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Delaware Chancery Update: Director and Creditor Liability in Distressed Companies

In Connection with a Forbearance Agreement, the Delaware Court of Chancery Finds Directors Liable for Breaching Their Duty of Loyalty and Creditors Liable for Aiding and Abetting Those Breaches

SUMMARY

On November 15, 2024, the Delaware Court of Chancery found that certain of the directors of Bridge Street Worldwide, Inc. ("BSW"), a Delaware corporation, were liable for breaching their fiduciary duty of loyalty by entering into a forbearance agreement with BSW's creditor, Domus BWW Funding LLC ("Domus"), a subsidiary of Versa Capital Management, LLC ("Versa"). The court held that the directors approving the forbearance agreement were materially interested in the transaction due to the creditor agreeing to indemnify the directors in the face of substantial litigation risk and that the transaction was not entirely fair to BSW or its stockholders.[1] The court went on to find that Versa and Domus aided and abetted BSW's directors' breach of their duty of loyalty because the creditor parties knew of the substantial litigation risk BSW's directors were facing and exploited BSW's directors' fear of litigation by offering indemnification to finalize the forbearance transaction.

Although this case is fact-specific and likely to be appealed, there are three important implications for directors and creditors of Delaware corporations to consider:

1. Directors may be deemed materially interested in a transaction that involves indemnification of the directors or the provision of supplemental insurance where a high and specific risk of litigation exists. This could trigger entire fairness review of the transaction, which is the most stringent standard of review under Delaware law.
2. Creditors may be found to have aided and abetted directors' breaches of fiduciary duties where such creditors are aware that the target company's directors are at a high level of litigation risk and the creditor offers such directors indemnification or enhanced insurance coverage.

3. If an investor has a roster of directors from which the investor frequently chooses its director designees, a director that has been placed on boards in the past by the investor and that may expect to be placed on portfolio company boards in the future may not be considered to be independent from the investor.

CASE SUMMARY AND ANALYSIS

A. Facts

In the early 2010s, BSW was in debt to its lender syndicate. Seeking strategic alternatives, BSW initiated an ultimately unsuccessful sale process. Versa, one of the bidders for BSW in the failed sale process, decided to attempt to gain control and economic ownership of BSW by purchasing the Company's senior secured debt, which was already in default as of December 31, 2012, from BSW's existing creditors through Domus. After Domus' acquisition of BSW's senior secured debt and BSW's continued default on such debt, on September 30, 2013, BSW entered into a forbearance agreement with Domus. Pursuant to the forbearance agreement, BSW provided Domus with first-priority security interests in additional collateral and agreed to adhere to stringent financial covenants. In exchange for these collateral and covenant enhancements, Domus advanced additional first-lien loans to cover items such as past-due interest payments and working capital needs and agreed to forbear for a five-month period.

Prior to and during negotiations of the forbearance agreement, BSW's board had refused to honor certain contractual rights of its largest stockholder (the "Stockholder") under a shareholders agreement (the "Shareholders Agreement"), including the right to appoint a designee of the Stockholder to BSW's board of directors and the right to receive certain requested information.

As part of the forbearance agreement, Domus, with knowledge of the facts underlying the likely breaches of the Shareholders Agreement, agreed to indemnify the existing directors (the "Pre-Forbearance Directors") for any claims asserted or supported by the Stockholder related to BSW or its subsidiaries, including in their personal capacities as stockholders and parties to the Shareholders Agreement. The pre-forbearance directors also received D&O coverage. Further, in connection with the forbearance agreement, BSW's senior management, including two of the Pre-Forbearance Directors, also entered into MOUs for continued employment and bonuses from Domus. The four independent directors among the Pre-Forbearance Directors signed agreements under which they agreed not to stand for reelection—effectively resigning as part of the transaction.

A few weeks after entering into the forbearance agreement, five new directors were elected to join the board (the "Post-Forbearance Directors"). Four of the Post-Forbearance Directors required the approval of Domus and the fifth director was the designee of the Stockholder under the Shareholders Agreement. In November 2013, the Company breached the financial covenants provided for by the forbearance agreement. Following months of negotiations and in consultation with their advisers, the Post-Forbearance Directors approved a consensual foreclosure on collateral by Domus. Pursuant to foreclosure, BSW transferred all of the equity

of its operating subsidiaries to Domus in exchange for the cancellation of approximately $38 million of the remaining $46 million owed under the senior secured debt.

