AMERICAN BANKRUPTCY INSTITUTE

Winter Leadership Conference

Corporate Investigations for Companies in Distress: Planning, Process and Execution

Hosted by the Ethics and Professional Compensation & Financial Advisors and Investment Banking Committees

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CONCURRENT SESSION

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American Bankruptcy Institute Winter Leadership Conference 2023

"Corporate Investigations for Companies in Distress: Planning, Process and Execution"

Panelists

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- Mike Nestor – Partner, Young Conaway Stargatt & Taylor, LLP
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- Mike Katzenstein – Senior Managing Director, FTI Consulting

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- Forms of Independent Governance
- Work Plan
- Issues Encountered During Investigations
- SPACs – Understanding and Addressing in Distress

Goal of Corporate Investigation – Certainty and Value

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- Issues To Be Addressed:
  - Releases in Plan
  - Sale of Claims in 363 Sale
  - Review of Pre-Petition Conduct, Distribution, or Transaction
  - Breaches of Fiduciary Duty/Aiding and Abetting

Examiner's Best Practices

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- Initial steps
- Organization of the team
- Government Coordination
- Document Collection and Review
- Witness Interviews
- The Report

Source: The Valukas Letter (Lehman Examiner) (April 1, 2010)

Examiner v. Independent Director Investigations: What is Success?

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"Private" Success

- Bond prices
- Post-bankruptcy net income
- Post-bankruptcy employee headcount
- Creditor recoveries

"Public Success"

- Public confidence
  - Debtors in possession and managers in control—discharging debts
  - Securities markets
  - Justice has been done in context of catastrophic business failure

Cases with "Independent" Directors

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- In 2019, 48% of chapter 11 cases had at least one independent director
  - About one-half of those debtors controlled by private equity
- Some of the criticisms
  - Unsecured creditors recover, on average, 21% less when independent director appointed
  - Not "independent" because beholden to the private equity sponsors or others who appointed them but position themselves as "quasi trustees"
  - Structural and "auditioning" bias, particularly for the "super repeaters"
  - IDs rush to negotiate quick settlement of claims and argue for quick approval to save employee jobs

Source: Jared A. Ellias, Ehud Kamar, and Kobi Kastiel,
The Rise of Bankruptcy Directors (2021)

Examiner Case Outcomes Compared to Outcomes Where No Examiner

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- Pattern of higher bond prices
- Statistically significant higher median net income post-bankruptcy
- Statistically significant higher median post-bankruptcy employee headcount
- Public confidence in fairness

Source: Jonathan C. Lipson & Christopher Fiore Marotta,
Examining Success, 90 Am. Bankr. L.J. 1 (2016)

Examiner Case Examples

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- Caesars Entertainment
  - Reasonable or strong claims for fraudulent transfer valued between $3.6-$5.1 billion
  - Sponsors contributed almost additional $1 billion to plan thereafter
  - Unsecured creditor and second lien noteholder recoveries substantially increased
- Dynegy
  - Debtor's transfer of certain assets to its parent actual fraudulent transfer
  - Board breached fiduciary duty in approving asset transfer
- DBSI
  - Found debtor maintained two sets of books, and CRO that was in place for months had not uncovered the accounting fraud
- Cred
  - "dereliction in corporate responsibility"
  - former chief capital officer a fugitive from justice in United Kingdom who had escaped from prison in a jail break
- Celsius
  - Creditor constituencies clamored for neutral examiner and forced OCUC into agreeing to appointment

Goal of Corporate Investigation (Cont'd)

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- Questions to Ask:
  - What led to transaction at issue?
  - Goal of process/transaction at issue?
  - Stakeholders affected by process/transaction?
  - What is the corporate investigation solving?
    - Sponsor/controller on board or controlling less conflict?
    - Claims against or held by sponsor/controller?
    - Material pre-petition contracts/transactions between sponsor and company/debtor?

Four Touchstones of Proper Governance

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- Haste – avoid haste in making decisions but also appearance of haste
- Preparation - advance dissemination of materials; seek input from advisors/experts as appropriate
- Ask questions – active involvement in process; don't merely accept information presented but, instead, probe and test to assess its accuracy and reliability. (*In re Puda Coal, Inc.*, 2013 Del. Ch. LEXIS 338 (Feb. 6, 2013))
- Accurate record – contemporaneous recording and dissemination of minutes to reflect issues considered and board deliberations. (*Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985))

Independent Governance

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- Forms of Fiduciary:
  - Special Committee
  - Independent Director
  - Special Litigation Committee
  - Chief Restructuring Officer
- Timing – when to implement?
- Scope of Authority and Balance of Control
  - **RESOLVED**, that, subject to the restrictions contained in these resolutions, the [Special Committee] shall have the full power and authority of the Board, to the maximum extent permitted by Section 141(c)(2) of the DGCL and the Bylaws, to take any and all actions on behalf of the Board and the Company that it may deem necessary, advisable or appropriate in connection with any and all aspects of any Potential Transaction, including, without limitation, to evaluate and negotiate one or more Potential Transactions, to manage and administer the process of reviewing Potential Transactions, to determine the appropriate strategy and personnel for engaging in discussions with respect to one or more Potential Transactions, to retain and supervise external advisors with respect to one or more Potential Transactions, to approve or disapprove any Potential Transaction and to take such other actions with respect thereto as shall be authorized in these resolutions, including, without limitation, the approval of any "business combination" for purposes of Section 203 of the DGCL or waiver of the application of said Section 203 to any person in connection with any Potential Transaction.

Best Practices for Independent Governance

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- Standard of review – what is the goal?
  - Business judgment – is this possible?
  - Heightened scrutiny (fair process/price) – is it necessary?
  - Reasonableness of `special committee's conclusions after reviewing independence and good faith of special committee and scope of the investigation
    - Special Litigation Committee Review (*In re Baker Hughes, Derivative Litig.*, C.A. No. 2019-0201-LWW (Del. Ch. April 17, 2023))

Best Practices for Independent Governance

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- Establish independent fiduciary on front end:
  - Single member fiduciary or two<?
    - Burden of independence is hefty/difficult "if a single member [fiduciary] is used," which requires fiduciary to "meet unyielding standards of diligence and independence." *In re Baker Hughes*
  - Independence of fiduciary
    - Fiduciary "should, like Caesar's wife, be above reproach." *In re Baker Hughes*
  - Independence of counsel and, if necessary, financial advisor
  - Full empowerment or limited scope?
  - Sufficient scope/breadth of information and advice to fiduciary
  - Full engagement by fiduciary in process

Best Practices for Independent Governance

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- Issues that have arisen regarding special committee/fiduciary independence:
  - Pay – "director for hire," but, as noted by Vice-Chancellor Fioravanti, "serving as a director on the board of a Delaware corporation is not a pro bono gig."
  - Inappropriately close connection to controller [Question – range of "connections"]
  - Falling victim to "controlled mindset" – did controller control allegedly independent fiduciary?
  - Passive reliance on outside advisors or management
  - Failure to engage in process and understand fundamental aspects of investigation
  - Failure to understand scope of assignment
  - Failure to document deliberations/key decision
  - Acting too quickly

Lawyer's Role

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- "Lawyers can and should give advice. Lawyers can and should tell directors if they believe a course of action could result in a breach of fiduciary duty. And lawyers can and should explain the potential consequences to the company. But lawyers should not be giving orders. If a director determines that fiduciary principles mandate a particular course of action, then the director has a duty to act." (*Hyde Park Venture Partners Fund, III, L.P et al. v. FairXchange, LLC*, C.A. No. 2022-0344-JTL (Ch. Ct. March 9, 2023))

Investigation: Process and Scope

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- Process – independent fiduciary must lead process and make decisions, but advisors will develop process from a legal perspective
- Scope – depends in part on triggering event and typically determined by outside counsel in coordination and discussions with independent directors. Initial scope set based on available information, including:
  - Who is involved (number and seniority of employees, current or past)
  - When and where conduct occurred (and its nature)
  - Whether investigation could lead to other transactions or conduct that require investigation

Work Plan Strategies

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- Implement litigation hold to ensure all relevant documents are retained
  - (contemporaneously with hiring of independent directors, discussed below)
- Develop work plan:
  - Document requests to debtor/parties
    - Process for document review
  - Interviews – board, management, relevant employees/third parties
  - Timeline for investigation, including proposed dates for interim and final reports to fiduciary
  - Keep a record of deliberations of fiduciary and professionals

Best Practices for Certainty and Maximum Value (Cont'd):

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- Interim reports to independent fiduciary
  - Provide opportunities for fiduciary to ask questions, provide input and direction, and implement changes if necessary
- Draft final report
  - Provide to independent fiduciary sufficiently in advance of meeting
- Draft declaration in support of process – to do or not to do?

Extra Credit – SPACs

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- *Delman v. GigAcquisitions3, LLC*, et al., -- A.3d --, 2023 WL 29325 (Del. Ch. Jan 4, 2023):
- The de-SPAC merger transaction follows the following deal structure:
  - A shell company raises cash in an initial public offering ("IPO"), pursuant to which the shareholders receive shares and fractional warrants to purchase additional shares.
  - The proceeds from the IPO are put into trust for the benefit of the shareholders.
  - The SPAC sponsor administers the SPAC (having selected the board), receives a percentage of the SPAC equity (founder shares), and invests in the SPAC to cover underwriting, legal, and other fees and costs.
  - The organizational documents provide a deadline for a de-SPAC transaction – a reverse merger with a private company – to be completed **or** the SPAC will liquidate and the trust proceeds will be distributed to the public SPAC shareholders with interest.
  - If the SPAC liquidates, the founder shares become worthless and the founder is not reimbursed for the fees and costs that it advanced.

Extra Credit – SPACs

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- Inherent potential conflict in de-SPAC mergers between sponsor and shareholder interests:
  - In a de-SPAC merger, founder typically receives founder shares and warrants in post-merger entity, as consideration for its obligations. At that time, the SPAC will have incurred substantial underwriting, legal and other fees and costs, from which the shareholder trust-funds are shielded and for which the sponsor bears responsibility.
  - There are (at least) three reasons sponsor overwhelmingly favors a merger over shareholder redemptions:
    - First, costs of transaction will be satisfied through a merger, saving founder from bearing substantial costs (millions) if SPAC were liquidated.
    - Second, sponsor receives its sponsor shares, even if value materially diluted, can nevertheless be valuable compared to founder's *de minimis* investment.
    - Third, if cash funding is necessary to satisfy the SPAC's merger with the target, then substantial redemptions by SPAC shareholders could leave the SPAC without sufficient capital to close the de-SPAC transaction.
    - As a result, the sponsor is "incentivized to undertake a value-decreasing transaction because it [will lead] to colossal returns on the [sponsor investment] …" *Id.* at 33.
- Conversely, redemption provides shareholders with option to receive value of investment, with interest, from trust. Without full disclosure about de-SPAC merger transaction, shareholder decisions to invest in post-merger de-SPAC entity can pose great uncertainty and risk of loss
- As in *Delman*, shareholders' "voting interests [are] decoupled from their economic interests" because they could "simultaneously divest themselves of an interest in [the SPAC] by redeeming and [still] vote in favor of the deal." *Id.* at 47-48. Because redeeming shareholders retained their warrants in post-merger business, they had no incentive to vote against even a bad deal.

Extra Credit – SPACs

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- Chancery Court DENIED defendants' motion to dismiss, ruling:
  - Although controller owned fewer than 50% of pre-merger SPAC shares, it nonetheless "controlled" SPAC because pre-merger entity selected and controlled board (with whom there were close ties and influence) and controlled SPAC's most important decision – to merge or liquidate.
  - SPAC board's member were all affiliated and closely aligned with sponsor: "[U]nique" value for sponsor in merger evidenced by "enormous return" on its $25,000 investment – post-merger sponsor shares valued at over $39 million at closing ($32 million when the litigation was filed) and payment of transaction costs.
  - Merger agreement required SPAC to contribute $150 million at closing, including $50 million from shareholder trust account, which could be insufficient if many redemptions

Extra Credit – SPACs

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- Projections from target company included in proxy provided "hockey-stick" increases over 5 years in profits ($0 to $500 million) and in revenue ($9 million to $2 billion), without an impartial/independent financial analysis.
- Proxy assessed post-merger value of $10/share but failed to account for substantial dilution resulting from significant transaction costs, market value of outstanding warrants, and amount of certain public equity (or PIPE) subscription agreements and notes, all of which cut the value/share in half.
- Shareholder voting and economic interests were de-coupled because shareholders could redeem but vote for transaction (which preserved value for their warrants). Not surprising that 98% of shareholders voted for transaction even though 29% of shareholders elected to redeem.
- Defendants argued presumption of entire fairness given purported conflict was rebutted and business judgment standard applied because under under *Corwin v. KKR Financial Holding, LLC*, 125 A.3d 304 (Del. 2015), vote was cleansed through a "fully informed, uncoerced majority." But court summarily rejected argument because proxy was "materially false and misleading…." *Delman*, at 46.

