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THE ROLE OF INDEPENDENT DIRECTORS IN MITIGATING LIABILITY ARISING FROM RESTRUCTURING DECISIONS

In this article the authors begin by discussing the law relevant to board decision-making when a corporation is in distress, the fiduciary duties of directors, and the important role of the independent director in the bankruptcy process. They then turn to detailed discussions of the recent D&O litigation challenging restructuring decisions in the Toys "R" Us and SportCo Holdings chapter 11 plans. They conclude with steps boards can take to mitigate the risk of liability in connection with negotiating and approving restructuring transactions.

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Corporate restructurings usually have one thing in common — rarely are *all* the stakeholders happy with the result. This is particularly true in a bankruptcy proceeding involving significant creditor loss. Moreover, in a bankruptcy proceeding where the debtor's tangible assets are encumbered by liens, it is likely that unsecured creditors' only hope for recovery is from litigation claims constituting property of the debtor's estate ("estate causes of action") which are typically unencumbered. A frequently asserted estate cause of action involves a transfer of assets from the debtor to insiders for less fair market value or no consideration. In that scenario, the commentary on distressed company governance focuses on the role of the independent director in reducing liability for these types of claims. In contrast, recent litigation against the board of directors ("Board") brought by trustees formed by the *Toys "R" Us* and *SportCo Holdings* chapter 11 plans highlights a different fact pattern arising from decisions made by those Boards with respect to the structure and terms of the restructuring itself. This article describes the law relevant to Board decision-making when a corporation is in distress, the relevant D&O litigation arising in *Toys R Us* and *SportCo Holdings*, and concludes with steps Boards can take to mitigate the risk of liability in connection with negotiating and approving restructuring and restructuring-related transactions.

BACKGROUND: DISTRESSED COMPANY GOVERNANCE AND APPLICABLE LAW

The internal affairs doctrine provides that "the law of the state where a corporation is incorporated governs issues relating to the internal affairs of a corporation, which include issues relating to a corporations' directors' and officers' fiduciary duties."[1] The *primary* fiduciary duties of directors and officers are the duty of care and the duty of loyalty. The duty of care obligates every corporate director and officer to discharge duties to the corporation with the same diligence, care, and skill which ordinary prudent persons exercise in their personal affairs. Under Delaware law, directors owe a

[1] *In re Hydrogen, L.L.C.*, 431 B.R. 337, 346 (Bankr. S.D.N.Y. 2010).

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