AMERICAN BANKRUPTCY INSTITUTE
JOURNAL
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Feature

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The Importance of Being Truly Independent

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In times of financial distress, there is a natural tension between the debtor, which owes fiduciary duties to its creditors, and the debtor's sole or majority equityholders, who are often driven by self-interested economic motives, as well as a desire to obtain broad releases. In most chapter 11 cases, unsecured creditors recover only a fraction on their claims, and holders of equity receive nothing. In order to avoid being completely marginalized, equityholders must find ways to participate in the restructuring process without being disabled by the inherent conflicts involved in doing so.

A successful restructuring process must be managed in a fair and unbiased manner, and, under any circumstance where a conflict can be foreseen, the debtor's first step is to appoint competent and independent directors. This article examines the role that independent directors can and should play in complex restructurings with real or perceived conflicts. It also explores how equityholders can maintain their influence despite potential conflicts, including through corporate governance controls and the provision of debtor-in-possession (DIP) financing.

Introduction

Directors owe duties of care and loyalty to the corporation and its equityholders. The duty of care requires directors to be informed, make a reasonable effort to become familiar with relevant and available facts, and act with due care when making decisions. The duty of loyalty requires directors to act in good faith and not out of self-interest, such that the interests of the company and its equityholders are paramount. As part of the duty of loyalty, the obligation to act in good faith might be violated where directors know they are making material decisions without adequate information and without sufficient deliberation. Disregarding these responsibilities might amount to bad faith, even when directors have no financial or other self-interest in the transaction.

A board's decisions are also protected by the business-judgment rule, so long as the board is well-informed and acts in the corporation's best interests. However, if the board either does not act in good faith and in an informed manner, or in the corporation's best interests, or a conflict of interest existed at the time of the board's decision, the decision will then be held to the heightened "entire fairness" standard. This additional burden might further complicate a debtor's restructuring.

Distressed companies often engage a chief restructuring officer (CRO) to supplement the existing management team's efforts, but hiring a CRO might not be enough to solve the underlying governance problem. A CRO typically reports to the board, but if the board members have ties to the nondebtor parent, then the board's business judgment might not be disinterested, regardless of how effectively the CRO manages the restructuring of the business. The best way to avoid this problem is to involve one or more independent directors with restructuring acumen to manage critical aspects of the restructuring and any conflict matters. Because independent directors have not previously been involved in a corporation's business affairs, their decisions should not be influenced by the self-interests of an existing equityholder. Therefore, the distressed company's decisions are more likely entitled to deference under the business-judgment rule.

Discussion

Lack of Independence Impedes Reorganization Efforts

Coram Healthcare is a noteworthy example of how the lack of independence by key decision-

1 Morrison & Foerster was counsel to Maxus Energy Corp. in their chapter 11 cases.

makers may impede a debtor's reorganization efforts. In *Coram*, the debtor proposed an initial reorganization plan providing noteholders with reorganized equity and eliminating the pre-petition equityholder's interests. The bankruptcy court denied confirmation because the debtor's chief executive officer (CEO) was also employed as a consultant to one of the debtor's noteholders — a conflict of interest that violated 11 U.S.C. § 1129(a)(3) (*i.e*., plan not proposed in good faith). Thereafter, the debtor formed a special committee of independent directors to propose a new plan, but that cosmetic approach to independence failed because the CEO's conflicts remained. Following a second unsuccessful attempt to formulate a plan, a chapter 11 trustee was appointed, who confirmed a plan two years later.[2]

Independent Directors Facilitate Reorganization Efforts

By comparison, in *Station Casinos*, the debtors' independent director ran a process (contemporaneous to plan solicitation) to sell specific assets to insiders as part of the debtor's reorganization plan. Notwithstanding opposition by the creditors and other parties-in-interest to the bidding procedures, the court ultimately approved the debtor's procedures because the auction process was overseen in a fair manner by the independent director (in consultation with multiple creditor groups) and pursuant to appropriate court supervision.[3]

Similarly, in the case of *EFH*, the debtors employed separate independent directors — in response to and to address significant inter-debtor conflicts. Creditors complained about irreconcilable differences within the debtors' capital structure and manifest conflicts among the estates. The debtors' board authorized disinterested managers and directors to address "any matter pertaining to the Chapter 11 Case on which an actual conflict exists between [one debtor], on the one hand, and any other debtor, on the other hand."[4] The disinterested directors' responsibilities included almost everything that could affect the outcome of the bankruptcy proceeding and facilitate plan confirmation, including reviewing, revising and commenting on the plan and disclosure statement; settling inter-debtor claims and causes of action; addressing tax issues; and negotiating the allocation of the parent's reorganized equity under a plan.[5]

Maxus Energy: Another Example of Independence Fostering a Successful Reorganization

By delegating authority over significant case matters to truly independent directors, Maxus Energy managed to overcome challenging historical relationships between a parent and its subsidiaries and was able to timely exit from bankruptcy with the overwhelming support of its creditors.