Extra Credit – SPACs

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- How to address in a subsequent chapter 11?

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4. Sample Investigation Task Sheet
5. Article re SPACs: *Delman v. GigAcquisitions3, LLC* – The Inherent Conflicts in de-SPAC Mergers
6. Valukas (Lehman Examiner) Letter on Best Practices for Examiners

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Director Fiduciary Duties and Liability Concerns

Evaluating compliance with fiduciary duties

- When determining whether directors complied with their duties, Delaware corporate law distinguishes between the standard of conduct and the standard of review.
- The standard of conduct – refers to what directors are expected to do and is defined by the duties of loyalty and care.
- The standard of review – refers to the test that a court applies when evaluating whether the directors have met the standard of conduct.

Fiduciary Duties of Care and Loyalty

- Directors of Delaware corporations must uphold the duties of care and loyalty.
  - Duty of care: A fiduciary should act on an informed basis after due consideration of the relevant materials and appropriate deliberation, including the input of appropriate advisors
  - Duty of loyalty: A fiduciary should act in the best interests of the corporation and its shareholders, rather than for any other reason

The Duty of Care – General Standards to Follow

- Directors can fulfill their duty of care responsibilities by acting in an informed and active manner.
  - To be informed, a director must be knowledgeable with respect to the company's business and advised of, or involved in, ongoing negotiations.
  - Retention of independent advisors by the Board enhances a director's ability to be fully informed.
  - The directors should meet with their advisors as often as necessary to faithfully discharge their fiduciary duties under the circumstances.
  - While it may be prudent under certain circumstances for the directors to meet with their advisors in person, telephonic meetings are generally sufficient.

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Breach of The Duty of Loyalty

- Duty of loyalty is potentially implicated when fiduciaries stand on both sides of a transaction or receive a personal benefit not shared with all stockholders (an "interested" director).
- Duty of loyalty is also potentially implicated when fiduciaries are beholden to an interested party, such as an investor (a "non-independent" director).
- Delaware courts consider the duty to act in good faith to be a subset of the duty of loyalty.

Breach of The Duty of Loyalty

Breach of the Good Faith Element of Duty of Loyalty

- A failure to act in good faith may be shown where a fiduciary:
  - Intentionally acts with a purpose other than that of advancing the best interests of the corporation;
  - Acts with the intent to violate applicable positive law; or
  - Intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.
- Grossly negligent conduct (i.e., a breach of the duty of care), without more, does not constitute a breach of the fiduciary duty to act in good faith.

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Potential Liability for Breach of the Duty of Loyalty

Potential Directorial Liability for Breach of the Duty of Loyalty

- Personal monetary liability for breaches of the duty of loyalty (including not acting in good faith, regardless of a personal financial interest in the transaction in question) cannot be exculpated.
- Indemnification is not available for breaches of the duty of loyalty or for acts not in good faith.
- As mentioned previously, grossly negligent conduct (i.e., a breach of the duty of care), without more, does not constitute a breach of the fiduciary duty to act in good faith and cannot result in monetary liability.
  - But to the extent that grossly negligent conduct *also* represents a failure to act in good faith, it represents a breach of the duty of loyalty and can give rise to monetary liability.

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Standards of Judicial Review of Directors' Actions

- Under Delaware law, there are three tiers of judicial review for evaluating the conduct of a director of a corporation:
  - Business Judgment Rule (default standard)
  - Enhanced Scrutiny (intermediate standard)
    - Applies to sale of control of an entity
  - Entire Fairness Standard (strictest standard)

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The Business Judgment Rule

- Under the *Business Judgment Rule*, a board's decisions are presumed to have been made
  - on an informed basis,
  - in good faith, **and**
  - in the honest belief that the decision taken was in the best interests of the corporation and its stockholder(s).
- Unless this presumption is rebutted, a court will not second-guess the reasonableness of a board's decision if the decision can be attributed to any rational business purpose.
- To rebut the presumption, a plaintiff has the burden of proving that the board has committed a breach of the duty of care or loyalty.
- Under Delaware law, a board's inaction is not protected by the *Business Judgment Rule*. The *Business Judgment Rule* does apply, however, to a deliberate decision by a board to refrain from taking action.

The Business Judgment Rule

- Directors, acting on an informed basis and in good faith, are thus permitted to take risks (even when a corporation is insolvent) and should not be subjected to liability if their decisions do not bear positive results.
  - "The incantation of the word insolvency . . . should not declare open season on corporate fiduciaries. Directors are expected to seek profit for stockholders, even at risk of failure. With the prospect of profit often comes the potential for defeat." *Trenwick,* 906 A.2d at 174.
  - "If the board of an insolvent corporation, acting with due diligence and good faith, pursues a business strategy that it believes will increase the corporation's value, but that also involves the incurrence of additional debt, it does not become a guarantor of the strategy's success. That the strategy results in continued insolvency and an even more insolvent entity does not in itself give rise to a cause of action. Rather, in such a scenario the directors are protected by the business judgment rule." *Id*.at 205.

Enhanced Scrutiny

- Enhanced scrutiny is Delaware's intermediate standard of review. It applies to potential conflicts of interest where the realities of decision making can subtly undermine the decisions of even independent and disinterested directors. This might occur, for example, if directors favor one transaction over another because of a promise of future employment with the favored bidder.
- Enhanced scrutiny typically comes into play when control of a company is to be sold; the Court will apply the *Revlon* standard to ascertain if the directors have obtained the best available transaction for the benefit of the stockholders.

Enhanced Scrutiny – *Rural Metro*

- Because the enhanced scrutiny standard could, <u>in theory</u>, apply to the sale of assets of a Portfolio Company, insofar as control of each entity is being sold, we quote at length from the decision in *In re Rural Metro Corp. Stockholders Litig.,* 88 A.3d 54, 90 *(Del. Ch. 2014)* regarding the duties of an independent director, particularly as the case provides a good summary of the expected role of directors in the sale of a company:
- "As applied in M&A situations, the enhanced scrutiny standard of review asks whether the defendant directors employed a reasonable decision making process and reached a reasonable result. **There is, of course, "no single blueprint that a board must follow to fulfill its duties."** **"Directors are not required by Delaware law to conduct an auction according to some standard formula . . . ."** Nevertheless, the range-of-reasonableness standard has substance, and Delaware Supreme Court precedents offer meaningful guidance. *See Malone v. Brincat,* 772 A.2d 5,10 (Del. 1998) (explaining that "the fiduciary duty of a Delaware director is unremitting" and that "the exact course of conduct that must be charted to properly discharge that responsibility will change in the specific context of the action the director is taking with regard to either the corporation or its shareholders," but stressing that "[t]his Court has endeavored to provide the directors with clear signal beacons and brightly lined-channel markers as they navigate with due care, good faith, and loyalty on behalf of a Delaware corporation and its shareholders").

Enhanced Scrutiny – *Rural Metro*

- "One of the Delaware Supreme Court's clearest teachings is that **"directors cannot be passive instrumentalities during merger proceedings."** "[A] board of directors . . . may not avoid its active and direct duty of oversight in a matter as significant as the sale of [a corporation.]"; **Moreover, directors must maintain "an active and direct role in the context of a sale of a company from beginning to end."** Part of providing active and direct oversight is becoming reasonably informed about the alternatives available to the company. "The need for adequate information is central to the enlightened evaluation of a transaction that a board must make." "[M]ergers or recapitalizations . . . may be authorized by a board only advisedly. There must be a reasonable basis for the board of directors involved to conclude that the transaction involved is in the best interest of the shareholders. **This involves having information about possible alternatives." The scope of the required information includes a reasonably adequate understanding of the value of not engaging in a transaction at all. Directors must "act on an informed basis to independently ascertain how the merger consideration being offered . . . compare[s] to [the company's] value as a going concern." ("[T]he Board was entitled, indeed arguably required . . . to consider the attractiveness of [the offer] in light of the company's fundamental value.")**. **The directors not only must receive the information, but also have adequate time to consider it. "The imposition of time constraints on a board's decision-making process may compromise the integrity of its deliberative process. History has demonstrated boards that have failed to exercise due care are frequently boards that have been rushed.**
- " Another part of providing active and direct oversight is acting reasonably to learn about actual and potential conflicts faced by directors, management, and their **advisors. In a sale process, "the role of outside, independent directors becomes particularly important because of the magnitude of a sale of control transaction and the possibility, in certain cases, that management," and here I add other interested parties, such as contingently compensated professionals like investment bankers, "may not necessarily be impartial**." Because of the central role played by investment banks in the evaluation, exploration, selection, and implementation of strategic alternatives, directors must act reasonably to identify and consider the implications of the investment banker's compensation structure, relationships, and potential conflicts."

The Business Judgment Rule and Entire Fairness

- The strict "*Entire Fairness"* standard applies instead of the *Business Judgment Rule* where
  - an actual conflict of interest affects a majority of the directors making a decision,
  - interested persons control or dominate the directors(s) making a decision,
  - a decision involves a controlling owner, ***or***
  - a plaintiff shows that the directors(s) committed a breach of the duty of care or duty of loyalty.

Entire Fairness: When Applicable

- When a Delaware corporation enters into a transaction with a controlling shareholder that owns less than 100%, a Delaware court will not give the corporation the benefit of the business judgment rule, but instead, it will subject the transaction to entire fairness scrutiny. *Kahn v. Tremont Corp.*, 694 A.2d 422, 428 (Del. 1997).
- When a Delaware corporation enters into a transaction with a parent that owns 100% of its shares, a Delaware court will review the transaction under the business judgment rule. *Hamilton Partners, L.P. v. England,* 11 A.3d 1180,1210 (Del. Ch. 2010).

Entire Fairness: Standard of Review

- The entire fairness standard is "Delaware's most onerous standard." *Reis v. Hazelett Strip-Casting Corp.*, 28 A.3d 442, 459 (Del. Ch. 2011). "Not even an honest belief that the transaction was entirely fair will be sufficient to establish entire fairness. Rather, the transaction itself must be objectively fair, independent of the board's beliefs." *Id.*
- To prove a transaction was "entirely fair," directors must show:
  - <u>Fair dealing</u>: Courts focus on questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained.
  - <u>Fair price</u>: Courts focus on all relevant factors related to the economic and financial considerations of the transaction.
  - <u>Entire fairness will typically come into play in the context of a management buy-out, or a buy-out by a controlling stockholder. It is not clear that those facts would apply here.</u>

PRACTICAL ADVICE – Checklist for Directors Complying with Fiduciary Duties

- In evaluating breach of fiduciary duty claims, the following checklist summarizes conduct DE courts have cited in criticizing the actions of a director of a corporation:
  - acting too quickly
  - passive or sole reliance on outside advisors or management
  - utilizing advisors that are not independent and disinterested or are inexperienced
  - delegating key negotiations or due diligence to management
  - failure to negotiate aggressively
  - failure to understand key documents or fundamental aspects of a transaction
  - failure to review reasonably available information
  - failure to ask questions
  - failure to consider reasonable alternatives
  - failure to understand the scope of the assignment
  - failure to take into account different factual circumstances (i.e., one size does not fit all)
  - failure to document key decisions
  - falling victim to a controlled mindset and allowing a controlling party to dictate alternatives or terms

PRACTICAL ADVICE – 5 TOUCHSTONES FOR DELAWARE DIRECTORS TO FOLLOW-- Haste

- The following list reflects five principles or issues that should inform the conduct of Delaware directors in ensuring compliance with their fiduciary duties:
- HASTE – Avoid not only haste in making decisions, but also the appearance of haste. Although the DE courts have recognized that circumstances beyond the control of the board may require an accelerated timetable when making a decision (such as a deadline imposed by a bona fide bidder), more likely than not, a Delaware court will question the reason for the haste. Prudent practice suggests that major decisions should be taken only after directors have had a full opportunity to digest all available material information. Practically speaking, this may mean introducing a subject at one board meeting, presenting an overview of the proposed action, and then tabling consideration for the following meeting, so as to allow board members to reflect upon the matter in a mature way.

