LAW360

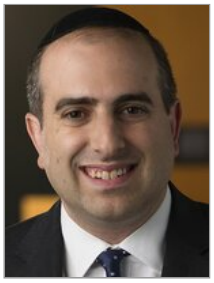
Portfolio Media. Inc. | 111 West 19th Street, 5th floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Avoiding Independent Director Challenges In Ch. 11 Litigation

By **Kenneth Rosen, Howard Brownstein and Philip Gross** (July 13, 2021, 1:14 PM EDT)

Kenneth Rosen

Howard Brownstein



Philip Gross

Recently, a materially revised Chapter 11 restructuring plan of reorganization was negotiated, in part, by a purportedly independent special committee of the board of Purdue Pharma LP.[1]

In the Chapter 11 case of Purdue Pharma, filed in the U.S. Bankruptcy Court for the Southern District of New York Bankruptcy Court in September 2019, the Purdue debtors stated that the special committee was comprised of "four blue-chip restructuring and pharmaceutical professionals, none of whom had any prior connection to the Sackler Families."[2]

However, the independence of that special committee was challenged by a parent — whose child allegedly died as a result of the opioid epidemic — who sought the appointment of an examiner.[3]

On June 16, U.S. Bankruptcy Judge Robert Drain ordered the appointment of an examiner with limited powers tasked with investigating whether the Purdue special committee, "in directing that the Chapter 11 plan ... to be filed and pursued, was acting independently."[4]

Had the independent committee made adequate disclosures at the outset of the case, as we suggest below, so that the independence issue was thoroughly vetted earlier, perhaps this whole sideshow could have been avoided, particularly now nearly two years after the Purdue Pharma bankruptcy petition was filed and on the verge of plan confirmation.

The appointment of independent directors or special litigation committees by a debtor or prospective debtor in anticipation of a company commencing a bankruptcy case has become a common tool.

Such an appointment may be recommended by restructuring advisers to help insulate a company's board or its shareholders from criticism of prepetition decisions and/or to help a soon-to-be debtor maintain control over potential post-petition investigations of actions taken by the company leading up to the bankruptcy filing.

One issue with such practice, though, is determining what diligence must be done before a bankruptcy court and creditors can be satisfied that the corporate governance tool of independent directors is sufficient. Before responding, we review certain applicable statutes and case law, and then focus on practicalities and realities with respect to suggested disclosure regarding independent directors.

We note at the outset that the practice of appointing independent directors has come under recent criticism for supposedly divesting creditors of the right to conduct their own investigation. The concern is that such independent directors may be beholden to the party responsible for their appointment, and "tread softly in the investigation,"[5] which would of course violate their independence, as professors Jared Ellias, Ehud Kamar and Kobi Kastiel recently put it in their paper, "The Rise of Bankruptcy Directors."

The paper is critical of the independent director practice and states that "[t]raditionally, there has ... been little need to focus on the independence of board members," as a bankruptcy judge "was the final decision-maker, and creditors were ready to weigh in on important bankruptcy decisions and state their position."[6]

Then, the paper says that that is no longer the case, that there is an increased need today to focus on the independence of such board members, and that such directors should be approved only if creditors actively support their appointment.[7]

We respectfully disagree, and believe that this solution is misguided. Requiring creditor blessing of an independent director is, in our view, an invitation to an unnecessary controversy, which may be expensive and cause delays.

The appropriate response to the concerns stated in the article is fuller disclosure, so that the bankruptcy court can make an informed decision regarding director independence and any investigation to be conducted.

With proper disclosure requirements, the debtor's professionals and other parties with influence in the selection process will be more cautious in their appointments, given the risk of (1) a court taking a deep dive into the director's independence, based on full and complete disclosure of such director's relationships, and (2) the court appointing an examiner or Chapter 11 trustee, as occurred in the Purdue Pharma case.

In addition, where sophisticated creditors, ad hoc and official committees, nonconsenting shareholders, and/or other parties are actively participating in large corporate bankruptcies — as is typical — such parties can also evaluate and raise issues as to director independence.

Bankruptcy judges regularly determine whether bankruptcy estate professionals are independent and conflict-free, and the U.S. Trustee's Office is typically involved in that process. The same should hold true for independent directors.

