

Fiduciary Considerations for Pre-Bankruptcy Transactions

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While Chapter 11 remains an attractive mechanism for selling distressed assets, some purchasers and sellers looking to avoid the costs or oversight associated with the Chapter 11 process instead choose to effectuate a pre-bankruptcy sale followed by filing a Chapter 7 petition. There is no denying that Chapter 11 can be expensive and that there may be a heightened level of scrutiny from committees or other interested parties analyzing the transaction. There may also be less certainty for the proposed buyer, as a Chapter 11 process is likely to result in a competitive auction process where other prospective purchasers may submit higher bids. That said, a pre-bankruptcy sale is not free from challenge. A Chapter 7 trustee will undoubtedly scrutinize the pre-petition transaction for potential causes of action that could result in a potential recovery for the bankruptcy estate.

This was precisely the fact pattern before the court in *Miller v. American Capital Ltd. (In re Newstarcom Holdings)*, Case No. 08-10108, Adv. Proc. No. 10-50063 (Bankr. D. Del. Aug. 6, 2014) (Sontchi, C.). Prior to commencing Chapter 7 cases, the debtors were a holding company with three electrical contractors as subsidiaries. Two of the subsidiaries were closed in October 2007, and the third subsidiary, Matco Electric Corp. (Old Matco), faced a risk of foreclosure if not sold on an expedited basis. Thus, in late 2007, the debtors completed a sale of Old Matco to three former officers of Old Matco for a purchase price of \$2 million. The debtors then filed voluntary petitions under Chapter 7 of the Bankruptcy Code on Jan. 14, 2008. On Jan. 12, 2010, the trustee commenced an adversary proceeding seeking to recover damages related to the sale of Old Matco, asserting that the actual value of Old Matco at the time of the sale was in excess of \$15 million, and breaches of fiduciary duties based on Old Matco being sold to "insiders" for substantially less than fair market value.

The issue before the court related to a motion by the trustee to compel the production of post-sale financial data, which it asserted was relevant to determining the reasonableness of any valuation of Old Matco at the time of the sale. The defendants objected to the discovery requests on the basis of relevance, overbreadth and undue burden, and asserted that the requests were not limited appropriately by date. The opinion not only addresses the issues raised by the motion to compel, but also provides an excellent overview of applicable fiduciary duty law relevant to assessing a board's consideration of a pre-bankruptcy sale. As is familiar to practitioners and noted by the court, under Delaware law, directors of a corporation (and, in many instances, managers of a limited liability company) owe a duty of care and a duty of loyalty and good faith. Generally, directors are presumed to have made business decisions on a fully informed basis, in good faith, and in the honest belief that the action taken was in the company's best interest. Upon rebutting this presumption, the burden shifts to the defendant-directors to establish that they complied with their fiduciary duties. In the context of a sale of a company, directors' decisions are generally more heavily scrutinized to ensure that a fair process was used and fair price reached.

The court in *Newstarcom* proceeded to review the relevance of post-acquisition financial information in determining whether the purchasers of Old Matco complied with their fiduciary duties as "insiders" of the debtors. While stating

that confirmatory data can be used to determine the accuracy and reasonableness of projections, the court concluded that the accuracy of projections provides little information in determining whether reliance on such valuations constituted a breach of fiduciary duty in approving a sale at a specific price. Rather, the court noted that the relevant inquiry should be of the decision-making process of a sale, rather than the accuracy of any valuation that was considered. Indeed, the court indicated that the appropriate examination should be as to "whether the valuations were made by individuals selected with reasonable care, whether the directors had active and direct oversight in the sale process, whether the directors had improper motives, and more."

In addition to addressing the underlying discovery issue, the *Newstarcom* decision provides several insights that should be considered in the pre-bankruptcy sale context. First, directors, officers and other deemed "insiders" effectuating a pre-bankruptcy sale need to be fully informed of and act consistently with their state-law fiduciary duties. Unlike a post-petition sale of assets under Section 363, where there is an open auction conducted pursuant to a court-approved process, the sale is not afforded the protections typically provided in a well-drafted order of the bankruptcy court. Relatively standard protections found in Section 363 sale orders include: (1) a finding that the buyer is a "good-faith" purchaser under Section 363(m) of the Bankruptcy Code; (2) a finding that the price paid was the highest and best price, and therefore fair and reasonable, insulating a buyer from later claims such as those raised in *Newstarcom*; and (3) mutual releases of, and injunctions of causes of action against, the buyer, seller and other interested parties (including the seller's directors and officers) from any claims related to pre-sale events. Counsel to a board contemplating a pre-bankruptcy sale therefore needs to ensure that its clients understand their obligations as "insiders" of a company under applicable state law. Moreover, *Newstarcom* highlights some of the benefits of an in-court rather than out-of-court acquisition. Though an out-of-court sale followed by a Chapter 7 filing may be quicker and outside the overview of the bankruptcy court (and the scrutiny of creditors), a Section 363 sale and the benefits of a well-drafted Section 363 sale order afford a purchaser with significant protections that should be considered in any distressed acquisition.

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