Practical Advice – The 5 Touchstones - Preparation

- PREPARATION
- Delaware courts have been particularly critical of directors who acted without having availed themselves of available material information.
- The chairman and management should provide pertinent information to the board as far in advance of the meeting as possible. If time permits, advance dissemination of data and other materials will enhance the opportunity for a director to become adequately informed prior to acting. A board member should consider such materials, together with any other reasonably available information before acting. If a board member wants the input of inside or outside experts on a topic, he or she should request that input sufficiently far in advance of a meeting to allow the company to arrange for appropriate presentations.

Practical Advice – The 5 Touchstones -- Ask Questions

- ASK QUESTIONS
- Individual board members should take an active interest in every decision they are called upon to make. The Delaware courts have encouraged activity on the part of directors, often focusing on whether individual members of the board asked questions of management or outside consultants. The unifying theme in the various decisions addressing this point appears to be that directors should not merely accept information presented to them, but instead should probe and test it, judge its reliability and accuracy, and understand it fully. The *Puda Coal* case underscores this point.
- Importantly, the minutes of meetings should also reflect directors asking questions. The minutes do not need to reflect every question asked by a director, but, assuming questions were asked, that fact should be memorialized in the minutes.

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Practical Advice – The 5 Touchstones – Keep minutes

- KEEP ACCURATE MINUTES
- A lack of a contemporaneously prepared set of minutes of a meeting may trouble a reviewing court.[69] Although this is admittedly less important in small, privately held companies, it is extremely important in publicly held corporations that may find themselves the subject of shareholder scrutiny.
- Every effort should be made to prepare drafts of minutes as close in time to the actual meeting as practicable. Disagreements that occur at meetings do not necessarily need to be reflected in minutes, but significant dissension on an issue or a disagreement on a vote should be recorded.

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Practical Advice – The 5 Touchstones –Avoid acting on new matters

- Review relevant documents in advance.
- Avoid acting on matters that should be documented without a prior review of the relevant documents. Although it is not the law that a Delaware director may only approve a “final” draft of a document, directors who give approval to a transaction without having reviewed its material terms may find themselves subject to judicial criticism. *See generally Van Gorkom*.
- If the documents are available, they should be presented to the board for review prior to the meeting. If they are not available until the meeting itself, counsel or other experts should review with the board each and every material provision, and allow members an opportunity to ask questions and to become familiar with the documents they are being asked to approve.
- The board and its advisors should generally anticipate that materials presented at a meeting will need to be produced in discovery, so care and attention should be paid to the materials that are disseminated to the board in advance of a meeting.

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Special Considerations and Protections for Independent Directors

- As a policy matter, Delaware courts seek to encourage individuals to serve as independent directors of Delaware corporations. Accordingly, the case law frequently confirms the need to protect such directors, even when a corporation is dominated by a controlling stockholder (as Ms. Tilton might be considered here):
- Independent directors are presumed to be motivated to do their duty with fidelity. *Leal v. Meeks*, 115 A.3d 1173 (Del. 2015).
- As observed in *Leal,* the fact that a director serves on the board of a corporation with a controlling stockholder "does not automatically make that director not independent … [the court will not] presume that an independent director is not entitled to the protection of the business judgment rule solely because the controlling stockholder may itself be subject to liability for breach of the duty of loyalty if the transaction is not entirely fair to the minority stockholders."
- "We decline to adopt an approach that would create incentives for independent directors to avoid serving as special committee members, or to reject transactions solely because their role in negotiating on behalf of the stockholders would cause them to remain as defendants until the end of any litigation challenging the transaction."

The Warning from *Puda Coal* for Independent Directors

- In the case of *In re Puda Coal, Inc. Stockholders Litig.,* 2013 Del. Ch. LEXIS 338 (Feb. 6, 2013), then Chancellor Strine issued a stern warning shot to independent directors in the course of a hearing on whether fiduciary duty claims against independent directors should be dismissed.
- Because of the authoritative role of this decision around the law of independent directors, we quote from it at length on the next 2 slides. The overarching message of *Puda Coal*: if independent directors see something wrong, they must speak up; if they are serving on the board for a company whose business they do not understand, they must seek guidance from professionals, or choose not serve on the board in the first place:

The Warning from *Puda Coal* for Independent Directors

- "**Independent directors who step into these situations involving essentially the fiduciary oversight of assets in other parts of the world have a duty not to be dummy directors.** I'm not mixing up care in the sense of negligence with loyalty here, in the sense of your duty of loyalty. I'm talking about the loyalty issue of understanding that if the assets are in Russia, if they're in Nigeria, if they're in the Middle East, if they're in China, that you're not going to be able to sit in your home in the U.S. and do a conference call four times a year and discharge your duty of loyalty. That won't cut it. That there will be special challenges that deal with linguistic, cultural and others in terms of the effort that you have to put in to discharge your duty of loyalty.
- "**There's no such thing as being a dummy director in Delaware, a shill, someone who just puts themselves up and represents to the investing public that they're a monitor. Because the only reason to have independent directors -- remember, you don't pick them for their industry expertise. You pick them because of their independence and their ability to monitor the people who are managing the company.** And a lot of life -- I would not serve on -- if I were in the private sector -- not that anybody would want me -- but there are a lot of companies on boards I would not serve because the industry's too complex. **So if I can't understand how the company makes money, that's a danger. If it's a situation where, frankly, all the flow of information is in the language that I don't understand, in a culture where there's, frankly, not legal strictures or structures or ethical mores yet that may be advanced to the level where I'm comfortable? It would be very difficult if I didn't know the language, the tools. You better be careful there.** You have a duty to think. You can't just go on this and act like this was an S&L regulated by the federal government in Iowa and you live in Iowa.

The Warning from *Puda Coal* for Independent Directors

- "**There's also another thing that in my view states a claim for breach of fiduciary duty, which is the behavior of these directors once they recognized what the insiders had done.**

- "I'm not sure that the Monty Python response -- and I refer to the scene involving the words "run away." I don't believe that -- **there are some circumstances in which running away does not immunize you.** It in fact involves a breach of duty. And I think the extreme circumstances here might well constitute one. If these directors are going to eventually testify that at the time that they quit they believed that the chief executive officer of the company had stolen the assets out from under the company, and they did not cause the company to sue or do anything, but they simply quit, I'm not sure that that's a decision that itself is not a breach of fiduciary duty. And that's another reason for sustaining the complaint."

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To Whom Do Directors of Delaware Corporations Owe Fiduciary Duties, Generally?

- Fiduciary Duties – Solvent Corporations
  - Directors owe fiduciary duties to the corporation's stockholders.
  - **Directors of a solvent corporation do not owe fiduciary duties to creditors**. *Cf. N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla,* 930 A.2d 92, 99 (Del. 2007) (no duties beyond relevant contractual terms.
- Fiduciary Duties – Insolvent Corporations
  - When a corporation is insolvent, its creditors become part of the corporation's residual beneficiaries.
  - Nevertheless, **even in insolvent corporations (as well as corporations in the "zone of insolvency"), directors do not owe direct fiduciary duties to creditors.** *Gheewalla* at 103.
  - NOTE: this differs from the approach in Bankruptcy, where the directors DO owe fiduciary duties to the creditors. (See discussion below.)

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To Whom Do Directors of a Wholly-Owned Subsidiary Owe Fiduciary Duties?

- Fiduciary Duties – Solvent Wholly-Owned Corporation
  - Directors of a solvent wholly-owned corporation owe fiduciary duties to the corporation's parent company and its shareholders. *See Trenwick Am. Litig. Trust v. Ernst & Young*, 906 A.2d 168, 200 (Del. Ch. 2006).
  - Directors of a solvent wholly-owned corporation do not owe fiduciary duties to creditors. *Cf. Quadrant Structured Prods. Co. v. Vertain,* 102 A.3d 155, 184 (Del. Ch. 2014) (holding that upon an insolvency of a wholly owned corporation, the creditors take the place of the shareholders as the residual beneficiaries of any increase in value, and that a transfer in value from an insolvent sub to its controller parent creates a derivative claim for the creditors of that subsidiary).
- Fiduciary Duties – Insolvent Wholly-Owned Corporation
  - Logically, the holding in *Gheewalla* would mean that no fiduciary duties run to the creditors of a corporation, whether it be wholly-owned or otherwise. Nevertheless, *Quadrant* reaches the opposite result. The approach suggested in *Quadrant* is more akin to the approach under Bankruptcy, wherein the directors are viewed as having duties that run to the creditors and the stockholders. (See further discussion below.)

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Fiduciary Duties in a Chapter 11 Bankruptcy

- It is clear and well settled that the officers, directors and employees of a corporate Chapter 11 debtor-in-possession owe the same fiduciary duties as a bankruptcy trustee.
- Although it is well accepted and established that in a Chapter 11, fiduciary duties of directors will expand to include creditors, there is not necessarily uniform acceptance of what reviewing standard a court will apply.
- As observed at length by J. Ronald Trost and Roger G. Shwartz in their seminal ABA-ABI materials on Fiduciary Duties in a Chapter 11:
  - "The filing of a Chapter 11 petition is a bright line upon which the allegiance, goals and fiduciary duties of corporate directors are transformed. Indeed, upon the filing of a chapter 11 case, the directors of the debtor corporation continue to operate the business and to manage the assets as a debtor-in-possession. Under the Bankruptcy Code, the debtor-in-possession assumes the rights and duties of a trustee. **As a consequence, the directors of the debtor-in-possession, like a trustee, have fiduciary obligations to protect the interests of creditors, and perhaps, other constituencies involved in the case.**

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Fiduciary Duties in a Chapter 11 Bankruptcy

- “Although it is well established that directors of a debtor-in-possession owe fiduciary duties to creditors, **the precise scope and nature of such duties is not clear**. Indeed, beyond the express provisions of the Bankruptcy Code that protect creditors and the bankruptcy estate from criminal misconduct and the wasting of estate assets, **case law has not adequately defined the parameters of the fiduciary duties that directors of a debtor-in-possession owe to creditors of the debtor corporation.**
- “**One of the primary difficulties in defining the scope of a debtor-in-possession's fiduciary duties to creditors is accounting for the competing interests of the creditors, shareholders and other constituencies involved in the case through which the directors of a debtor-in-possession must navigate.** For example, as a statutory matter, pursuant to the priority scheme established by the Bankruptcy Code, unless waived, creditors of the insolvent corporation are entitled to full recovery from the debtor prior to shareholders receiving any distributions under a plan of reorganization. **This statutory scheme creates an inherent conflict of interest between creditors and shareholders.** Moreover … directors and managers are commonly called upon to resolve three basic conflicts in the reorganization context: (1) the levels of investment risk the corporation should seek while it determines whether or how to reorganize; (2) the degree to which assets of the company should be liquidated rather than reorganized; and (3) the mix of cash, debt and equity that is to be distributed under a plan of reorganization and the parties who are to receive such distributions.

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Fiduciary Duties in a Chapter 11 Bankruptcy

- "Courts considering the question of whether a debtor-in-possession has satisfied its fiduciary duties to creditors of the debtor corporation generally have applied two different standards: **(i) a business judgment standard; and (ii) a more stringent trustee-type standard. Under the business judgment standard, courts have held that the fiduciary duties that debtors-in-possession owe to creditors are similar to the duties that directors of a solvent corporation owe their shareholders outside of bankruptcy.** In practice, this standard makes the duties of care and loyalty applicable to the debtor-in-possession. To this end, debtors-in-possession are prohibited from any form of self-dealing, including taking a corporate opportunity at the expense of the estate. Debtors-in-possession must also exercise 'the degree of care that a person of ordinary intelligence and prudence would exercise.'
- "The substance of the duty of care, as applied in chapter 11, is to require the debtor-in-possession to protect and conserve property for the benefit of creditors, and to refrain from acting in a manner which could damage the value of the estate or hinder a successful reorganization. **Essentially, this standard requires debtors-in-possession 'to act in the best interests of the Bankruptcy Estate' in order to satisfy their fiduciary duties. Some courts have suggested that the duty to act in the best interests of the estate requires the debtor-in-possession to seek to maximize the value of the estate.**

Fiduciary Duties in Chapter 11 Bankruptcy

- "In contrast, some courts and commentators have suggested that a more stringent standard, akin to that of a common law trustee, is the more appropriate standard to apply to determine whether a debtor-in-possession has met its fiduciary duties.
- " According to Bowles and Rapoport, **there are two primary differences between a trustee-type standard of care and a business judgment standard of care: (1) under a trustee-type standard, debtors-in-possession may be liable for ordinary negligence in the performance of their duties, whereas more than mere negligence is required under the business judgment standard; and (2) under the trustee-type standard, debtors-in-possession may have a higher duty to reveal information surrounding a proposed transaction."**

Fiduciary Duties in Chapter 11 Bankruptcy

- The tension suggested in the previous slide regarding the application of the business judgment rule versus the more stringent trustee-type standard is also suggested or underscored in the Delaware case law.
- Some cases in the Delaware bankruptcy court, for example, discussed in the next slide, have suggested a trustee-type approach, while others have clearly supported a business judgment-type review.

