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Delaware Decision Highlights Risks Facing Directors and Lenders Negotiating a Restructuring When a Distressed Company Faces Substantial Litigation Risk

By Andrew V. Tenzer*

In this article, the author discusses a Delaware court ruling that is a cautionary tale about the limits that the protections the "business judgment rule" provides to directors of an insolvent company and the potential risks to lenders exercising leverage over a distressed company, especially where the company faces a substantial risk of litigation.

The Delaware Court of Chancery recently held that certain directors of Bridge Street Worldwide, Inc. (BSW) breached their fiduciary duty of loyalty when they entered into a forbearance agreement with BSW's debt holders, who had indemnified the directors against litigation risk from BSW's majority shareholder.[1] The court found that the directors had a material interest in the forbearance agreement and, therefore, their actions had to be evaluated under Delaware's rigorous "entire fairness" standard and not the more lenient "business judgment" rule.

Further, the court ruled that BSW's lenders aided and abetted the directors' breach of their fiduciary duties because the lenders knew of the litigation risk and took advantage of the directors' personal interests to complete the forbearance agreement on terms favorable to themselves and detrimental to BSW.

The decision is a cautionary tale about the limits that the protections the "business judgment rule" provides to directors of an insolvent company and the potential risks to lenders exercising leverage over a distressed company, especially where the company is staring at litigation.

BACKGROUND

BSW was a Delaware corporation that serviced leased apartments and corporate housing. GB-SP owned more than 60% of BSW's outstanding common stock. GB-SP and BSW's other stockholders, including four independent members of BSW's board, entered into a shareholders agreement which gave GB-SP the right to designate one director and required BSW to furnish information that any shareholder reasonably requested.

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[1] GB-SP Holdings, LLC v. Walker, C.A. No. 9413-VCF (Del. Ch. Nov. 15, 2024) (GB-SP).

Through much of 2011 and 2012 BSW tried to find a buyer, with no success. While the sales process was ongoing IEOT, a company controlled by Donal Kinsella, obtained ownership of GB-SP. Throughout 2012 and 2013 Kinsella requested, pursuant to the shareholders agreement, appointment to BSW's board and that BSW furnish him with company information.

These requests were not immediately fulfilled, in part because of BSW's concerns that acknowledging a change in control of GB-SP could adversely impact the tax benefits of BSW's net operating losses. In March 2013, BSW's counsel advised that there was no good faith basis on which to refuse Kinsella's requests. IEOT and Kinsella continued to press their demands and threatened legal action, and Kinsella was not elected to BSW's board until October 2013.

BSW was experiencing financial distress and starting in December 2012 failed to make scheduled principal and interest payments under its credit agreement. In April 2013, Versa, a company that had expressed interest in BSW during its marketing process, purchased (via its subsidiary, Domus)[2] the outstanding debt under the credit agreement as a first step in a "loan-to-own" acquisition of BSW. Around the same time, BSW's D&O insurance policy had come up for renewal. As a result of Kinsella's demands and threatened legal action, the D&O policy was renewed with a major stockholder exclusion that did not provide coverage for claims brought against BSW's directors by GB-SP, IEOT, or Kinsella.

BSW and Versa began negotiating a forbearance agreement to address the defaults under the credit agreement. Versa extended additional funds to BSW (used partially to obtain D&O coverage for directors) and agreed not to foreclose under the credit agreement for five months so long as BSW met the financial covenants in the forbearance agreement and did not otherwise breach the credit agreement.

In addition, the four independent members of BSW's board agreed to not seek re-election to the board, to be replaced by four directors Versa selected. Versa also agreed that in the event of a consensual foreclosure on BSW's assets it would assume the employment agreements of BSW's chief executive officer and president and pay retention bonuses to them and other BSW executives.

Finally, the forbearance agreement required Versa to indemnify BSW's directors and officers, including in their personal capacities as parties to the shareholders agreement, both for claims arising out of the forbearance agreement and claims brought by GB-SP, IEOT, or Kinsella.

Not long after it was signed, BSW defaulted under and Versa terminated the forbearance agreement. Over the next few months BSW and its advisors

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[2] For convenience this article refers to both Versa and Domus as "Versa."

discussed strategic options, including raising new money, a bankruptcy filing, and a consensual foreclosure. Kinsella repeatedly expressed opposition to the decisions of BSW and its directors and sought to explore other courses of action for the company. Versa completed a consensual foreclosure in March 2014 in which BSW transferred the equity in its operating subsidiaries in exchange for the cancellation of over 80% of BSW's outstanding debt under the credit agreement.