Following the consensual foreclosure, the Stockholder and its designated director ("Plaintiffs") asserted a variety of claims against the Pre-Forbearance Directors, the other Post-Forbearance Directors, Versa, Domus, and BSW. Plaintiffs alleged that the BSW and certain of its directors had breached the Shareholders Agreement and that the BSW's directors breached their fiduciary duties in approving the forbearance agreement and the consensual foreclosure. Plaintiffs further alleged that Versa and Domus (the "Versa Defendants") aided and abetted the directors' breach of fiduciary duty.

In its post-trial opinion, the court concluded that the BSW and certain of its directors breached the Shareholders Agreement and breached their fiduciary duty of loyalty by approving the forbearance agreement and that the Versa Defendants aided and abetted that breach. As a remedy for the Pre-Forbearance Directors' breach of fiduciary duty, the court ordered the Pre-Forbearance Directors to disgorge and return to BSW all amounts paid to Pre-Forbearance Directors or their counsel as indemnification from the creditor, as well as the management bonuses approved in connection with the forbearance transaction. Further, as a remedy for the Versa Defendants aiding and abetting the Pre-Forbearance Directors' fiduciary breach, Versa Defendants' debt was equitably subordinated as to any amounts collected or received by or on behalf of the Company from the directors as a result of the court's ordered disgorgement.

B. Analysis

The court determined that BSW and certain of BSW's directors breached the Shareholders Agreement because the facts made it clear that BSW and the directors had no good-faith basis for denying the Stockholder its rights under the Shareholder Agreement. Importantly, the court found that the Pre-Forbearance Directors were aware that they were violating the Stockholders' rights under the Shareholder Agreement and that the Pre-Forbearance Directors knew that they could be personally liable for breaches of the Shareholders Agreement as parties to the Shareholder Agreement in their personal capacities.

Analyzing whether the Pre-Forbearance Directors breached their duty of loyalty in approving the forbearance agreement, the court considered whether the following benefits each Pre-Forbearance Director received in connection with the forbearance agreement made the director materially interested in the forbearance agreement transaction: 1) D&O insurance coverage; 2) indemnification from Domus for claims arising out of the forbearance agreement and for any claims related to BSW asserted by or with the assistance of the Stockholder; and 3) a release from Domus of any claims against them in connection with the forbearance agreement.[2]

Normally, the inclusion of these benefits would not be enough to make a director materially interested in a transaction.[3] The court, however, determined that because of the high risk of litigation and personal liability

arising out of the Pre-Forbearance Directors' violations of the Stockholder's rights under the Shareholder Agreement, and the Pre-Forbearance Directors' insistence on indemnification from Domus for the specific, non-ordinary-course litigation risk the Pre-Forbearance Directors were facing, that the benefits were material benefits to the Pre-Forbearance Directors that made them interested in the transaction.

Having determined that half or more of the Pre-Forbearance Directors were interested in the forbearance agreement transaction, the court applied the entire fairness standard to the Pre-Forbearance Directors' approval of the forbearance agreement. Under the entire fairness standard, the defendant directors bear the burden of establishing that the transaction was the product of a fair process and resulted in a fair price to the company (*i.e.*, the "give" in exchange for the "get" was within the range of reasonableness). Pointing to the Pre-Forbearance Directors' exclusion of the Stockholder's designee during the negotiation of the forbearance agreement and the Pre-Forbearance Directors' insistent focus on obtaining indemnification as a top priority, the court found that the forbearance agreement transaction was not the product of fair dealing. Further, the court found that the Pre-Forbearance Directors did not submit sufficient, credible evidence to carry their burden to prove that BSW received a fair price in the Forbearance Agreement. Looking at the forbearance agreement under a unitary standard, the court determined that the forbearance agreement was not entirely fair because it was not the product of fair dealing and the Pre-Forbearance Directors failed to carry their burden of proving that the financial terms of the forbearance agreement were fair.

As a remedy for the Pre-Forbearance Directors' breach of their duty of loyalty, 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 were to be disgorged and returned to BSW.

Next, the court held 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 the Post-Forbearance Directors' decision to approve it, because the terms of the foreclosure ensured that the management directors would retain management positions and retention bonuses. In addition, one of the non-management directors ("Walker") was interested in the consensual foreclosure because Versa had selected Walker's insolvency company to administer, and receive significant fees in connection with, the assignment for the benefit of creditors ("ABC") proceeding anticipated to occur after the consensual foreclosure. Finally, the court found that an additional Domus-selected director was not independent from the Versa Defendants because that director had been appointed by Versa Defendants to the board of another Versa portfolio company and, accordingly, had an expectation that the Versa Defendants would consider that director for future directorships if he acted in the Versa Defendants' best interests. Having determined that at least half of the Post-Forbearance Directors were not independent with respect to or disinterested in the transaction, the court applied the entire fairness test to the Post-Forbearance Board's decision to approve the consensual foreclosure.