We agree with the article's recommendation[8] that bankruptcy judges adopt a practice of holding a hearing early in large Chapter 11 cases in which the debtor presents any independent directors it has recently appointed or plans to appoint during the bankruptcy. But, as with bankruptcy professionals, there first must be adequate disclosure of connections so that the court can properly evaluate the independence of a particular director.

Our purpose is not to be critical of persons who commonly serve as board members in bankruptcy cases. We believe that the practice of the appointment of independent board members, particularly as a company approaches insolvency, is an appropriate tool for maintaining and improving corporate governance. However, evaluation of such a board member's independence requires scrutiny of the board member's relationships.

A determination that an appointed or proposed board member is not sufficiently independent is not necessarily a comment on such person's integrity or reputation. Rather, per the Delaware Chancery Court in its 2003 In re: Oracle Corp. Derivative Litigation decision, it is solely a conclusion that such person is "not situated to act with the required degree of impartiality."[9]

Bankruptcy has long imposed its own standards regarding independence, such as where a conflict waiver pursuant to applicable state law may be insufficient for legal professionals.

Appointment of Independent Directors to Retain Control and Criteria for Appointments

In bankruptcy cases, one strategy may be to convince the bankruptcy court that the independent director will report on an examination as a neutral expert, similar to that of a court-appointed examiner.

The appointment of independent directors to oversee an investigation, or to negotiate a transaction when a majority of its directors may not be disinterested, enables the corporation to retain better control over the investigation and/or over the transaction negotiations.

The U.S. Trustee's Office may seek the appointment of an examiner despite the existence of an independent board member or special committee, if there is evidence that a debtor is attempting to weaken the process via the appointment of directors who are not truly independent. This is an additional reason for the debtor's professionals to exercise care in their appointment.

Similarly, if the independent director's appointment is perceived by creditors as a device for a company to soften dealings with a possible adversary, creditors' committees may discount the value of the independent board member,[10] and seek to conduct and control the investigation themselves. The debtor's counsel should avoid this danger by ensuring the true independence of directors.

Delaware Law

In bankruptcy cases, appointing independent directors is often an attempt to insulate actions taken prior to commencing the bankruptcy case, such as cash bonuses, modification of employment contracts, key employee retention agreements or insider transactions. The argument is that, if independent directors approved the prepetition action, it should not be subject to challenge post-petition.

However, in reality, the mere appointment of one or more purportedly independent board members does not ipso facto mean that the inquiry is over as to whether an investigation should be conducted, or whether the debtor's board's view that a particular transaction is reasonable should be accepted.[11]

Delaware law generally does not provide bright-line guidance to determine independence.[12]

As discussed by Arthur Kohn, a partner at Cleary Gottlieb Steen & Hamilton LLP in a recent post, the determination of director independence "involves a fact-intensive inquiry that is made on a transaction- or decision-specific basis. ... Under Delaware law, '[i]ndependence means that a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences.'"[13]

Kohn continues that, "much of the case law in this area has concentrated on business relationships or other economic ties among directors, particularly in industries that foster tight networks of repeat players." The Delaware courts have focused on the circumstances in which personal relationships impact independence.[14]

Whether an individual is an independent director largely depends on the situation and its context. Delaware courts have adopted a flexible, fact-based approach to the determination of directorial independence. This test, laid out in the Oracle decision, focuses on whether the director a "director is, for any substantial reason, incapable of making a decision with only the best interests of the corporation in mind."[15]

What constitutes a material relationship or one that would interfere with the exercise of independent judgment is a fact-

based question.

As discussed by Orrick Herrington & Sutcliffe LLP attorneys Jim Kramer, Todd Scott and Alex Talarides, the question of whether a director is independent "must be evaluated on a case-by-case basis, and should involve careful consideration of the director's background, business history and personal relationships."[16]

Per Kohn's post, the "Delaware Supreme Court's recent case law has stressed that 'when evaluating director independence, personal relationships do matter.'"[17]

In Chapter 11 bankruptcy cases, the unspoken question is whether the independent board member will cede to the often-unspoken influence of such person's nominator by being too soft in an investigation, or in approving an insider transaction without being sufficiently aggressive in negotiations to fully maximize the estate's benefit from the transaction.