Prior to the bankruptcy, Maxus's two independent directors (the "special committee")[6] examined the historical transactions, interrelationships and course of dealings between Maxus and its corporate parent, YPF SA, and identified potential claims arising from that relationship.[7] The special committee, following diligence and on the advice of professionals, agreed to settle the claims of Maxus and certain affiliates (the "debtors") with YPF and its affiliates (the "YPF entities"). As part of a bankruptcy proceeding, YPF agreed to pay $130 million to the debtors upon the satisfaction of certain conditions, and YPF Holdings agreed to provide DIP financing in the amount of $63.1 million to the debtors, part of which was subordinate in payment to all general unsecured claims. In exchange, the debtors agreed to release their claims against the YPF entities and adhere to certain case milestones set forth in the post-petition financing agreement (collectively, the "YPF settlement agreement").[8]

In light of YPF's control of the Maxus board and its roles as the settlement counterparty and post-petition lender in the bankruptcy proceeding, the debtors were actively encouraged by their creditors to adopt amended bylaws[9] during the bankruptcy to broaden the scope of the special committee's authority over the debtors' restructuring efforts. As a result, the special committee was given exclusive authority over any claims, transactions, litigations, disputes, arrangements or other matters among the debtors and the YPF entities, including the YPF settlement agreement (*i.e*., any decisions concerning its prosecution or amendment), the financing provided by YPF Holdings (including any decisions concerning alternative financing) and all plan matters that implicated the YPF entities.[10]

Throughout the chapter 11 cases, creditors voiced their oppositions to the settlement, both with respect to the amount of consideration and the procedural means by which the settlement was being pursued (*i.e*., under Bankruptcy Rule 9019 as opposed to under a plan). However, the special committee would not abandon the YPF settlement agreement without having a viable alternate and value-maximizing course of action. Ultimately, the creditors' committee delivered term sheets to the special committee outlining a replacement DIP financing facility to be provided by an affiliate of one of the members of the creditors' committee, a liquidation plan to transfer the debtors' assets and causes of action (including claims against the YPF entities) to a liquidating trust, and a post-confirmation financing facility and promissory note to fund a liquidating trust.[11]

Given the feasibility of the structure proposed by the creditors, the special committee reconsidered the best strategy for maximizing the value of the alter-ego claims and determined that pursuing an amended plan, which enjoyed substantial creditor backing, was in the best interests of the debtors' stakeholders as compared to the plan that depended on approval of the YPF settlement agreement. The new structure included favorable replacement DIP and exit financing, involved limited execution risk, aligned the debtors' interests with their creditors, and allowed the creditors to pursue the debtors' claims against the YPF entities through a well-funded liquidating trust.[12]

2 *In re Coram Healthcare Corp. and Coram Inc*., 315 B.R. 321, 327 (Bankr. D. Del. 2004).
3 *See In re Station Casinos Inc*., No. 09-52477, *slip op*. at 18 (Bankr. D. Nev. July 14, 2010).
4 *See In re Energy Future Holdings Corp., et al*., Case No. 14-10979 (CSS) (D.E. 8747; Third Amended Disclosure Statement for the Second Amended Joint Plan of Reorganization of Energy Future Holdings Corp., *et. al*., Pursuant to Chapter 11 of the Bankruptcy Code as it Applies to the TCEH Debtors and EFH Shared Services Debtors) at 117.
5 *Id*.
6 After the appointment of the independent directors, the board included five members, including three that had been appointed and employed by YPF.
7 *See In re Maxus Energy Corp., et al*., Case No. 16-11501 (CSS) (D.E. 1232; Amended Disclosure Statement for the Amended Chapter 11 Plan of Liquidation Proposed by Maxus Energy Corp., *et al*., and the Official Committee of Unsecured Creditors) (hereinafter, "Maxus DS"), at 38-39.
8 On Aug. 29, 2016, the debtors filed a motion pursuant to Bankruptcy Rule 9019 seeking approval of the YPF settlement agreement [Docket No. 300].
9 Docket No. 533.
10 Maxus DS at 39, 46.
11 *Id*. at 54.
12 *Id*. at 55.

