RECENT DEVELOPMENTS IN
OFFICER AND DIRECTOR LITIGATION

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RECENT DEVELOPMENTS IN OFFICER AND DIRECTOR LITIGATION

I. Introduction

Because a substantial number of states follow Delaware law on matters of corporate governance and much of the law in the corporate governance area is made in the Delaware courts, these materials will focus on recent developments in Delaware law regarding the liability of directors and officers of corporations for breach of their fiduciary duties. The principal focus will be on a recent decision in the Delaware bankruptcy court, Bridgeport Holdings Inc. v. Boyer (In re Bridgeport Holdings Inc.), 388 B.R. 548 (Bankr. D.Del. 2008), in which the court held that the formidable defenses normally available to shield directors of Delaware corporations from liability for monetary damages resulting from the breach of their fiduciary duty of care were unavailable on the facts of that case. The case demonstrates, among other things, that a board of directors cannot simply rely on the decisions of an experienced and well-respected restructuring advisor brought in to deal with a corporation's financial crisis but must continue to exercise judgment and oversight with respect to the strategic direction of the corporation in light of its distressed condition.

II. Fiduciary Duties of Officers and Directors When a Corporation Is Insolvent or Operating in the Zone of Insolvency

Ordinarily, directors and officers of a Delaware corporation do not owe fiduciary duties to creditors of the corporation. Creditors have the ability to protect their interests through contractual arrangements with the corporation and enforcement of fraudulent transfer and similar laws, and corporate officers and directors are free to

negotiate vigorously against creditors, for the benefit of the corporation and its shareholders, unconstrained by any fiduciary duties to the creditors.

A 1991 decision of the Delaware Court of Chancery in Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., 1991 WL 277613 (Del. Ch. Dec. 30, 1991), however, raised questions about whether the normal rule continued to apply if the corporation was insolvent or operating in the "zone of insolvency." In a footnote, the chancellor indicated that, when a corporation was insolvent or in the vicinity of insolvency, the directors should not necessarily be guided solely by the interests of shareholders but rather should consider the community of interests (shareholders, creditors, employees and other interested constituencies) that the corporation represents. Id. at *36 n. 55.

Footnote 55 in the Credit Lyonnais opinion led some courts to the conclusion that, when a corporation is insolvent or in the zone of insolvency, the officers and directors become subject to fiduciary duties to creditors. See, e.g., Carrieri v. Jobs.com Inc., 393 F.3d 508, 534 n.24 (5th Cir. 2004) ("Officers and directors that are aware that the corporation is insolvent, or within the 'zone of insolvency' as in this case, have expanded fiduciary duties to include the creditors of the corporation."); Weaver v. Kellogg, 216 B.R. 563, 583-84 (S.D. Tex. 1997) (corporate insiders may have a fiduciary duty to creditors when the corporation is in the vicinity of insolvency).

Credit Lyonnais raised questions about the nature of officers' and directors' duties to creditors under Delaware law, when the corporation was insolvent or in the vicinity of insolvency and whether claims for breach of any such duties were direct or derivative. For a number of years, the Delaware courts wrestled with these questions,

opining that, when a corporation becomes insolvent, the creditors have standing to assert breach of fiduciary duty claims against officers and directors but that such claims are, in most instances, derivative and are for harm done to the corporation by the alleged breaches, not for direct injury to the creditor. See, e.g., Production Resources Group L.L.C. v. NCT Group, Inc., 863 A.2d 772, 792 (Del. Ch. Nov. 17, 2004); Big Lots Stores, Inc. v. Bain Capital Fund VII, L.L.C., 922 A.2d 1169 (Del. Ch. 2006); Trenwick America Litigation Trust v. Ernst & Young, L.L.P., 906 A.2d 168, 195 n. 75 (Del. Ch. Aug. 14, 2006), aff'd, 931 A.2d 438 (Del. 2007). These decisions did allow for the possibility, however, that, in exceptional circumstances, in which the directors of an insolvent corporation displayed a marked degree of animus toward a particular creditor with a proven entitlement to payment, the directors might expose themselves to a direct breach of fiduciary duty claim by that creditor. Production Resources, 863 A.2d at 798; see also North American Catholic Educational Programming Foundation, Inc. v. Gheewalla, 2006 WL 2588971 *13-18 (Del. Ch. Sept. 1, 2006) (if corporation is insolvent, a creditor may have a direct breach of fiduciary duty claim against officers and directors, but only if the creditor's claim is clearly and immediately due and payable and their conduct is invidious and directed particularly at the creditor or demonstrates a marked degree of animus toward the creditor).