The Delaware Chancery Court has given some guidance as to requirements for independence. Such a director must:

- Not be dominated or controlled by any party with an interest in the transaction;[18]
- Not be compromised by virtue of being, per the Oracle court, "beholden to an interested person";[19]
- Not be controlled by another;[20]
- Have the power to say "no" to the controlling shareholder;[21] and
- Have real freedom to negotiate and the ability to exercise it on an arm's-length basis.[22]

Greater Scrutiny for Evaluating Director Independence in the Bankruptcy Context

The above criteria are relatively vague in providing adequate guidance as to the panoply of relationships that may impact the independence of director in a bankruptcy case.

Because the restructuring industry is relatively small, the universe of players in bankruptcy cases — lawyers, investment bankers, financial advisers, bankruptcy directors and investors — often intersects in numerous bankruptcy cases, with people sometimes playing the same or different roles.

Being dominated or controlled by another does not mean just owing someone money in the financial sense. Rather, dominance or control can flow from personal or other relationships to the interested party.

The concern exists that an independent board member's reliance on their nominator[23] for future paid board appointment roles can, intentionally or not, cause the board member to be dominated or beholden.

Therefore, in the bankruptcy context where a court is considering the appointment of an independent director, inquiry into the number of appointments by the nominator of a particular nominee is an appropriate area of inquiry.

The counterargument is that the nominee is an attentive, diligent and true independent and, therefore, has been asked more than once by the nominator to serve on boards. The point is that this is an appropriate area of inquiry. It is not that a nominee should automatically be disqualified if regularly nominated by the nominator. Rather the issue should be reviewed and considered.

Proposed Required Disclosures for Independent Directors in a Bankruptcy Context

Below are suggested disclosures to be made by a proposed independent director — or an existing director that is purportedly independent — in the bankruptcy context, in order to enable the court to make an informed decision as to such director's independence and whether such director is appropriately deemed independent for the circumstances at issue:

- Who introduced or recommended the independent board member?
- If recommended by another board member, provide that board member's name, and whether they will be the potential subject or target of an investigation and/or party to a proposed transaction to be evaluated by the special committee or independent board member.
- Was the person recommended by the debtor's counsel or debtor's financial adviser? If so, identify the cases and companies where the debtor's counsel or financial adviser is or has been a retained professional to a company of which the independent board member currently or formerly was a board member, whether the independent board member was previously employed by the debtor's counsel or financial adviser, and whether the independent board member is currently a board member of any other companies currently or previously represented by the debtor's counsel or debtor's financial adviser.

- Does the independent board member currently serve, or have they in the past three years previously served as a board member of any other companies where a member of the debtor's board also served or serves as a board member?
- Identify the for-profit and nonprofit boards of which the independent director is a member, and any companies for which the nominee serves as an officer.
- Identify the bankruptcy cases, companies and/or situations where the director serves or has previously served as financial adviser, chief restructuring officer, litigation trustee, liquidation trustee, disbursing agent, or other expert or agent.
- Is the debtor's counsel also counsel to any party in any of the cases, companies and/or situations where such independent director served (or serves) as financial adviser, chief restructuring officer, litigation trustee, liquidation trustee, disbursing agent, or other expert or agent?
- Will the independent board member, or a special board committee on which the independent board member will serve, have the ability to appoint counsel and financial advisers of their own choosing, separate and apart from the debtor's professionals?
- Identify any other companies where the independent director is or has been a board member in the past three years and where the debtor's counsel or financial adviser is or has been a professional retained by a principal equity holder or principal creditor of the company in the past three years.
- Identify any other companies where the independent board member is or has been a board member in the past three years, and where principal stockholders or principal creditors of the debtor are also principal stockholders or creditors of such other company in the past three years.

With these disclosures, both a court and creditors can sufficiently evaluate the asserted independence of a director prior to turning to more drastic and costly bankruptcy tools such as examiners or Chapter 11 trustees.

Kenneth A. Rosen is a partner and chair emeritus of the bankruptcy and restructuring department at Lowenstein Sandler LLP.

Howard Brod Brownstein is president of the Brownstein Corp.