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Fiduciary Duties in a Chapter 11 Bankruptcy

- Under one of the leading Delaware cases on this question, the debtor's directors "bear essentially the same fiduciary obligation to creditors and shareholders **as would the trustee** for a debtor out of possession." *In re Nugelt, Inc.*, 142 B.R. 661, 666 (Del. Bankr. 1992).
- As also observed in *Nugelt*: "[T]he willingness of courts to leave debtors in possession is premised upon an assurance that the officers and managing employees can be depended upon to carry out the fiduciary responsibilities of a trustee…. The hallmark of a trustee is accountability and segregation of funds." *Id*.
- Although not directly in conflict with *Nugelt,* it has also been observed that a "debtor in a Chapter 11 bankruptcy has a fiduciary duty to act in the best interest of the estate as a whole, including its creditors, equity interest holders and other parties in interest." *LaSalle Nat. Bank v. Perelman*, 82 F.Supp.2d 279, 292 (Del. Bankr. 2000).
- "The fiduciary duties that a debtor [and its directors] owes the estate are comparable to the duties that the officers and directors of a solvent corporation owe their shareholders outside bankruptcy …. **The debtor has a duty to use reasonable care in making decisions but once those decisions are made, the debtor is protected by the business judgment rule.** Furthermore, the debtor has a duty of loyalty and must not engage in any form of self-dealing." *Id. See also In re Nortel Networks, Inc.,* 522 B.R. 491, 516 (Del. Bankr. 2014).

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Fiduciary Duties in a Chapter 11 Bankruptcy

- But while "officers and directors [have] a duty to the noteholders at the commencement of the bankruptcy cases, the officers and directors also had other duties. For example, they had a duty to enforce the automatic stay to protect the [debtor entity] and their creditors…. Officers and directors should have broad latitude to balance competing interests in a bankruptcy case in order to make decisions that are in the best interests of the estate." *Id.*
- ***So, in a Chapter 11 Bankruptcy, it may be said that the Directors assume a fiduciary duty to all of the constituencies, including creditors. This differs from the duties of Directors of a solvent Delaware corporation, where the fiduciary duties only run to the stockholders.***
- ***What is less clear is whether under Delaware bankruptcy law, the Directors' actions will be evaluated and reviewed under the business judgment rule or the more exacting standard of a trustee. Caution counsels for acting with the vigilance of a trustee, suggesting maximum care, oversight and transparency in all actions being taken by the director(s) of a Chapter 11 debtor.***

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MEMORANDUM

TO:	Board of Directors of [DEBTORS]
DATE:	[●], 2023
RE:	Elements of Potential Claims to be Investigated

This memorandum summarizes the legal requirements of the types of potential claims that [THE DEBTORS] conceivably could have against [THE DEBTORS'] directors, officers, employees, stockholders, lenders or advisors that were investigated by Corporate Governance Counsel: (i) breach of fiduciary duty and aiding and abetting breach of fiduciary duty; (ii) breach of contract; (iii) fraud; (iv) avoidance actions (fraudulent transfer or preference); and (v) equitable subordination and recharacterization.

1. <u>Breach of Fiduciary Duty</u>

Traditionally, directors and officers of a Delaware corporation owe fiduciary duties of loyalty and care to the corporation and its stockholders.

a. Duty of Loyalty

A claim that a director or officer breached the duty of loyalty requires proving that the director or officer:[1]

> harbored self-interest adverse to the stockholders' interests, acted to advance the self-interest of an interested party from whom they could not be presumed to act independently, or acted in bad faith.

In re Orbit/FR, Inc. S'holders Litig., 2023 WL 371640, at *5 (Del. Ch. Jan. 24, 2023). "Bad faith" is generally understood to be "where the fiduciary intentionally acts with a purpose other than

[1] Officers' duties may have "additional dimensions beyond the directors' duty of loyalty because officers act as agents for the entity[,]" such as a duty to provide material information to their superiors. *In re P3 Health Grp. Holdings, LLC,* 2022 WL 16834482, at *2 (Del. Ch. Nov. 7, 2022).

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advancing the best interests of the corporation[,] acts with the intent to violate applicable positive law[, or] intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties." *In re Walt Disney Co. Derivative Litigation*, 906 A.2d 27, 67 (Del. 2006) (emphasis added). A plaintiff alleging a breach of the duty of loyalty must establish that (i) a majority of the board was materially conflicted or acted in bad faith, (ii) the board was dominated by the conflicted/bad faith director(s), or (iii) the conflicts were material and not disclosed to other board members. *Cinerama, Inc. v. Technicolor, Inc*., 663 A.2d 1156, 1168 (Del. 1995).

b. Duty of Care

The fiduciary duty of care requires that:

> in making business decisions, directors must consider all material information reasonably available, and that the directors' process is actionable only if grossly negligent . . . . [T]he standard for judging the informational component of the directors' decisionmaking does not mean that the Board must be informed of *every* fact. The Board is responsible for considering only *material* facts that are reasonably available, not those that are immaterial or out of the Board's reasonable reach.

San Antonio Fire *& Police Pension Fund v. Amylin Pharms., Inc.,* 983 A.2d 304, 318 (Del. Ch.), *aff'd*, 981 A.2d 1173 (Del. 2009). A violation of the duty of care occurs only when a fiduciary's process is grossly negligent, which is said to be evidenced by a "devil-may-care attitude or indifference to duty amounting to recklessness." *Albert v. Alex. Brown Mgmt. Servs., Inc.*, 2005 WL 2130607, at *4 (Del.Ch. Aug. 26, 2005).

The Debtors' Certificate of Incorporation typically exculpate the Debtor's directors from monetary damages for breaches of the duty of care, as permitted by Section 102(b)(7) of the Delaware General Corporation Law (the "DGCL"). 8 *Del. C.* § 107(b)(7). This is a typical and traditional provision for publicly traded Delaware corporations. This means that, even if the Debtor's directors were determined to have acted with gross negligence in making a decision, the

Debtor could not obtain a monetary judgment against them. They could still be liable for breaches of the duty of loyalty, as Delaware law does not permit exculpation for such breaches.

c. Entire Fairness

Even where it is established that a fiduciary breached his or her duty of loyalty or care, the fiduciary may still avoid liability by proving that the challenged decision was entirely fair to the corporation and its stockholders, in terms of both process and price. *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1163 (Del. 1995).

This "entire fairness" analysis is particularly relevant with respect to transactions in which a controlling stockholder stands on both sides of the transaction or receives some benefit that differs from that received by other stockholders. When such controlling stockholder transactions are challenged, the burden falls on the controlling stockholder (who also owes fiduciary duties to the company and the non-controlling stockholders) and the directors approving the transaction to prove that the transaction was entirely fair, or they may be liable for any harm. *See Americas Mining Corp. v. Theriault*, 51 A.3d 1213, 1239 (Del. 2012).

d. Recent Case Law Addressing Fiduciary Duties in the SPAC Context

The Delaware Court of Chancery has issued several recent decisions on motions to dismiss claims that directors violated the duty of loyalty with respect to certain transactions involving Special Purpose Acquisition Companies ("SPACs"). *See, e.g., Delman v. GigAcquisitions3, LLC*, 2023 WL 29325 (Del. Ch. Jan. 4, 2023); *In re MultiPlan Corp. Stockholders Litig.*, 268 A.3d 784 (Del. Ch. 2022). Importantly, the Delaware Supreme Court has not yet addressed these cases to confirm it agrees with the approach of the Court of Chancery.

For example, on January 4, 2023, Vice Chancellor Will issued an opinion in *Delman* declining to dismiss a class action complaint brought on behalf of the plaintiff and other current and former stockholders of the SPAC in connection with a merger between the SPAC and an acquired company wherein the stock of the acquired company fell by almost $3 per share within a month of the closing. 288 A.3d at 706. The first cause of action was for breach of fiduciary duty against the SPAC's board members. The second cause of action was against the primary organizer, sponsor and controlling stockholder of the SPAC. The third cause of action was for unjust enrichment against the same parties.

One of the central issues of the case was whether the claims should be considered direct (belonging to the stockholders themselves) or derivative (belonging to the company, with a stockholder plaintiff proceeding on the company's behalf). The distinction between direct and derivative claims can be elusive, but, at its heart, a derivative claim is one centering on the mismanagement of company assets that causes harm to the company, and to its stockholders only indirectly, with any recovery going to the company itself:

> In *Kramer v. Western Pacific Industries, Inc.,* this Court found to be derivative a stockholder's challenge to corporate transactions that occurred six months immediately preceding a buy-out merger. The stockholders challenged the decision by the board of directors to grant stock options and golden parachutes to management. The stockholders argued that the claim was direct because their share of the proceeds from the buy-out sale was reduced by the resources used to pay for the options and golden parachutes. Once again, our analysis was that to bring a direct action, the stockholder must allege something other than an injury resulting from a wrong to the corporation. We interpreted *Elster* to require the court to determine the nature of the action based on the "nature of the wrong alleged" and the relief that could result. That was, and is, the correct test. The claim in *Kramer* was essentially for mismanagement of corporate assets. Therefore, we found the claims to be derivative.

Tooley v. Donaldson, Lufkin & Jenrette, Inc., 845 A.2d 1031, 1038 (Del. 2004).

By contrast, a challenge by a former stockholder to the fairness or validity of a merger that extinguished the stockholder's ownership interest is generally a direct claim. The Delaware Supreme Court explained:

> Stockholders may sue on their own behalf (and, in appropriate circumstances, as representatives of a class of stockholders) to seek relief for direct injuries that are independent of any injury to the corporation. **A stockholder who directly attacks the fairness or validity of a merger alleges an injury to the stockholders, not the corporation, and may pursue such a claim even after the merger at issue has been consummated**. The problem is that it is often difficult to determine whether a stockholder is challenging the merger itself, or alleged wrongs associated with the merger, such as the award of golden parachute employment contracts.

Parnes v. Bally Entm't Corp., 722 A.2d 1243, 1245 (Del. 1999) (emphasis added).

In *Delman*, without a significant degree of analysis, the Court immediately characterized the claims relating to the de-SPAC as direct, rather than derivative, because they alleged that the defendants' disloyal conduct prevented the public stockholders from receiving adequate information on whether to exercise their redemption rights. *Id*. at 709. As the Court noted, the alleged harms were "individually compensable, separate and distinct from any potential injury to [the SPAC] caused by the merger." *Id*.

The defendants countered that the plaintiffs' claims were derivative because they were essentially asserting that the SPAC overpaid for the acquisition, which harmed the SPAC directly and only harmed the stockholders indirectly insofar as their shares would lose value. *Id*. The Court rejected this analysis: "Because of a SPAC's distinctive structure and the absence of a meaningful vote on the merger, the redemption right is the central form of stockholder protection and the focus of the harm alleged. Interference with that right produces an injury that would not run to the corporation." *Id*.

The Court then ultimately held that the plaintiffs had stated a claim that would withstand a motion to dismiss. Even though the stockholders had voted overwhelmingly in favor of the merger, the Court held that this vote did not serve to cleanse the vote of any board-level conflicts such that the business judgment standard of review would apply:

> Unlike the vote on a typical merger or acquisition, however, the Gig3 stockholder vote on the de-SPAC merger could not reflect its investors' collective economic Stockholders' voting interests were decoupled from their economic interests. Gig3's public stockholders could simultaneously divest themselves of an interest in New Lightning by redeeming and vote in favor of the deal. Many did. Although 98% of all Gig3 stockholders (according to the defendants) voted in favor of the merger, 29% of the public stockholders redeemed their shares.
>
> Public stockholders had no reason to vote against a bad deal because they could redeem. Moreover, redeeming stockholders remained incentivized to vote in favor of a deal—regardless of its merits—to preserve the value of the warrants included in SPAC IPO units. Because this vote was of no real consequence, its effect on the standard of review is equivalently meaningless.

