AMERICAN BANKRUPTCY INSTITUTE

2019 New York City Bankruptcy Conference

Corporate Governance in Distress Situations

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CONCURRENT SESSION

2019

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Related Party Transactions

Fiduciary duty considerations in transactions involving a sponsor and its portfolio companies

May 22, 2019

Related party transactions and the standard of review

- Under Delaware law, sponsors who are controlling shareholders owe fiduciary duties to the companies they control and their minority shareholders, which implicates private equity sponsors in transactions with their portfolio companies.
  - Who constitutes a "controlling shareholder"?
    - De jure → à over 50% shareholder
    - De facto → significant block + exercises sufficient influence over the board

Related party transactions and the standard of review (continued)

- Transactions between sponsor and controlled portfolio company generally means heightened entire fairness review as opposed to more lenient business judgment review.
  - **Business Judgment Rule** – Presumes that directors acted on an informed basis, in good faith, and in best interests of the company. Such actions will be upheld if attributable to rational business purpose.
  - **Entire fairness** – Burden is on sponsor to prove that both price and procedure of deal are fair to other shareholders.
    - Burden may be shifted back to plaintiff if there are procedural safeguards such as (a) a special committee or (b) approval by a majority of the minority investors.
    - If *both* (a) and (b) are present and properly functioning from the outset, then Business Judgment Rule still applies (*MFW Shareholders Litigation*).

Nine West bankruptcy and claims against sponsor Sycamore Partners

- Fashion retailer filed for Chapter 11 in April 2018.
- Unsecured creditors wished to investigate/pursue claims against equity sponsor Sycamore Partners arising from alleged self-dealing fraudulent transfers in connection with the company's 2014 LBO whereby:
  - Nine West sold Jones Apparel, Kurt Geiger and Stuart Weitzman to Sycamore affiliates at below market prices
  - Sycamore affiliates then resold assets for a handsome profit
- The unsecured creditors further accused the debtors of breaching fiduciary duties in offering to give up these fraudulent transfer claims for a fraction of their value.
- Making matters worse, Sycamore was accused of compelling another Sycamore portfolio company and major Nine west customer, Belk Inc., to cease purchasing goods from Nine West for its department stores
- After court-ordered mediation and months of fighting (including a contested confirmation hearing), parties reached a deal whereby Sycamore made a $120 million contribution to settle claims and unsecured creditors received enhanced recoveries.
  - Unsecured creditors had originally asked for standing to bring over $1 billion in claims
  - Judge, however, concluded that deal fell well within the range of reasonableness

RMH Franchise Holdings, Inc.

- RMH was large Applebee's franchisee, operating 163 restaurants in 15 states, second largest in system
- Filed for Chapter 11 after falling behind on royalty and advertising payments to Applebee's, and to stave off franchise termination.
  - Bankruptcy process required that RMH maintain independence from its sponsor in order to strike a deal that was fair to all stakeholders.
  - In bankruptcy, RMH's sponsor, ACON, was represented by Hogan Lovells while RMH retained its own independent counsel (Young Conaway).
- After resolving litigation with Applebee's and secured lender, RMH achieved plan confirmation whereby ACON contributed new money and assumed trade debt and other liabilities in exchange for 100% of equity in reorganized RMH.
- Avoided sales process by securing necessary votes even though plan sponsor was prior equity.

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Potential Conflicts in Private Equity Representation

Best practices when representing both a private equity fund and a distressed portfolio company of the private equity fund

May 22, 2019

Professional Conduct & Ethics

New York Rules of Professional Conduct Rule 1.7 – Conflict of Interest: Current Clients

(a) Except as provided in paragraph (b), a lawyer shall not represent a client if a reasonable lawyer would conclude that either:

(1) the representation will involve the lawyer in representing differing interests; or

(2) there is a significant risk that the lawyer's professional judgment on behalf of a client will be adversely affected by the lawyer's own financial, business, property or other personal interests.