Philip J. Gross is counsel at Lowenstein Sandler.

[1] See Debtors' Opposition to Motion for Order to Appoint an Examiner, In re Purdue Pharma LP, Case No. 19-23649 (Bankr. S.D.N.Y.), Docket No. 3020, available at https://restructuring.primeclerk.com/purduepharma/Home-DownloadPDF?id1=MTIyNzMyMg==&id2=-1.

[2] See id.

[3] See Motion for Appointment of Chapter 11 Examiner, In re Purdue Pharma LP, Case No. 19-23649 (Bankr. S.D.N.Y.), Docket No. 2963, available at https://restructuring.primeclerk.com/purduepharma/Home-DownloadPDF?id1=MTIyMjA2Mg==&id2=-1.

[4] See Maria Chutchian, Purdue Pharma Bankruptcy Judge OKs Examiner but Condemns Sackler-Related Attacks, Reuter News, available at https://www.reuters.com/legal/transactional/purdue-pharma-bankruptcy-judge-oks-examiner-condemns-sackler-related-attacks-2021-06-16/.

[5] See, Jared A. Ellias, Ehud Kamar, and Kobi Kastiel, The Rise of Bankruptcy Directors, European Corporate Governance Institute - Law Working Paper No. 593/2021 (June 14, 2021), at pp.1, 37-39 (noting that while independent directors "claim to be neutral experts that act to maximize value for the benefit of creditors, they suffer from a structural bias because they are part of a small community of repeat private-equity sponsors and law firms."), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3866669.

[6] Id. at 11.

[7] Id. at 36-38.

[8] Id. at p. 39.

[9] See In re Oracle Corp. Derivative Litigation , 824 A.2d 917, 847 (Del. Ch. 2003).

[10] See, e.g., In re MAXXAM, Inc./Federated Dev. Shareholders Litig ., 659 A.2d 760, 774 (Del. Ch. 1995) (court had "serious questions" about independence of directors).

[11] Id. at 13 (citing Rabkin v. Olin Corp. , No. 7547, 1990 WL 47648, at *861-62 (Del. Ch. Apr. 17, 1990), aff'd 586 A.2d 1202 (Del. 1990).

[12] Arthur H. Kohn, Update on Director Independence, available at https://www.clearymawatch.com/2019/11/update-on-director-independence/.

[13] Id. (citing Aronson v. Lewis , 473 A.2d 805, 816 (Del. 1984)).

[14] Id.

[15] Oracle Corp. Derivative Litigation, 824 A.2d at 920.

[16] Jim Kramer, M. Todd Scott and Alex Talarides, What Makes a Director "Independent"?, Orrick Corporate Governance Weekly Blogs, available at https://blogs.orrick.com/securities-litigation/2013/05/02/corporate-governance-weekly-what-makes-a-director-independent/.

[17] Arthur H. Kohn, Update on Director Independence, available at https://www.clearymawatch.com/2019/11/update-on-director-independence/ (citing Park Employees' & Ret. Bd. Employees' Annuity & Benefit Fund of Chicago on behalf of BioScrip, Inc. v. Smith, 2017 WL 1382597, at *10 (Del. Ch. Apr. 18, 2017) (citingSandys v. Pincus, 152 A.3d 124 (Del. 2016))).

[18] See, e.g., In re Maxxam, Inc. / Federated Dev. S'holder Litig., 659 A.2d 760, 773 (Del. Ch. 1995).

[19] See, e.g., Oracle Corp Derivative Litig., 824 A.2d at 938-39.

[20] Orman v. Cullman , 794 A.2d 5 (2002); Kahn v. Lynch Communication Systems, Inc. , 638 A.2d 1110 (1994).

[21] Jonathan Rosenberg & Alexandra Lewis-Reisen, Controlling-Shareholder Related-Party Transactions Under Delaware Law at p. 5, available at https://www.omm.com/omm_distribution/delaware_controlling_shareholder/delaware_controlling_shareholder_article.pdf (citing Kahn v. Lynch, 638 A.2d at 1110, 1119 (Del. 1994)).

[22] Id. (citations omitted).

[23] We define "nominator" as a person who is in large part responsible for the independent board member's appointment.