Id. at *19–20.[2] The Court's analysis in reaching this conclusion relied almost exclusively on commentary and articles from academics, rather than established precedent in what is, admittedly, a new area of law for the Court. Thus, whether this reasoning would be upheld by the Delaware Supreme Court remains to be seen.

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[2] In addition to *Delman*, Vice Chancellor Will issued an earlier opinion, in *In re MultiPlan Corp. Stockholders Litigation*, declining to dismiss a claim by stockholders of a SPAC that they had been misled into supporting a merger, and declining to redeem their investment in the SPAC, because of misstatements and omissions by the conflicted directors. *Multiplan*, 268 A.3d 784 (Del. Ch. 2022). In light of *Delman* and *Multiplan*, other members of the Court of Chancery adjudicating SPAC claims have requested additional briefing on the issues. *E.g. Malork v. Anderson, et al.,* No. 2022-0260-PAF (January 11, 2023 letter to counsel requesting further briefing on motion to dismiss centering on whether directors had adequately disclosed facts concerning de-SPAC merger).

e. Aiding and Abetting

To establish a claim that a third party aided and abetted a fiduciary's breach of fiduciary duty, a plaintiff must show: "'(1) the existence of a fiduciary relationship, (2) a breach of the fiduciary's duty[,] (3) knowing participation in that breach by [the alleged aider and abettor],' and (4) damages proximately caused by the breach." *Malpiede v. Townson*, 780 A.2d 1075, 1096 (Del. 2001) (citations omitted). The element of "'[k]nowing participation' means just that—the alleged aider and abettor must know the fiduciary is breaching his fiduciary duty and then must participate, in some way, in that breach." *In re Xura, Inc. Stockholder Litig.*, 2019 WL 3063599, at *3 (Del. Ch. July 12, 2019). A "plaintiff must demonstrate that the aider and abettor had 'actual or constructive knowledge that their conduct was legally improper.'" *RBC Capital Markets, LLC v. Jervis*, 129 A.3d 816, 862 (Del. 2015) (citations omitted).

2. <u>Breach of Contract</u>

"Under Delaware law, plaintiffs must establish the following three elements to succeed on a breach of contract claim: (1) the existence of a contract, whether express or implied; (2) breach of one or more of the contract's obligations; and (3) damages resulting from the breach." *GEICO Gen. Ins. Co. v. Green*, 276 A.3d 462 (Del. 2022).

3. <u>Fraud</u>

"Under Delaware law, fraud consists of the following elements: '(1) a false representation, usually one of fact, made by the defendant; (2) the defendant's knowledge or belief that the representation was false, or was made with reckless indifference to the truth; (3) an intent to induce the plaintiff to act or to refrain from acting; (4) the plaintiff's action or inaction taken in justifiable reliance upon the representation; and (5) damage to the plaintiff as a result of such reliance.'"

Columbus Life Ins., Co. v. Wilmington Tr. Co., 2023 WL 1956868, at *6 (Del. Super. Ct. Feb. 13, 2023) (quoting *Stephenson v. Capano Dev., Inc.*, 462 A.2d 1069, 1074 (Del. 1983)).

4. <u>Avoidance Actions</u>

a. Fraudulent Transfer

Section 548 of the Bankruptcy Code allows a debtor to avoid (i.e., undo) actual fraudulent transfers and obligations made within the two years prior to the filing of the bankruptcy petition. 11 *U.S.C.* § 548(a)(1)(A). A transfer or obligation is voidable as actually fraudulent if it was made "with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted." *Id*. In other words, to avoid a transaction as an actual fraudulent transfer, the debtor must show: "(i) a transfer of an interest of the debtor in property; (ii) made within two years of the petition date; (iii) with actual intent to hinder, delay, or defraud a creditor." *In re Bernard L. Madoff Inv. Sec. LLC*, 2022 WL 493734, at *5 (S.D.N.Y. Feb. 17, 2022).

Section 548 also allows a debtor to avoid "constructive" fraudulent transfers made within the two years prior to the petition. *See* 11 U.S.C. § 548(a)(1)(B). Such a claim requires showing that the debtor <u>both</u> "received less than a reasonably equivalent value in exchange for [the challenged] transfer or obligation" <u>and</u>:

> (I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;
>
> (II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital;
>
> (III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured; <u>or</u>

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> (IV) made such transfer to or for the benefit of an insider, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business.

11 U.S.C. § 548(a)(1)(B) (emphasis added).

Many states have enacted their own actual and constructive fraudulent transfer laws with elements substantively similar to those of the Section 528. See*, e.g.,* 6 *Del. C.* § 1304.

b. Preference

Section 547 of the Bankruptcy Code allows a trustee to "avoid any transfer of an interest of the debtor in property" if the transfer was: (1) "to or for the benefit of a creditor"; (2) "for or on account of an antecedent debt owed by the debtor before such transfer was made"; (3) "made while the debtor was insolvent"; (4) made within 90 days before the petition was filed or within ninety days and one year if the transferee was an insider; and (5) allowed the "creditor to receive more than such creditor would receive if" the "case were a case under chapter 7 of this title[,] the transfer had not been made[,] and "such creditor received payment of such debt to the extent provided by the provisions" of the Bankruptcy Code. 11 *U.S.C.* § 547.

Section 547 does, however, enumerate several situations in which a trustee may not avoid a transfer even if it otherwise satisfies the five required elements, including where the transfer was a "contemporaneous exchange for new value" or was in payment for a "debt incurred by the debtor in the ordinary course of business[,] and the transfer was either made in the ordinary course of business or "according to ordinary business terms[.]" *Id*.

5. <u>Equitable Subordination and Recharacterization</u>

a. Equitable Subordination

Equitable subordination is a remedy that comes into play "when equity demands that the payment priority of claims of an otherwise legitimate creditor be changed to fall behind those of other claimants." *In re SubMicron Sys. Corp.*, 432 F.3d 448, 454 (3d Cir. 2006). "A party seeking equitable subordination must prove the following three elements: '(1) the claimant must have engaged in some type of inequitable conduct, (2) the misconduct must have resulted in injury to the creditors or conferred an unfair advantage on the claimant, and (3) equitable subordination of the claim must not be inconsistent with the provisions of the bankruptcy code.'" *In re Optim Energy, LLC,* 527 B.R. 169, 175–76 (D. Del. 2015) (quoting *Citicorp Venture Capital, Ltd. v. Comm. of Creditors Holding Unsecured Claims*, 160 F.3d 982, 986–87 (3rd Cir. 1998). "'Courts recognize three general categories of behavior that may constitute inequitable conduct: 1) fraud, illegality, or breach of fiduciary duties; 2) undercapitalization; and 3) claimant's use of the debtors as a mere instrumentality or alter ego.'" *Id*.

b. Recharacterization

Recharacterization is a similar remedy, but it focuses on whether a debt "actually exists" or whether the advancement of funds at issue should be considered equity. *In re SubMicron Sys. Corp*., 432 F.3d 448, 454 (3d Cir. 2006). While the Third Circuit Court of Appeals has cautioned against allowing a "mechanistic scorecard" to replace a "common sense evaluation of the facts and circumstances surrounding a transaction[,]" there are a number of factors a court may consider in deciding whether an advancement is debt or equity:

> (a) names given to the instruments, if any, evidencing the indebtedness; (b) presence or absence of a fixed maturity date and a schedule of payments; (c) no fixed rate of interest and interest payments; (d) whether repayment depended on success of the business; (e) inadequacy of capitalization; (f) identity of interests between creditor and stockholder; (g) security, if any, for the advances; (h) ability to obtain financing from outside lending institutions; (i) extent to which the advances were subordinated to the claim of outside creditors; (j) the extent to which the advances were used to acquire capital assets; (k) presence or absence of a sinking fund; (l) presence or absence of voting rights; and (m) other considerations.

In re Autobacs Strauss, Inc., 2012 WL 1836263 (Bankr. D. Del. May 21, 2012) (citations and internal quotations omitted).

__________, 2023

VIA EMAIL

Re: Due Diligence Process

[NAME OF COUNSEL], as counsel to [DEBTORS] (collectively, the "Companies"), has been tasked with conducting diligence (the "Diligence Process") regarding assets and claims of the Companies, against any person or entity proposed to be released under either an out-of-court restructuring transaction or a chapter 11 plan of reorganization. You have been provided with authority by the board of directors of the board with respect to the Diligence Process. The Diligence Process will likely be comprised of three principal components: (i) a review of the Companies' historical corporate records, including non-public documents; (ii) a review of documents from third-parties; and (iii) interviews of all relevant persons. In order to facilitate the Diligence Process, it is important that the following information be provided to [COUNSEL] at the Companies' earliest convenience:

- Lists of persons having institutional knowledge relevant to the purposes of the Diligence Process. As necessary, interviews of certain individuals will be scheduled promptly.

- Minutes, including any attachments, presentations, and packages, of the meetings of any boards of managers of the Companies (collectively, the "Board") from [PREVIOUS 4-6 YEARS] to the present (the "Diligence Period").

- Resolutions or written consents adopted by the Board during the Diligence Period.

- Audited consolidated financial statements of the Companies for the years [PREVIOUS 3-4 YEARS] TO present.

- Unaudited consolidated financial statements of the Companies for the current fiscal year and the previous year if audited financial statements are not yet available for that year.

- Organizational documents (e.g., certificate of incorporation, certificate of designation, bylaws, limited liability company agreements, limited partnership agreements) of the Companies and any of their parents, and any organizational charts reflecting the ownership and relationship among the Companies and any of their parents.

[_________], 2023
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- Lists of any material contracts between or among the Companies.

- Lists of any material contracts between any of the Companies, on the one hand, and any stockholders, officers, managers, members and directors of any of the Companies, on the other (including employment agreements or similar arrangements).

- Lists of distributions and/or payments (if any) made to any stockholders, officers, managers, members and directors of any of the Companies during the Diligence Period other than ordinary-course compensation and benefits.

- Lender registers for any of the Companies' credit agreements and financing arrangements, and copies of all such agreements and arrangements (collectively, the "Credit Agreements").

- Lists of principal and interest payments made under the Credit Agreements during the Diligence Period.

- Any other documents that, to your knowledge, may be relevant to the Diligence Process.

In addition to the foregoing documents, it is likely that additional information, in the form of informal information requests and communications with certain of the Companies' directors and officers, will be requested to supplement the principal components of the Diligence Process. We will make every effort to provide as much lead time as possible in requesting such supplemental materials. We appreciate your time and attention to this task.

We anticipate that after we have reviewed documents in response to the above requests and any supplemental requests, we will schedule interviews with certain individuals regarding the issues implicated by releases contemplated under a chapter 11 plan.

In terms of process of timing, we will preliminary review documents to understand the scope of the Diligence Process, identify potential witnesses, and prepare an anticipated timeline. We expect to review core documents over the course of the next week and provide you with our initial anticipated timeline thereafter. It would be our expectation, barring any delays, that we would conclude the Diligence Process by no later than the Bankruptcy Court's consideration of a disclosure statement that would accompany a chapter 11 plan.

We anticipate reporting to you at least once per week so that you are informed regarding the Diligence Process, have the opportunity to review information and updates, and are able to consider, reflect and exercise your judgment regarding the Diligence Process.