KINSELLA'S CLAIMS

Immediately after the consensual foreclosure was completed, GB-SP (individually and derivatively) and Kinsella sued Versa, BSW, and the BSW directors who served before and after entry into the forbearance agreement. The plaintiffs' claims included breach of the shareholders agreement and that the directors' approval of the forbearance agreement and consensual foreclosure violated their fiduciary duties. The plaintiffs also alleged that Versa aided and abetted the directors' breaches of their fiduciary duties, primarily by offering to indemnify the directors against threatened litigation in order to push the forbearance agreement negotiations over the finish line.

The court ruled that:

(1) The directors serving when the forbearance agreement was approved (the Pre-Forbearance Directors) had violated GB-SP's rights under the shareholders agreement;

(2) The Pre-Forbearance Directors violated their fiduciary duties because the indemnities provided them with a material non-pro-rata benefit and the forbearance agreement was not entirely fair;

(3) Versa aided and abetted the Pre-Forbearance Directors' breaches of fiduciary duty by exploiting conflicts arising from the indemnities to its benefit; and

(4) The directors who approved the consensual foreclosure (the Post-Forbearance Directors) did not breach their fiduciary duties, as, although they were conflicted, the foreclosure was entirely fair.

FIDUCIARY DUTIES AND THE STANDARD OF REVIEW

The court first held that BSW violated GB-SP's rights under the shareholders agreement by failing to timely (a) provide BSW's audited consolidated balance sheet, income statement, cash flow statement and information relating to BSW's financial condition, business, prospects, or corporate affairs, and (b) seat Kinsella on the board. But the court denied Kinsella's request for rescissory damages and ruled that Kinsella did not prove compensatory damages and awarded only $1 for the breach. The court did, however, award Kinsella attorneys' fees as the prevailing party in a dispute under the shareholders agreement.

The court next analyzed the claims against the Pre-Forbearance Directors for breach of fiduciary duty. The court noted that directors of Delaware corporations owe two fundamental fiduciary duties to the corporation and its stockholders – the duty of care and the duty of loyalty. When a Delaware corporation is facing insolvency, a director's fiduciary responsibilities "do[] not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners."[3] When a Delaware corporation becomes insolvent, directors "continue to owe fiduciary duties to the corporation for the benefit of all of its residual claimants, a category which now includes creditors."[4]

The court also stated that Delaware has three levels of judicial review for evaluating directors' decisions: the business judgment rule; enhanced scrutiny; and entire fairness. The Pre-Forbearance Directors argued that their decision to approve the forbearance agreement was subject to the business judgment rule, which is a "presumption that in making a business decision[,] the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[5] If the business judgment standard of review applies, then a court will not second guess the decisions of disinterested and independent directors. The reviewing court will only interfere if the board's decision lacks any rationally conceivable basis, thereby resulting in waste or a lack of good faith.[6]

There are several ways to rebut the business judgment presumption, "including by showing that: (1) a controlling stockholder stands on both sides of a transaction or (2) at least half of the directors who approved the transaction were not disinterested or independent."[7] A director is interested in a transaction if the director "'will receive a personal financial benefit from a transaction that is not equally shared by the stockholders' or if 'a corporate decision will have

[3] GB-SP at 76.

[4] Id.

[5] Id at 78.

[6] Id at 79.

[7] Id.

a materially detrimental impact on a director, but not on the corporation and the stockholders.'"[8]

GB-SP argued that the entire fairness standard of review applied to the approval of the forbearance agreement because the Pre-Forbearance Directors, comprising a majority of the board, was interested in the transaction because each received:

(1) D&O insurance coverage;

(2) Indemnification for claims arising out of the Forbearance Agreement and claims related to BSW asserted by or with the assistance of GB-SP; and

(3) A release from Versa of any claims in connection with the forbearance agreement.

GB-SP also argued that BSW's CEO and President were interested for the additional reason that they were promised continued employment, retention of their salaries, and additional bonuses if a consensual foreclosure was approved.