Lessons Learned and Suggested "Best Practices"

The independent directors in *Maxus* were experienced restructuring practitioners and their backgrounds added tremendous value to its restructuring. Independent directors, when given the necessary oversight over conflict and key restructuring matters, can help to produce consensual outcomes that benefit all stakeholders, including existing equityholders such as private-equity sponsors.

Independent Directors Should Manage Key Aspects of Restructuring

Maxus's creditors had a long and contentious history with the debtors' parent, so it was essential for the independent directors to demonstrate that they had ample authority to manage the restructuring process without interference from the parent. By refining the debtor's bylaws (with input from the creditors), the independent directors gained meaningful control over the most critical aspects of the restructuring.

As in the case of *EFH*, Maxus's bylaws broadly defined conflict issues as anything involving the debtors, on the one hand, and their parent entity and nondebtor affiliates, on the other, or any matter where the debtors' interests might be adverse to, opposite of or otherwise not fully aligned with the interests of those of the parent and its nondebtor affiliates. In addition, the independent directors were the sole arbiters of what constituted a conflict matter and had primary responsibility for, *inter alia*, the preparation, negotiation and prosecution of a chapter 11 plan, and any negotiation for the disposition of all or substantially all of the company's assets. Through this effective division of authority, the debtors' senior management team utilized their institutional knowledge of the debtors' affairs to effectively manage the day-to-day aspects of the business and preserve value for the benefit of creditors, while the independent directors managed the chapter 11 strategy and engaged with the creditors in negotiations that ultimately set the framework for the confirmed chapter 11 plan.

Opportunities for an Equityholder to Meaningfully Participate in Restructurings

As a post-petition lender, YPF Holdings provided a material benefit to the debtors' estate that enabled it to utilize the power of the purse to shape the course of the chapter 11 cases. So long as the post-petition loan remained outstanding, YPF Holdings had the ability to set case milestones, closely monitor the debtors' use of post-petition funding and mandate that the debtors would continue to pursue approval of the YPF settlement agreement. Moreover, as post-petition lender, YPF Holdings established its right to be involved in all material aspects of the chapter 11 cases — a role that would not have otherwise been available to an out-of-the-money equityholder and its affiliates.

Independent Directors' Decisions Must Be Guided by What Is in the Creditors' Best Interests

The special committee periodically struggled with other parties-in-interest. If the YPF settlement agreement was not approved or confirmation of a plan not acceptable to the parent/post-petition lender occurred, Maxus risked a default and would lose access to its post-petition financing. In addition, the creditors wanted the debtors to pursue the settlement as part of a chapter 11 plan, but at the same time, the creditors also adamantly opposed the merits of the settlement. This created a significant challenge for the independent directors because financing from the parent was critically needed to remediate environmentally contaminated properties, maintain the existing operations and achieve plan confirmation. The independent directors had a fiduciary obligation to maintain the debtors' post-petition operations, seek approval of the settlement and monetize their most significant asset for the benefit of their creditors.

This paradigm of fiduciary duties set the stage for the creditors to develop a counterproposal to the YPF settlement agreement and the existing chapter 11 plan. The special committee, exercising its duties to creditors, changed direction and chose to forgo the YPF settlement agreement and pursue confirmation of an alternative plan structure based on the informed judgment that the plan favored by the creditors was in the best interest of the estate.

Conclusion

The independent directors fulfilled their fiduciary obligations to Maxus's creditors by working with the creditors to confirm a value-maximizing plan. Even though the historical tension between the equityholder and Maxus's creditors complicated the special committee's efforts, it also brought about constructive governance changes that ultimately led to an extremely favorable outcome in these chapter 11 cases. The additional governance responsibilities given to the special committee allowed them to effectively manage the interests and expectations of the creditors and equityholder throughout the bankruptcy case. In summary, having two truly independent individuals manage a contentious and challenging bankruptcy proceeding was critical to achieving broad consensus in a timely manner. abi

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