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[DEBTOR] AND SUBSIDIARIES – INVESTIGATION TASK SHEET

I. CREDIT DOCUMENT REVIEW

ID #	Parties	Date	Date Reviewed	Reviewed By	Relevant Terms / Issues	Privilege/Redaction
CREDIT AGREEMENT DATED AS OF [*]						
OTHER CREDIT AGREEMENTS						
OTHER CREDIT AGREEMENTS						
OTHER CREDIT AGREEMENTS						
DEPOSIT ACCOUNT CONTROL AGREEMENT, [IF APPLICABLE]						
PLEDGE AGREEMENT [IF APPLICABLE]						
SECURITY AGREEMENT [IF APPLICABLE]						

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EQUITY CONTRIBUTION AGREEMENT [IF APPLICABLE]						
AMENDMENT TO CREDIT AGREEMENT [IF APPLICABLE]						
CONSENT TO CREDIT AGREEMENT [IF APPLICABLE]						
FURTHER AMENDMENT TO CREDIT AGREEMENT [IF APPLICABLE]						
FURTHER AMENDMENT TO CREDIT AGREEMENT [IF APPLICABLE]						

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AMENDMENT TO CREDIT AGREEMENT [IF APPLICABLE]						
SPECIAL DEPOSIT ACCOUNT CONTROL [IF APPLICABLE]						
NOTICE OF EVENT OF DEFAULT TO CREDIT AGREEMENT [IF APPLICABLE]						
NOTICE OF DEFAULT AND RESERVATION OF RIGHTS [IF APPLICABLE]						
NOTICE OF ACCELERATION EVENT [IF APPLICABLE]						

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FORBEARANCE AGREEMENT [If applicable]						

II. REVIEW OF MINUTES AND RESOLUTIONS

ID#	Board/ Committee	Date	Date Reviewed	Reviewed By	Relevant Issues / Resolutions	Privilege/ Redaction
Meetings or Actions Taken by Written Consent or Resolution						

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MINUTES, CONSENTS OR RESOLUTIONS OF ANY RELEVANT COMMITTEES						

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III. REVIEW OF INSURANCE POLICIES

ID#	Parties	Date	Date Reviewed	Reviewed By	Material Terms	Privilege/Redaction

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IV. REVIEW OF MATERIAL CONTRACTS

ID#	Name and Parties	Date	Date Reviewed	Reviewed By	Material Terms	Privilege/Redaction
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V. REVIEW OF ORGANIZATIONAL DOCUMENTS

Starry, Inc.						
ID#	**Parties**	**Date**	**Date Reviewed**	**Reviewed By**	**Material Terms**	**Privilege/Redaction**
[Relevant subs, if any]						
ID#	**Document**	**Date**	**Date Reviewed**	**Reviewed By**	**Material Terms**	**Privilege/Redaction**
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ID#	**Document**	**Date**	**Date Reviewed**	**Reviewed By**	**Material Terms**	**Privilege/Redaction**
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ID#	**Document**	**Date**	**Date Reviewed**	**Reviewed By**	**Material Terms**	**Privilege/Redaction**

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Relevant subs [if any]						
ID#	**Document**	**Date**	**Date Reviewed**	**Reviewed By**	**Material Terms**	**Privilege/Redaction**
Relevant subs [if any]						
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Relevant subs [if any]						

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ID#	Document	Date	Date Reviewed	Reviewed By	Material Terms	Privilege/Redaction
[Relevant subs, if any]						
ID#	Document	Date	Date Reviewed	Reviewed By	Material Terms	Privilege/Redaction
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VI. REVIEW OF AUDITED AND UNAUDITED FINANCIALS

REVIEW OF AUDITED AND UNAUDITED FINANCIALS						
ID#	**Document**	**Date**	**Date Reviewed**	**Reviewed by**	**Material Terms**	**Privilege/Redaction**

VII. REVIEW OF PUBLIC FILINGS INCLUDING ANY PRESS RELEASES

PUBLIC FILINGS						
ID#	Document	Date	Date Reviewed	Reviewed by	Material Terms	Privilege/Redaction

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VIII. REVIEW OF ANY MATERIAL PENDING LITIGATION

PENDING LITIGATION				
Document	**Date**	**Date Reviewed**	**Reviewed by**	**Material Terms**

IX. LIEN ANALYSIS

LIEN ANALYSIS				
Document	**Date**	**Date Reviewed**	**Reviewed by**	**Material Terms**

X. INTERVIEWS

Interviewee / Position	Date / Time (EST)	RELEVANT NOTES	INTERVIEWERS

Delman v. GigAquisitions3, LLC et al.: The Inherent Conflicts of de-SPAC Mergers[1]

In 2021 and continuing into 2022, the magnitude of SPAC deals was historic. While the number of announced SPAC deals slipped in 2022 (by as much as half) and the number of withdrawn SPACs increased, the initial wave of "busted SPACs" has started, and many are approaching deadlines to consummate business mergers or consider liquidation and restructuring alternatives. At the same time, post-merger transactions are finding their way to the Delaware Court of Chancery. In *Delman v. GigAcquisitions3, LLC*, et al., -- A.3d --, 2023 WL 29325 (Del. Ch. Jan 4, 2023), the Chancery Court identified what it viewed as an inherent conflict as between SPAC shareholders and sponsors in connection with the decision to vote for a de-SPAC merger and, as such, provides guidance for go-forward SPAC structures and shareholder solicitations. Due to the magnitude of SPAC deals in the past 3 years, this article also suggests best practices for mitigating liability for post-merger claims.

1. SPAC Structure

The de-SPAC merger transaction follows the following deal structure:

- A shell company raises cash in an initial public offering ("IPO"), pursuant to which the shareholders receive shares and fractional warrants to purchase additional shares.
- The proceeds from the IPO are put into trust for the benefit of the shareholders.
- The SPAC sponsor administers the SPAC (having selected the board), receives a percentage of the SPAC equity (founder shares), and invests in the SPAC to cover underwriting, legal and other fees and costs.
- The organizational documents provide a fixed period within which a de-SPAC transaction – a reverse merger with a private company – must be completed **or** the SPAC will liquidate and the trust proceeds will be distributed to the public SPAC shareholders with interest.
- In the event of a liquidation of the SPAC, the Founder Shares become worthless and the founder is not reimbursed for the fees and costs that it advanced.

This SPAC structure seems like a "win-win." Shareholders invest in the SPAC and preserve the right to invest in the post-merger de-SPAC entity. The invested funds are held in trust for the shareholders. And, if a merger partner is identified, the shareholders then have the opportunity to choose between investment in the de-SPAC **or** redemption of their investment. However, as the Chancery Court determined in *Delman*, the risk for shareholders may, in certain circumstances, be more material than contemplated.

[1] Written by Mike Nestor and Bob Brady of Young Conaway Stargatt & Taylor, LLP.

2. The Potential Inherent Conflict

The Court began its analysis by noting the importance of a shareholder's right to redeem, noting that

> *[t]he right to redeem is the primary means protecting stockholders from a forced investment in a transaction that they believe is ill-conceived. It is a bespoke check on the sponsor's self-interest, which is intrinsic to the governance structure of a SPAC.*

Id. at 30. Having identified the importance of shareholders' right of redemption, the Court detailed the inherent potential conflict in de-SPAC mergers as between the interests of the sponsor and shareholders:

- In a de-SPAC merger, the founder typically receives founder shares and warrants in the post-merger entity, as consideration for its obligations and responsibilities. At that time, the SPAC will have incurred substantial underwriting, legal and other fees and costs, from which the shareholder trust-funds are shielded and for which the sponsor bears responsibility.

- There are (at least) three reasons that the sponsor would overwhelmingly favor a merger as opposed to shareholder redemptions:

    - First, the costs of the transaction will be satisfied through a merger, saving the founder from bearing the substantial costs (millions) if the SPAC were liquidated.

    - Second, the sponsor receives its Sponsor shares, which, even if the value is materially diluted, can nevertheless be valuable as compared to the founder's *de minimis* investment.

    - Third, if cash funding is necessary to satisfy the SPAC's merger with the target, then substantial redemptions by SPAC shareholders could leave the SPAC without sufficient capital to close the de-SPAC transaction.

    - As a result, the sponsor is "incentivized to undertake a value-decreasing transaction because it [will lead] to colossal returns on the [sponsor investment] …" *Id*. at 33.

- Conversely, a redemption provides the shareholders with the option to receive the value of their investment, with interest, from the trust. Without full disclosure regarding a de-SPAC merger transaction, a decision by shareholders to invest in the post-merger de-SPAC entity can pose considerable uncertainty and risk of loss.

- Importantly, as in *Delman*, shareholders' "voting interests [are] decoupled from their economic interests" since they could "simultaneously divest themselves of an interest in [the SPAC] by redeeming and [still] vote in favor of the deal." *Id.* at 47-48. Since even redeeming shareholders retained their warrants in the post-merger business, they had no incentive to vote against even a bad deal.

Since the sponsor stands to materially benefit from consummating the de-SPAC merger, and since shareholders may be materially impaired by the merger if not adequately informed about the decision to redeem or invest, it is critical that all aspects of the proposed merger are disclosed to shareholders to enable them to be fully informed when deciding what to do with their investment.

3. *Delman*

Since the contextual considerations and concerns of the Chancery Court arose in connection with the claims and allegations in *Delman*, it is not surprising that the facts mirror and support the Court's conclusions. The Court found and ruled as follows:

- In spite of the fact that the controller owned less than 50% of the pre-merger SPAC shares, it nonetheless "controlled" the SPAC since the created the pre-merger entity, selected the board, controlled the board (with whom there were close ties and influence), and controlled the most important decision of the SPAC – to merge or liquidate.

- The members of the SPAC board were all affiliated with the sponsor and closely aligned with the sponsor.

- The "unique" value for the sponsor in the merger was evidenced by its "enormous return" on account of a $25,000 investment – post-merger Sponsor Shares valued at more than $39 million at closing[2] (and $32 million when the litigation was filed) and payment of transaction costs.

- The merger agreement required that the SPAC contribute $150 million at closing, $50 million of which was to come from the shareholder trust account, which could be insufficient should there be a high number of redemptions.

- The projections from the target company included in the proxy provided hockey-stick increases over a 5 year period in profits ($0 to $500 million) and revenue ($9 million to $2 billion), without an impartial/independent financial analysis.

- While the proxy assessed a post-merger value of $10/share, such value failed to account for substantial dilution resulting from significant transaction costs, the market value of outstanding warrants, and the amount of certain public equity (or PIPE) subscription agreements and notes, all of which cut the value/share in half.

- The voting and economic interests of the shareholders were de-coupled since shareholders were able to redeem but nonetheless vote in favor of the transaction (which

[2] The Court noted that this represented a 155,900% return on the sponsor's investment.

preserved value for their warrants). It is not surprising that 98% of shareholders voted in favor of the transaction even though 29% of shareholders elected to redeem.

- Defendants argued that the presumption of entire fairness due to the purported conflicts as rebutted, and the business judgment standard of review applied, since under under *Corwin v. KKR Financial Holding, LLC*, 125 A.3d 304 (Del. 2015), the vote was cleansed through a vote of a "fully informed, uncoerced majority." However, the Court summarily rejected the argument since it found that the proxy was "materially false and misleading…" *Delman*, at 46.

As a result of the Court's findings regarding conflict and the insufficiency of proxy disclosures, the defendants' motion to dismiss was denied as it was "reasonably conceivable that the defendants breached [their] duties of loyalty depriving public stockholders of information material to the redemption decision." *Id*. at 2.

<u>What to do?</u>

When considering go-forward best practices regarding the structure and utilization of SPACs and de-SPAC mergers, *Delman* provides some go-forward guidance – (a) establish independence at the board to preserve review under the business judgement rule; and (b) be clear to disclose in detail in the merger proxy (i) the specific nature and extent of any board conflict(s), (ii) the financial benefits to the sponsor, (iii) deducts to value (costs, PIPE interest and notes), (iv) the actual post-merger stock value (after accounting for costs and dilution), and (v) an impartial assessment of the post-merger projections and enterprise value.

However, since the rapid ascension of SPAC deals has been meet with an equally swift decline, the "practical remedy" available to potential director, officer and sponsor defendants is primarily defensive as de-SPAC mergers are finding their way to Chancery Court. The establishment of a special committee of the board to review and render judgment regarding potential claims may assist in the Court's assessment of the merits of shareholder claims against a purportedly conflicted board. When establishing a special committee, there are 3 critical components: (i) the committee member(s) must be independent, (ii) the special committee must have exclusive authority to investigate the subject claims and provide a recommendation regarding pursuit of such claims, and (iii) the special committee must have independent counsel to assist and advise regarding the subject investigation. While the empowerment of a special committee may not be dispositive regarding the litigation outcome, the judgment of a special committee that is disinterested, independent and that has acted in good faith will receive substantial deference from a Delaware court.