The court ruled that benefits such as indemnification usually would not render a director materially interested in a transaction, but that the existence of a substantial risk of litigation and personal liability arising out of the Pre-Forbearance Directors' violations of the shareholders agreement, and their requirement that they receive indemnification for the related litigation risk, rendered these benefits material. Thus, the Pre-Forbearance Directors were materially interested in the transaction and the court had to evaluate their approval of the forbearance agreement pursuant to the "entire fairness" standard. Under that test, the directors had to establish that the transaction resulted from a fair process that yielded a fair price to BSW.[9] The Pre-Forbearance Directors' exclusion of Kinsella from the board and their focus on obtaining indemnification led the court to conclude that the forbearance agreement did not result from fair dealing. As a remedy, the court held the Pre-Forbearance Directors liable to BSW for all amounts paid to them or their counsel under the indemnity agreement. Further, the court ordered that the bonuses paid to the management directors as a part of the forbearance agreement transaction had to be disgorged and returned to BSW.

The court also found that at least half of the Post-Forbearance Directors were materially interested in (or not independent) with respect to the consensual foreclosure and applied the entire fairness test to their decision to approve it. In

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[8] Id. at 81.

[9] Id. at 80.

addition to retaining their positions and receiving bonuses, a company owned by one of directors had been selected to administer an assignment for the benefit of creditors anticipated to occur after the consensual foreclosure. The court also ruled that one of the Directors designated by Versa was not independent because that Director had been appointed to the board of another Versa portfolio company and, accordingly, had an expectation that the Versa would consider that Director for future directorships if he acted in Versa's interests.

In applying the entire fairness standard, though, the court found that the consensual foreclosure was imperfect but resulted mostly from fair dealing. The interested parties negotiating the foreclosure had few strategic options due to BSW's dire financial situation and the consensual foreclosure yielded a fair price to BSW; a substantial amount of debt to Versa was wiped out in exchange for the transfer of equity interests in BSW's subsidiaries which, given the debt release, were essentially worthless. Thus, the consensual foreclosure transaction was entirely fair to BSW.

AIDING AND ABETTING CLAIM AGAINST THE LENDER

The court sustained the claims that Versa aided and abetted the Pre-Forbearance Directors' breach of their fiduciary duty of loyalty. Versa knew the substantial litigation risk staring at the Pre-Forbearance Directors due to their refusal to seat Kinsella on the board or provide him with information requested under the shareholders agreement. The court found that Versa offered the Pre-Forbearance Directors indemnification for that potential litigation to close the forbearance agreement, thereby inducing their breaches of their fiduciary duties. Versa diverted value otherwise payable to BSW into the hands of the Pre-Forbearance Directors. The court equitably subordinated Versa's claims against BSW remaining after the consensual foreclosure debt, which would direct any value BSW then had or later received to BSW creditors other than Versa.

ANALYSIS

The BSW case serves as an important reminder for financially distressed companies, their directors, and their lenders when they violate clear contractual obligations and negotiate transactions in which directors have a stake. BSW's board slow-walked the appointment of Kinsella to its board and his requests for information without a good faith legal basis to do so. At the same time, those directors were securing benefits for themselves in the form of D&O coverage, indemnification, and (for some) job assurances and retention bonuses. Such actions may not seem outlandish in isolation, but under these circumstances the court determined that they had to be evaluated under the entire fairness standard, not the more forgiving business judgment rule. This case demonstrates that the details of the conditions under which such agreements are reached matter and could trigger a review of the board's actions under the entire fairness standard. That context may be important where board members are negotiating personal benefits for themselves, especially protections against personal liability in a situation in which litigation against the directors is likely. One potential mitigant for these risks is to ensure that there is a meaningful number of independent directors on the board who can act without substantial self-interest and build a record that the concerns of the distressed company, and not those of interested directors, were paramount in negotiating a restructuring.

The decision is also a cautionary tale for a distressed company's debt holders. In restructurings, lenders are often focused on lender liability, a broad grouping of causes of action that, in many instances, require a lender to exert a substantial degree of control over its borrower. But findings of lender liability often involve egregiously bad lender conduct. Under normal circumstances, lender liability would not include negotiation of a common arrangement like a forbearance agreement. But Versa's liability was not grounded in a legal theory that relied on control of the company. Instead, it was found to have aided and abetted fiduciary duty breaches by the company's individual directors. Versa knew of the substantial litigation risk facing the Pre-Forbearance Directors and exploited their concerns and related conflicts by providing indemnification in exchange for concessions to Versa under the forbearance agreement to the detriment of BSW. In such circumstances, a lender could face liability in the form of money damages or, as in this case, equitable subordination of its claims.