Even this narrow window of exposure to **direct** creditor claims for breach of fiduciary duty was slammed shut by the Delaware Supreme Court, however, in its decision on appeal of the Court of Chancery's decision in the Gheewalla case. Though affirming the decision of the Court of Chancery, the Supreme Court adopted a different position regarding direct creditor claims against directors for breach of fiduciary duty,

holding that creditors of Delaware corporations **never** have **direct** breach of fiduciary duty claims against directors. North American Catholic Educational Programming Foundation, Inc. v. Gheewalla, 930 A.2d 92, 103 (Del. 2007). Under this ruling, creditors do not have direct breach of fiduciary duty claims even if the corporation is insolvent and even if the exceptional circumstances referenced in Production Resources and the decision of the Court of Chancery in Gheewalla are present. Id. Moreover, the Delaware Supreme Court clarified that, under Delaware law, "[w]hen a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners." Id. at 101. Effectively then, under the Delaware Supreme court's decision in Gheewalla, creditors of Delaware corporations are relegated to bringing breach of fiduciary duty claims against directors only when a corporation is insolvent and only derivatively, on behalf of the corporation. Furthermore, if the insolvent corporation goes into bankruptcy, such claims belong to the bankruptcy estate and can only be brought by the representative of the bankruptcy estate.

A noted commentator has summarized the State of Delaware law with respect to directors' fiduciary duties to creditors post-Gheewalla as follows:

> [U]under Delaware law, directors have no fiduciary duties to creditors if a corporation is in the "zone of insolvency." Further, the settled principle that directors owe fiduciary duties to creditors when a corporation is insolvent is actually very limited. It means that creditors of an insolvent corporation have the right to bring a derivative action for

> breach of fiduciary duty. They have no direct claim for relief for breach of fiduciary duty.

Sally S. Neely, Recent Developments Re: Fiduciary Duty in the Zone of and During Insolvency and Re: Deepening Insolvency (Southeastern Bankruptcy Law Institute – April 3-5, 2008), pp. 24-25. (internal footnotes omitted).[1]

III. The Delaware General Corporation Law's Exculpatory Provision

The fact that breach of fiduciary duty claims brought by creditors of Delaware corporations against the corporations' directors are derivative rather than direct is extremely significant because of, among other things, the exculpatory provision in Delaware's General Corporation Law, Del. Code Ann., title 8, § 102(b)(7). Section 102(b)(7) authorizes a Delaware corporation's certificate of incorporation to contain:

> A provision eliminating or limiting the personal liability of a director **to the corporation or its shareholders** for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit.

(emphasis added).

Almost without exception, an exculpatory provision completely eliminating any monetary liability of a director to the corporation or its shareholders for

[1] Under the laws of some states, officers and directors of insolvent corporations appear to have a duty to creditors not to prefer themselves over noninsider creditors. A breach of such duty seems to give rise to a direct claim by the creditor. As an example, in Ware v. Rankin, 97 Ga. App. 837 (1958), the Georgia Court of Appeals stated: "Directors and managers of insolvent corporations are trustees of the funds, as well for the creditors as for the corporation, and are bound to apply them pro rata, and can not use them to exonerate themselves to the injury of other creditors." Id. at 838. (internal quotations omitted). In 2002, Georgia enacted the Uniform Fraudulent Transfer Act, O.C.G.A. § 18-2-70 et seq., which includes a provision for the avoidance of insider preferences, O.C.G.A. § 18-2-75(b). Query whether this provision has replaced the doctrine enunciated in Ware v. Rankin.

breach of fiduciary duty (except as provided in clauses (i), (ii), (iii) and (iv) of section 102(b)(7)) will be found in the certificate of incorporation of a Delaware corporation.[2] Thus, when a claim is brought against a director of a Delaware corporation for monetary damages for injury to the corporation or its shareholders caused by the director's breach of the duty of care (including gross negligence) and none of the exceptions set forth in clauses (i), (ii), (iii) or (iv) of section 102(b)(7) apply, the claim is doomed to failure. If, on the other hand, a creditor could bring a **direct** claim against a director for monetary damages to the creditor resulting from breach of the duty of care, the exculpatory provision in the certificate of incorporation would not shield the director from liability on such claims because section 102(b)(7) only authorizes the exculpation of a director from personal liability to the corporation or its shareholders. Gheewalla, however, forecloses a direct claim by a creditor. Because a creditor of an insolvent Delaware corporation may only bring a derivative claim against a director for breach of fiduciary duty, the claim is deemed to be for liability to the corporation rather than liability to the creditor, and the exculpation provision in the certificate of incorporation applies. Production Resources, 863 A.2d at 792. Thus, when a claim against a director of a Delaware corporation seeking monetary damages for breach of fiduciary duty is based solely on the director's negligence or gross negligence (breach of duty of care) and the corporation's charter contains an exculpatory provision, the claim will be dismissed even if it is brought by a creditor of the corporation.