Applying the entire fairness standard, the court determined that while the process leading up to the consensual foreclosure was not perfect because, among other things, Walker helped negotiate the consensual foreclosure for BSW despite being conflicted, the Post-Forbearance Board's process in approving the consensual foreclosure was largely the product of fair dealing. The court noted that perfection is not required under Delaware law, the Post-Forbearance Directors' hands were largely tied due to BSW's dire financial situation, and the Post-Forbearance directors engaged in a well-advised, thoroughly deliberative process in approving the foreclosure.

The court determined that the consensual foreclosure provided BSW a fair price given the exchange of equity interests in BSW's subsidiaries, which had no residual equity value due to the pledge in favor of Domus' debt, in satisfaction of BSW's outstanding debt to Domus. The court determined that this was a fair exchange. Accordingly, analyzing the approval of the consensual foreclosure under a unitary standard, the court determined that the fair-dealing and fair-price factors counseled in favor of finding that the consensual foreclosure transaction was entirely fair to BSW.

Next, the court analyzed Plaintiffs' claim that the Versa Defendants aided and abetted the Pre-Forbearance Directors' breach of their duty of loyalty.[4] The court concluded that the Versa Defendants knew of the facts underlying the substantial litigation risk the Pre-Forbearance Directors were facing as a result of the Pre-Forbearance Directors' exclusion of the Stockholder and that the Versa Defendants exploited BSW's directors' fear of litigation by offering the board indemnification in order to finalize the forbearance transaction. Accordingly, the court held that the Versa Defendant's exploitation of the BSW Directors' fear and attendant conflict of interest, through offering indemnification, induced the BSW directors' fiduciary breach and made Versa liable for aiding and abetting such breach. The court found that the Versa Defendants were in a unique position to exploit the conflicted Pre-Forbearance Board and that the Versa Defendants seized that opportunity to extract additional benefits from those directors at BSW's expense. Specifically, the court stated that the Versa Defendants diverted potential consideration away from BSW and into the pockets of the Pre-Forbearance Directors by agreeing to provide broad indemnification for claims brought by the Stockholder in exchange for security in additional collateral. As a remedy, the court equitably subordinated Domus' outstanding BSW debt (*i.e.*, Domus' outstanding debt post the foreclosure's reductions of the same), essentially allowing any funds flowing to BSW as a result of the court's ruling to flow to BSW's other creditors first.

C. Conclusion

This case highlights that directors of Delaware corporations should always remain aware of their fiduciary obligations and consider whether the prioritization of certain objectives in negotiations—including indemnification, D&O insurance coverage and releases—may lead to a finding that those directors were self-interested, and cause the transaction to be evaluated under an entire fairness standard. Additionally, this case emphasizes that where a creditor has knowledge of a director's potential conflict of interest and

exploits that conflict for its own benefit, such a creditor may be found liable for aiding and abetting liability. A record demonstrating that value was given by the corporation to the creditor in exchange for director-specific benefits is likely to increase the risk of such a finding.

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ENDNOTES

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

[2] The court separately considered the disinterestedness of the management directors with respect to the approval of the forbearance agreement and found that the management directors were not disinterested because they stood to receive continued employment arising out of the employment MOUs. *Id.* at 82–83.

[3] *See In re Sea-Land Corp. S'holders Litig.*, 642 A.2d 792, 804 (Del. Ch. 1993) (citations omitted), *aff'd subnom. Sea-Land Corp. S'holder Litig. v. Abely*, 633 A.2d 371 (Del. 1993) (TABLE) ("Normally, the receipt of indemnification is not deemed to taint related director actions with a presumption of self-interest. That is because indemnification has become commonplace in corporate affairs, and because indemnification does not increase a director's wealth.").

[4] *GB-SP* at 139. To establish a claim for aiding and abetting a breach of fiduciary duty, a plaintiff must prove: "(i) the existence of a fiduciary relationship, (ii) a breach of the fiduciary's duty, (iii) knowing participation in that breach by the defendants, and (iv) damages proximately caused by the breach." *RBC Cap. Mkts., LLC v. Jervis*, 129 A.3d 816, 861 (Del. 2015) (citations omitted).

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