(b) Notwithstanding the existence of a concurrent conflict of interest under paragraph (a), a lawyer may represent a client if:

(1) the lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;

(2) the representation is not prohibited by law;

(3) the representation does not involve the assertion of a claim by one client against another client represented by the lawyer in the same litigation or other proceeding before a tribunal; and

(4) each affected client gives informed consent, confirmed in writing.

Professional Ethics Committee of the NYC Bar Formal Opinion 2001-2

- A law firm may represent a client with interests in a corporate transaction that are adverse to the interests of a current client in a separate matter, and may represent multiple clients in a single matter with disclosure and informed consent, so long as the "disinterested lawyer" test is met.
  - The "disinterested lawyer" test asks if a disinterested lawyer would believe that the lawyer can competently represent the interests of each client. Satisfaction of this test in a non-litigation context depends on the circumstances of the simultaneous representations, including the factors set out below.

NYCB Opinion 2001-2, https://www.nycbar.org/member-and-career-services/committees/reports-listing/reports/detail/formal-opinion-2001-2-conflicts-in-corporate-and-transactional-matters.

"Disinterested Lawyer" – Factors to Consider

- The nature of the conflict
  - Whether the interests are inherently antagonistic or whether the lawyer can simultaneously represent different interests
- The likelihood that client confidences in one matter will be relevant to the other representation
  - Requires appropriate measures to protect each client's confidences
- The ability of the lawyer or law firm to preserve confidential information of the clients
  - Safeguards, such as screening and firewalls, should be offered by the lawyer as control mechanisms to protect client confidentiality
- The ability of the lawyer to explain and sophistication of the client to understand the reasonably foreseeable risks of the conflict
  - A lawyer must make full disclosure of the implications of simultaneous representation, and bot the advantages and the risks involved when seeking consent from each client
  - The client's sophistication matters for consent to a transactional conflict (e.g., a client represented by other counsel or in-house counsel)
- The lawyer's relationship with the clients
  - The "disinterested lawyer" test requires that the lawyer represent both clients with equal and undiminished vigor, and without bias in favor of one client over the other

Bankruptcy Requirements

Section 327(a) of the Bankruptcy Code

- Mandates that bankruptcy professionals, including attorneys, who "represent or assist the trustee in carrying out the trustee's duties under this title" be "disinterested persons"
  - A disinterested person "does not have an interest adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor, or for any other reason." 11 U.S.C. § 101(14).
  - The "disinterested person" requirement under section 327(a) is more restrictive than the "disinterested lawyer" test as discussed by the Professional Ethics Committee of the NYC Bar.

Bankruptcy Requirements

Section 327(e) of the Bankruptcy Code

- "The trustee, with the court's approval, may employ, *for a specified special purpose*, other than to represent the trustee in conducting the case, an attorney that has represented the debtor, if in the best interest of the estate, and if such attorney does not represent or hold any interest adverse to the debtor or to the estate *with respect to the matter on which such attorney is to be employed*." (emphasis added)
  - Less restrictive than section 327(a) retention because it only requires that the attorney does not represent or hold an adverse interest to the special purpose for which the attorney is employed

Federal Rule of Bankruptcy Procedure 2014

- Requires a professional retained in a bankruptcy case to disclose connections of parties-in-interest ("to the best of the applicant's knowledge, all of the person's connections with the debtor, creditors, any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee").

Best Practices

Strategically Plan for Potential Conflicts

- A law firm considering whether to represent both a private equity fund and a distressed portfolio company of the private equity fund should:
  - Consider the likelihood of potential intercompany claims;
  - Evaluate whether a restructuring would involve an actual conflict;
  - Evaluate likelihood restructuring will be implemented through a bankruptcy;
  - Assess whether it can provide undivided loyalty to both clients; and
  - Establish safeguards and measures to preserve confidentiality and protect interests.
- A law firm must plan for potential conflicts and be able to provide undivided loyalty to both clients, including on matters potentially adverse to the private equity fund resulting from the restructuring or potential bankruptcy of the distressed portfolio company.

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