when the board members resigned.[5]

Exculpatory Bylaw Provisions Did Not Protect the Directors

Jones Group's bylaws contained an exculpatory provision that limited a director's monetary liability to breaches involving self-dealing, willful misconduct, or recklessness. The Court found that the complaint sufficiently alleged that the directors' decision to set in motion the multi-step transaction, including the two steps that allegedly rendered the company insolvent and stripped it of its best assets, without reviewing the merits of those steps, was reckless.

The complaint alleged that the directors consciously disregarded whether the additional debt and carve-out transactions were in the best interests of the company by specifically excluding those elements of the transaction from their assessment or approval. The Court found that the complaint also alleged certain "red flags" that should have put the director defendants on notice that the additional debt and carve-out transactions would leave the company insolvent.

The first red flag was that the $2.2 billion valuation that the company received in the transaction, minus the $800 million historical purchase price of the carve-out businesses, implied that the rest of Jones Group was worth, at most, $1.4 billion. This relatively simple math—that a company worth no more than $1.4 billion was to be saddled with $1.55 billion of debt—should have alerted the directors that they needed to investigate RemainCo's solvency. The second red flag was the simple fact that the increased debt burden would increase the debt to EBITDA ratio to between 6.6 and 7.8—both of which were substantially above the 5.1 maximum ratio that Citigroup had previously advised the board was sustainable.

The Court held that the red flags alleged in the complaint, coupled with the failure of the board to conduct any investigation in the face of such notice, was reckless. The denial of the motion to dismiss and conclusion that the complaint adequately alleged recklessness is premised in large part on the directors' alleged decision to abdicate their duties by not reviewing the merits of two of the steps of the multi-step transaction and not an indication that an informed, but incorrect, assessment of the merits of the transaction would not have been protected.

Aiding and Abetting the Breach of Fiduciary Duty Claim

In addition to claims for their own breaches of fiduciary duty, the directors also faced allegations of aiding and abetting the breaches of the fiduciary duties of the two Sycamore principals who became directors after the closing of the merger. The Court, rather summarily, upheld this claim for two reasons.

First, the Court rejected the directors' argument that any acts taken before the Sycamore principals became directors cannot form the basis of this claim, finding that no such temporal requirement for the fiduciary relationship existed, and that there were no grounds for creating one. The allegations that the directors had enabled the Sycamore directors to strip away assets and overleverage RemainCo by approving the merger without reviewing the merits of the transfers of the crown jewels or the additional debt, even though the directors allegedly had actual knowledge these additional steps would be taken post-merger, was sufficient to state a claim for aiding an abetting the actions of the Sycamore directors.

Second, the complaint adequately pled that the director defendants knowingly participated in the breaches because the same “red flags” discussed above were sufficient to show that the directors had actual or constructive knowledge that the contemplated carve-out transactions constituted a breach of fiduciary duty by the Sycamore principals, which the director defendants knew the Sycamore directors intended to carry out as part of the multi-step transaction. The directors’ decision not to address the merits of two critical steps in the multi-step transaction may even justify an inference that the directors knew that these steps were problematic.

Key Considerations

While this decision is not a departure from established law, it does provide guidance to directors and other interested parties as to what practices must be employed to satisfy their fiduciary duties and minimize liability risk. Process is critical. To obtain the benefits of the business judgment rule directors must actually exercise business judgement and cannot intentionally distance themselves from responsibility for certain steps in an integrated multi-step transaction that they knowingly facilitate, especially when all steps in the transaction occur substantially concurrently.

This opinion denies a motion by the director defendants to dismiss the claims against them. It is not a ruling finally imposing liability. On a motion to dismiss, the court is required to accept all facts in the plaintiff’s complaint as true and to view them in the light most favorable to the plaintiff. Additionally, the Court was applying Pennsylvania law. While fiduciary duty law is fairly similar across jurisdictions, this decision is merely persuasive authority regarding one state’s fiduciary duty laws. That said, the Court refused to apply the business judgment standard, which is one of the key protections available to directors.

This decision reaffirms that directors must thoroughly and meaningfully review all parts of a transaction that are contemplated when they decide whether to approve it, even if some steps of a multi-step integrated transaction may occur after the director is no longer a board member. A director cannot evade the obligation to review part of the transaction by simply excluding it from the board approval analysis. Directors should anticipate that a multi-step transaction may be viewed by a court as a single transaction, even if certain steps are to be completed post-closing by different directors or entities. However, directors can further protect themselves by insisting on a bifurcated transaction structure with meaningful conditions so that any risky steps (e.g., incurrence of additional debt, spinoff transactions, etc.) will only occur if the company is solvent and can support the transaction.

In evaluating a transaction, directors should also consider whether the valuation metrics they receive are compatible all other current financial information that had been provided to the directors. While there is nothing in the *Nine West* decision to indicate that directors cannot rely on the analyses and presentations of advisors and experts, the Court’s comments regarding the disconnect between the numbers provided to the valuation advisors by the proposed buyer and other information available to the directors may imply an expectation that a reasonable exercise of business judgment requires directors to consider whether valuation metrics are at odds with the other information that they have regarding financial performance of the company.

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[1] *In re Nine W. LBO Sec. Litit.*, __ F. Supp. 3d __, 2020 WL 7090277 (S.D.N.Y. Dec. 4, 2020). All of the facts and legal analysis in this memorandum are from the above citation unless otherwise noted.

[2] *Id.* at * 29.

[3] *Id.* at * 30.

[4] *In re Tribune Co. Fraudulent Conveyance Litig.*, 2018 WL 6329139, at *8-9 (S.D.N.Y. Nov. 30, 2018). In step one of the *Tribune* transaction, the company borrowed money to repurchase approximately 50% of its outstanding stock, and then in step two the company borrowed additional money to redeem the remaining stock through a go-private transaction. *Id.* at *2.

[5] This decision does not suggest that a director would be liable for a transaction undertaken by a future board for which the prior board had no knowledge. But these cases suggest that a board may be able to insulate itself from liability for future actions undertaken for which it has knowledge, so long as those future actions are considered in a meaningful way or, like in *Tribune*, future transactions are meaningfully bifurcated from the transaction that the directors approve.

Gibson, Dunn & Crutcher's lawyers are available to assist with any questions you may have regarding these issues. For further information, please contact the Gibson Dunn lawyer with whom you usually work, any member of the firm's Business Restructuring and Reorganization practice group, or any of the following:

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