In the event that the post-merger entity finds itself insolvent, in the zone of insolvency, or in a liquidity crisis that necessitates the need to commence a chapter 11 proceeding, the utilization of an independent special committee or independent director to conduct a review of such claims will enable a company to mitigate the cost and uncertainty of derivate claims in three ways First, the judgment of an independent fiduciary who has conducted a review of potential claims will provide support for debtor releases under a chapter 11 plan. Second, in the event that derivative claims are acquired by a buyer in a sale pursuant to section 363 of the Bankruptcy Code, the judgment of such an independent fiduciary will be important in assessing the value ascribed to such claims (if any) to be sold to the buyer. And third, in the event that any viable claims of value are identified by the independent fiduciary in the course of its good-faith investigation, such claims can be settled in the chapter 11 case pursuant to Bankruptcy Rule 9019.

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New York
Washington, DC

April 1, 2010

Via E-mail and US Mail

Diana Adams
United States Trustee
Office of the United States Trustee
33 Whitehall Street, 21st Fl.
New York, NY 10004

Re: Best Practices for Examiners

Dear Diana:

When I undertook my appointment as Examiner in the Lehman bankruptcy, you and Cliff White asked that I report, at the conclusion of my investigation, on suggested best practices that might assist future Examiners perform their work. The Lehman examination was, of course, unique to Lehman; and given its size and scope, practices that worked for Lehman may or may not translate to other examinations. But I offer the following observations.

Initial Steps

Recommendation 1: New Examiners should speak with and review the reports of former Examiners to learn what worked in prior assignments.

The recommendations that follow are not simply mine. As I embarked upon this process, I began by speaking with other Examiners who had served in major proceedings, precisely to get a sense of best practices before I formed my own work plan. I spoke with Richard Thornberg (Worldcom), Neal Batson (Enron), and Josh Hochberg (Refco), and I was greatly assisted by their input. I reviewed the reports filed by those Examiners, and by others, in great detail, to see how they organized, conducted and reported upon their own investigations. All of that was enormously useful and future Examiners should build on our collective experience.

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Recommendation 2: If the Court has not imposed a timetable for the Report, the Examiner should give himself and his team the discipline of a deadline.

The Lehman matter was especially challenging, given the scope of my assignment and the size of the universe I was asked to explore. It was apparent that our factual investigation would require hundreds of witness interviews. The volume of Lehman documents alone was estimated to amount to close to half a trillion pages; and relevant documents resided not just at Lehman but with dozens of third parties. Added to the magnitude of the work was the limit of time. Although the Court did not impose any deadline for the completion of my Report, I was keenly aware of the exclusivity date for the Debtors to suggest a plan and the fact that the value of my Report would be greatly enhanced if I were able to deliver the Report prior to that date.

My team and I ultimately reviewed more than thirty million pages of documents and interviewed more than 250 witnesses; we produced a comprehensive Report and filed it within thirteen months of my appointment. We could have done more work. We had collected millions more pages we might have reviewed; we had billions more pages we might have requested. We had identified hundreds more people we might have talked to. We might have circled back and re-interviewed each of the 250+ persons we had already talked to. But the fact is that doing that additional work might in theory have added marginally to the final product, while the stark reality is that to do so would have come at an unreasonable cost, both in dollars and time. I set a deadline and adhered to it; and the process was better for that.

Recommendation 3: The Examiner should enlist, accept, and use the aid and cooperation of the community.

I have said this before, and I emphasize it again here. My Report could not have been filed as expeditiously as it was without the genuine assistance and cooperation my team and I received from nearly every constituent in the Lehman community.

My order of appointment required that I meet with the interested parties. I would like to think that I would have had the good sense to do exactly that even if the Court had

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not had the wisdom to have ordered it, because those meetings were extremely helpful.

By the time of my appointment, the Debtors, the Creditors Committee, and other parties had assembled documents and performed analyses. We asked for – and were provided access to – all of that work product.[1]

The Debtors, the Creditors Committee and the interested parties were and are represented by the cream of the New York and National bars. These excellent lawyers had excellent suggestions, and our conversations with the parties provided real guidance to steer the investigation. Other Examiners could benefit as I did by seeking out and listening to the parties.

That said, while it is important to seek suggestions and guidance from the parties and their counsel, it is critical that the Examiner maintain independence and objectivity.

Recommendation 4: The Examiner should perform every task necessary to produce a complete report; but do each task once, and do it right. That said, there is utility in doing some early interviews even before document production is complete.

We were eager to begin witness interviews immediately. We needed, of course, to first collect and review documents. But there were exceptions. One of the suggestions made by other Examiners was that a few key interviews – even before document production – could be very useful to inform issues and suggest the direction of the investigation.

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[1] While I am sincere in my praise of the parties' cooperation, I don't want to overstate its contribution to the final Report. I have also said this before: we had hoped that the parties' document collection and analysis, by the time of my appointment four months after the bankruptcy filing, would have been more mature and complete than it turned out to be. Because it was not so, I had to extend the projections I had made for completion of my work. But the fact remains that it is a good practice to feed off the work of others wherever possible.

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We identified a relatively small number of key witnesses to interview even though document production was in its infancy. In general, those early interviews were with persons who (1) would help inform us on overriding issues and (2) would be available and willing to submit to further interviews after document review. And the other Examiners were right – these initial, early interviews did greatly assist the direction of the investigation.

Organization of the Team

Recommendation 5: The Examiner, of course, needs to assemble the right team for the task and organize it efficiently.

Every examination will be different and the manpower and organization needs will vary accordingly. But let me set out what did work for me and this matter as a guide for others.

It was apparent that this matter would require the almost full-time participation of scores of lawyers and financial professionals. Organizing them, coordinating their efforts, and avoiding redundancies and waste would present challenges.

First, we analyzed the 10 issues that had been assigned to me in my order of appointment and sorted them into four substantive areas. Five teams were created – four substantive teams and one administrative team which exercised oversight and coordination.

Second, we assembled a group of senior lawyers as team leaders with backgrounds and experience as trial lawyers, former prosecutors, bankruptcy lawyers, securities specialists and corporate lawyers. Each team was then staffed with other lawyers as necessary. As you know, Bob Byman served as my lead attorney, basically as chief of staff. It was his job to coordinate the activities of the five teams.

Third, each team was required to develop a work plan for my approval, so that they and I had a shared understanding of what work they proposed to do and by what deadlines. The work plans were shared among all of the teams so that we could reach consensus that nothing was overlooked but that nothing was being done twice. The work plans from each team listed the documents they wanted to collect, the search

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terms to be used for collection, and the parties from whom to request documents. The work plans listed the witnesses each team proposed to interview and the anticipated order and dates for interviews. Of course, there were many witnesses listed by multiple teams; Bob would coordinate which team would take the lead for individual witnesses.

Fourth, each team prepared and periodically updated an annotated proof outline of its anticipated sections of the Report. That way, we were able to see early on what areas were covered, what areas remained for planned fills, and whether there were any holes that needed to be plugged.

Fourth, we asked Duff & Phelps, my financial advisors, to organize themselves similarly so that each legal team would have counterparts – dedicated advisors focusing on specific issues. To minimize unnecessary expense to the estate, Duff was asked to periodically list for us each deliverable they had been asked to perform, including the team which had made the assignment and the expected delivery date. Duff was instructed that it was not to perform any tasks unless they were reported on the deliverables list.

When we identified areas which required education on topics that even great lawyers might not be intimately familiar with – topics such as credit default swaps or derivative trading or FAS 157 accounting – we had Duff prepare and give us tutorials. We offered the same tutorials to the government as part of our cooperation with them (see below).

Fifth, we had regular communication among and within teams to ensure that teams and sub-teams did not develop silo mentalities, at the same time avoiding redundancy as much as possible.

Fee examiners in run of the mill cases typically react negatively to billing entries that show inter-office meetings. This was not a run of the mill event. As the investigation unfolded, hundreds of thousands of documents were reviewed daily; multiple witnesses were interviewed each day. Individual witnesses and documents did not usually fit neatly within a single team's responsibility. It was critical that every team knew what every other team was finding in real time.

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We held weekly team leader meetings; key documents were circulated to all team leaders as they were found; interview summaries were circulated to all team leaders as they were prepared. We decided that all team leaders needed to be kept as informed as possible about daily events; each team leader exercised discretion as to whether and to what extent to pass on information to team members.

Government Coordination

Recommendation 6: Government coordination is essential, and best accomplished by regular, agreed protocols.

My order of appointment, of course, required that I cooperate with government agencies that may have an investigative interest in Lehman; but even if I had not been so ordered, cooperation was essential lest the government decide to block or shut down an area of my inquiry.

I initially met with the SEC and representatives of the US Attorneys for the Southern and Eastern Districts of New York and the District of New Jersey. After the initial face to face meetings, we held weekly conference calls for most of the period. We had several other face to face meetings.

We established several protocols that made the process agreeable to the government, so that they did not feel a need to restrict my investigation.

First, we agreed to clear with them any witness before we took an interview. We sent our proposed list of witnesses to the government periodically; after a default period of time (generally 5 business days) without express reservation, we would then be free to schedule an interview. Once scheduled, we would give the government notice of that, so that they had another opportunity to ask us not to interview a particular individual. We asked the government to advise us if there were any questions or subjects they wished us to address in interviews. Over the course of the investigation, the government did ask us to defer speaking to a number of individuals; but eventually, they released us to speak with every person we requested.

Second, we kept the government informed in real time of the significant facts we were developing. Our communications were, as these things almost always are, one way.

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In our weekly calls, we would debrief the government on key information or documents as we learned it.

Third, as mentioned above, we made Duff available – as well as our lawyers who became expert in areas such as Repo 105 – to give the agencies tutorials on subjects they might not be totally familiar with.

Cooperation with the government, of course, includes our interaction with your office. We need not describe to you what that interaction was, but I hope you agree that I achieved my goal to keep you appropriately informed without overly immersing you in unnecessary detail.

Document Collection and Review

Recommendation 7: The Examiner should get – but try not to have to use – Rule 2004 Subpoena power.

Within weeks of my appointment, I filed a motion asking that the Court grant me expansive Rule 2004 subpoena powers. It was important to have subpoena power; and it was equally as important not to have to use it. Having the power gave my lawyers the leverage to negotiate voluntary production on a much faster track than formal process would have provided.

It was also important that the parties knew I would use the power if pressed. There was a single party which did not voluntarily in timely fashion produce the documents we requested. We issued a subpoena to that party and teed up a motion to compel for the Court; and the party decided to produce rather than fight the subpoena. With the exception of a few other instances where a producing party *requested* a subpoena, we were not otherwise required to use formal process or the Court's assistance to get the documents and interviews we sought.

The document experience carried into the way we conducted interviews, which I describe in detail below. But in all areas, the point is that the Examiner's role is investigative but not adversarial. It is necessary to get the facts, to ask the hard questions, to press for complete production. But it is not necessary to do so with an adversarial tone; it was my experience that we achieved full and complete production

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far more quickly by adopting a cooperative tone than we would have through a formal subpoena process.

Recommendation 8: The Examiner will likely be asked to agree to confidentiality stipulations to get documents; he should agree, but perhaps with a standard order.

Nearly every producing party requested confidentiality agreements during document production. As part of the cooperative process, I agreed to any reasonable request for such agreements rather than take the time to negotiate or argue. In retrospect, this is the one area in which I might have acted differently than I did. We ended up with 16 different formal agreements and 5 different informal undertakings. It turns out that only a single agreement has come to issue – our relatively minor dispute with the CME over the publication of three documents. But if there had been more disputes, the Court and I would have had to sort out all of these different agreements with slightly different terms. If I had it to do over, I might have asked the Court to approve a single form of protective order to govern production from all parties.

Recommendation 9: The Examiner should use contract attorneys where possible to conduct document review.

As you know, we used contract attorneys to the fullest extent practicable to do first level document review. We had as many as 70 contract attorneys working at the same time, and our experience with them was excellent. We estimate that the savings to the estate, over the rates that would have been charged by Jenner associates, was in the tens of millions of dollars; moreover, we could not have deployed 70 additional, full time Jenner lawyers without a substantial time lag – the whole process would have taken much longer without the use of contract attorneys.

Recommendation 10: But substantive review must be done by lawyers who are fully integrated and invested.

We do not want to suggest that contract attorneys should have been used to an even greater extent than they were. As a group, the contract attorneys performed very well for first level review – that is, the initial screening of a data dump to identify documents of possible substantive interest. All second level review was performed by Jenner lawyers. Our experience was that most of the contract attorneys did not have the skills, background and commitment to do effective and efficient second level review.

Jenner lawyers supervised the contract attorneys and exercised quality control. Jenner lawyers who did document review were fully integrated into the substantive teams so that they actually knew what to look for and so that they were able to make more refined searches to locate key documents more quickly.

Recommendation 11: The documents should be collected and maintained so as to make them an asset of the estate.

Our document collection and archival was conducted by seasoned trial lawyers who know how to try cases. As a result, the data base we have assembled is, as it should be, a valuable asset of the estate to limit costs in any pending and future litigation.

Many lawyers are familiar with document management systems such as Concordance which have served them in the past. But we recognized early on that those usual systems would not be up to the task of handling the quantities of documents we would assemble. We involved IT personnel at the outset to ensure that we had the right systems, and opted to maintain our document repository on two extremely robust, easy to search systems, CaseLogistics and Stratify.

The numbers are staggering. We extracted roughly 35 million pages of documents from Lehman's systems – an enormous amount of material, yet only one tenth of one per cent of the universe of Lehman's electronically stored data. We used carefully refined searches so that we would not be overwhelmed with returns. We kept careful records of the search terms we used, the date ranges of the searches, and the custodians against whom the searches were run. Those searches need not be rerun; the parties can look at our searches and add focused additional searches if necessary to their specific needs, but they need not reinvent our wheel. We have assembled the collected documents into electronic, searchable format, so that parties may pull what is relevant to them.[2]

Witness Interviews

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[2] Protective order issues still remain before free public access can be granted, but the documents are assembled; that substantial work need not be done again.

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Recommendation 12: The Examiner should consider using informal interviews in most cases.

As you know, one of the suggestions made to me by other Examiners – which I adopted – was that wherever possible interviews be conducted informally, without requiring that the witness be sworn and without transcripts. There are obvious pros and cons. Even had I used transcribed statements under oath, they would have no evidentiary value in pending or future litigation, so the real advantage of oath and transcription is that a quotation of a witness's testimony can be precise. But my team of seasoned litigators estimated that it could easily double the amount of time take interviews with transcription; it would add significant cost; and, significantly, we anticipated that witnesses would be far more likely to be open and candid in an informal setting than if a reporter was transcribing each word. Moreover, the creation of transcribed statements might have impacted pending Government investigations and the government's willingness to release persons for interview.

Balancing these factors, I decided to use informal interviews wherever possible – and that turned out to be possible in all cases. As I noted above in the document collection process, our tone was investigative rather than adversarial. The informality of the interviews was a definite aid. We asked the tough questions where we had to; but the informal setting and objectivity we brought to the process made the witnesses comfortable to fully answer our questions.

To assure accuracy, all interviews were conducted by at least two attorneys, one of whom was assigned to keep careful notes. Flash summaries were prepared as soon as possible, usually the day of the interview, and reviewed by all lawyers present while recollections remained sharp; and full summaries were made and reviewed as soon as practical after that.

Recommendation 13: The Examiner should make the interviews an open book, not an occasion for cross-examination.

Prior to each interview we provided advance notice of the topics we intended to cover and advance copies of the documents we anticipated showing the witness. That procedure would have been anathema to a litigator – but, again, my goal was to get the

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facts, not to surprise a witness into some admission. By giving advance notice, witnesses were able – and expected – to refresh recollection before the interview rather than on the fly. That greatly reduced the need for follow-up interviews. It put the witnesses and their counsel at ease that we were not trying to trap.

A number of the parties – including nearly every party against whom I reported colorable claims – have expressly told me that while they might disagree with my conclusions, they were satisfied with the process. I commend that process to future Examiners.

Recommendation 14: Interview outlines should be shared among teams.

In general, detailed interview outlines were prepared at least a week in advance and circulated among team leaders so that all substantive teams could have input on each interview. Moreover, having the outlines prepared in advance allowed us to identify the topics to counsel for the interviewee as described above.

Recommendation 15: The Examiner can supplement or supplant interviews with written questions.

In all, my lawyers and I interviewed more than 250 individuals. There was only one individual I sought to interview but could not – Hector Sants, chief executive of the UK's Financial Services Authority ("FSA"). However, the FSA did provide detailed, written answers to specific questions that would have been posed to Mr. Sants, and while not perhaps as satisfying as an interview, they sufficed.

In other cases, letters to interested parties' counsel with fairly discrete questions to confirm key background facts proved very helpful. For example, we asked a clearing bank to confirm that we had set out in a written question a comprehensive list of all collateral calls made in a particular period. The written exchange was more efficient than Q&A in an interview.

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The Report

Recommendation 16: Examiners should carefully define terms not defined in their orders of appointment.

My order of appointment asked me to opine on the existence of colorable claims but did not define that term. The Second Circuit has described colorable claims as ones "that on appropriate proof would support a recovery," "much the same as that undertaken when a defendant moves to dismiss a complaint for failure to state a claim."[3]

I was mindful of the fact that there is a high likelihood that an actual claim will be asserted wherever I have concluded that a colorable claim exists, so I was reluctant to adopt a motion to dismiss standard. Having conducted an extensive factual investigation, I felt it was appropriate to use a higher threshold standard, and therefore defined "colorable claim" as one for which I found sufficient credible evidence to support a finding by a trier of fact.

In addition to defining terms, I recommend that future Examiners do something early on that I did somewhat late. Appendix 2 to my Report is a 98 page glossary of defined terms, names, acronyms and phrases; without that glossary and the ability to use abbreviations for defined terms, the Report would have been cumbersome and unwieldy. I did not append another document that was created during the writing process – a set of protocols that collectively amounts to our own private Blue Book of Citations. Although there were many individuals who contributed first drafts of sections, the overall Report was carefully edited to conform to the Glossary and Blue Book, resulting in a uniform style and appearance. That is not merely cosmetic; I believe that it greatly enhanced the readability of this lengthy tome.

But I confess that we came a little late to the realization how useful the Glossary and Blue Book would be. The editing process would have been less a challenge had we begun assembling and circulating those documents to the substantive teams before first drafts were created.

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[3] *In re STN Enters*., 779 F.2d 901, 905 (2d Cir. 1985); *In re KDI Holdings, Inc*., 277 B.R. 493, 508 (Bankr. S.D.N.Y. 1999).

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Recommendation 17: The Report should contain as much detail on the claims that are not found as it does for claims which are found.

We devoted as much time and energy to conclude that claims did not exist as we did to conclude that there were claims. And we devoted almost as much space in the Report to those non-claims as we did to the claims.

I felt it was important that the Report set out the detailed facts that led me to conclude the absence of claims so that the parties can use that analysis to make measured judgments whether to expend their own time pursuing claims I have concluded are not there.

Recommendation 18: Examiners should consider whether persons against whom the Examiner tentatively determines there are colorable claims should be given an opportunity to supplement the record.

After I made tentative determinations as to colorable claims, I decided to give each such person and entity an opportunity to present additional factual detail they thought might dissuade me. I stressed that I was not looking for a *Wells* submission, but simply additional facts that I might not have had in making the initial determination. Every identified party took me up on the offer and presented additional materials.

I should stress that I perceived no obligation to go through that procedure, and I do not recommend that any such procedure be used in all Examiners' investigations. I simply note that under the unique circumstances of my investigation, the process worked; it had a real impact upon reaching fair and reasoned judgments. Future Examiners should consider whether it might work for them.

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Diana, it has been my great honor and privilege to have served as Examiner in this matter; thank you again for the trust you showed in me and our firm. I hope that this is useful to you; and I stand ready to assist in any further way I can.

Sincerely,

Anton R. Valukas

cc: Robert L. Byman

Faculty

Ted A. Dillman is a partner with Latham & Watkins LLP in Los Angeles, where he represents debtors, creditors, investment funds and buyers in corporate restructuring, distressed M&A and out-of-court workouts, as well as special situations finance and corporate matters. He also serves as vice chair of the firm's Retail & Consumer Products Industry Group, as well as on the firm's Finance Committee and Ethics Committee. Mr. Dillman regularly helps clients navigate large-scale corporate bankruptcies, cross-border restructurings and a variety of special-situations financing and M&A transactions across industries. He also represents hedge funds, private-equity funds, direct lenders and strategic buyers in wide range of challenged M&A and finance matters. Mr. Dillman is a past president of the Financial Lawyers Conference and a member of its Board of Governors. He often writes and speaks on intellectual property, M&A and finance-related issues. Mr. Dillman is recognized by *Chambers USA* for his Bankruptcy/Restructuring work in California and was named a 2021 Rising Star in the Bankruptcy industry by *Law360*. *Business Insider* also recognized him in a feature on top bankruptcy and restructuring lawyers for his representation of Lucky Brand in its restructuring, and of Sycamore Partners in department store chain Belk's prepackaged proceedings. Mr. Dillman received his B.A. with a concentration in history from the University of California at Berkeley and his J.D. from the University of Southern California Law School, where he was a founding member of its Small Business Clinic, which advised clients on entity selection, formation, governance and ongoing compliance.

Nan R. Eitel is associate general counsel for chapter 11 practice with the Executive Office for U.S. Trustees (EOUST) in Washington, D.C. Working with other members of the General Counsel's office, Ms. Eitel is responsible for handling all chapter 11 cases supervised by the U.S. Trustee Program (USTP). She advises the USTP's 93 field offices and 21 regions on complex chapter 11 issues, and coordinates with the EOUST to develop and promote consistent positions on chapter 11 issues significant to the USTP. In 2015, Ms. Eitel received the Attorney General's Award for Outstanding Contributions by a New Employee, which recognizes exceptional performance and notable accomplishments toward the Department of Justice's mission by an employee with fewer than five years of federal service. In 2018, the Attorney General recognized her with a Distinguished Service Award, the Department's second-highest honor for employee performance. Before joining the EOUST, Ms. Eitel was a partner in the law firm of Jones Walker, where she practiced in bankruptcy and commercial litigation for 21 years. Ms. Eitel received her J.D. from the University of Virginia School of Law and her B.A. *cum laude* from Georgetown University in 1984.

Michael Katzenstein is senior managing director and leader of Interim Management at FTI Consulting, Inc. in New York. He specializes in in-court and out-of-court restructurings and has led engagements across many industries including traditional and new media, entertainment, technology, biotechnology, telecommunications, and other subscriber-based businesses and investment funds and fund liquidations. He has decades of cross-border restructuring experience and is called upon to advise in many of the largest and most complex situations. Mr. Katzenstein is regularly called upon to lead and assist in implementing strategy for companies in financial or operating distress or transition. His clients include large and mid-sized corporations and many major financial institutions and hedge funds. Mr. Katzenstein served as chairman of the board of directors at Caribbean Asset Holdings, cable television, ILEC and competitive wireless operations in the U.S. Virgin Islands, British Virgin Islands and St. Maartin. He also served as chairman of the board of directors and member of the executive and audit committees at RCN, a business/enterprise CLEC and broadband services provider in major U.S. markets. In addition, he served on the board of directors and audit committee at Sun-Times Media Group, which owned and operated more than 30 newspaper titles in the greater Chicago market, and the board of directors at GSI Group. Mr. Katzenstein is a post-effective liquidating trustee for the Sun-Times estate and serves as monitor for the benefit of claimant trusts in the first St Vincent's hospital restructuring. On many occasions, he has served as a consulting or testifying witness on industry and corporate governance issues, and he has significant testimony experience, including in his capacity as CRO or financial advisor in restructuring proceedings. He began his career as a mergers and acquisitions and securities lawyer and was a partner in a New York law firm. Mr. Katzenstein received his B.A. in political science from the State University of New York at Binghamton and his J.D. from Boston University School of Law.

Michael R. Nestor is vice chair of and a partner with Young Conaway Stargatt & Taylor, LLP in Wilmington, Del., and has successfully guided distressed companies through out-of-court and chapter 11 proceedings. He is also a member of the firm's management committee, co-chair of the firm's Portfolio Company Specialty Group, and head of the firm's New York office. With more than 20 years of restructuring experience leading company-side representations, Mr. Nestor has developed a niche advising private-equity funds and portfolio companies regarding management, acquisitions/divestitures and governance. He is listed in *Chambers USA: America's Leading Lawyers for Business* as a leading Bankruptcy/Restructuring attorney and has been consistently recognized by *The Best Lawyers in America*, *The Deal*, *Delaware Super Lawyers*, *Corporate Counsel* and *Who's Who Legal* (Insolvency & Restructuring) as one of the top bankruptcy lawyers in Delaware and the country. Mr. Nestor received his B.A. from the University of Maryland and his J.D. from Widener University School of Law.