[2] Section 102(b)(7) authorizes the exculpation only of directors for breaches of fiduciary duty as directors. It does not authorize exculpation of officers, and a charter provision purporting to exculpate officers is ineffective to do so.

As shown in the following discussion of the Bridgeport Holdings case, however, the formidable insulation afforded directors by the exculpatory provision in the certificate of incorporation can be lost when the directors abdicate to a restructuring professional their responsibility for oversight with respect to the corporation's affairs.

IV. The Facts Alleged in the Bridgeport Holdings Case

A. Background

On September 10, 2003, Bridgeport Holdings Inc. and its domestic subsidiaries, which traded under the name, "Micro Warehouse," and engaged in a business similar to Office Depot, filed petitions for relief under chapter 11 of the Bankruptcy Code in the United States Bankruptcy Court for the District of Delaware (the "Bankruptcy Court"). Ultimately, a liquidating plan was confirmed in the chapter 11 cases pursuant to which a liquidating trust was created to investigate and pursue claims on behalf of the bankruptcy estate in an effort to obtain funds for distribution to creditors under the plan. On December 11, 2007, the liquidating trustee appointed under the plan caused the liquidating trust (the "Plaintiff") to file an adversary proceeding in the Bankruptcy Court against certain former officers and directors (the "D&O Defendants") and a financial advisor who had been retained by the debtors shortly before the filing of the chapter 11 cases (the "Turnaround Manager"). Count I of the complaint alleged breach of the fiduciary duty of loyalty and lack of good faith against the D&O Defendants. Count II alleged breach of the fiduciary duty of care and lack of good faith against the defendants named in Count I. Count V alleged breach of

the fiduciary duties of care and loyalty and lack of good faith against the Turnaround Manager, and Count VI alleged corporate waste against all defendants.[3]

The claims asserted by the Plaintiff were based principally on the rushed sale, shortly before bankruptcy, of a substantial portion of the debtors' United States assets, including a majority of the debtors' inventory and substantially all of their intellectual property, information technology hardware and furniture and equipment located at certain of the debtors' offices.

B. Events Leading to Financial Distress

In early 2000, at the height of the dot-com boom, Micro Warehouse was acquired in a leveraged buyout, incurring a large amount of debt in the process to a syndicate of lenders pursuant to a credit agreement (the "Credit Agreement"). By the end of 2000, the dot-com bubble had burst, a recession had commenced, and Micro Warehouse was not in compliance with the Credit Agreement. It was forced to negotiate amendments to the Credit Agreement at the end of 2000 and again in early 2002.

Though certain alternatives were available to Micro Warehouse to deal with its financial problems during this period, including attracting a new private equity investor, a business combination with a competitor or a refinancing with an assert-based lender, according to the complaint, the D&O Defendants took no action to cause the company to pursue any of the alternatives.

By the fall of 2002, Micro Warehouse was experiencing liquidity problems, and the D&O Defendants knew that it would default on a financial covenant in the Credit Agreement at year end. At the same time, key vendors had begun to restrict the

[3] Counts III and IV alleged claims against certain defendants to the extent they served as officers only.

credit they were willing to extend to the company. Micro Warehouse was required to restructure again the Credit Agreement in the spring of 2003, but the D&O Defendants continued not to take decisive action as the company's downward spiral continued.

C. Delay in Retaining a Financial Advisor

According to the complaint, by early June 2003, Micro Warehouse's lenders had begun urging the company to hire a restructuring advisor. The D&O Defendants failed to do so for approximately two months, however, though it was becoming increasingly difficult for the company to obtain products to fill customer orders on a timely basis and retain key sales personnel who were leaving to join competitors. In addition, certain trade creditors refused to continue to extend credit to the company. During this period, the D&O Defendants failed to contact competitors that previously had expressed interest in a transaction with the company to discuss a possible acquisition of Micro Warehouses' United States business operations. Meanwhile, as late as July 25, 2003, Micro Warehouse told its lenders that it expected to have strong profitability and cash flow in the second half of the year.

Finally, after repeatedly being urged by the company's lenders to engage a financial advisor, the D&O Defendants approved the concept of retention of a prominent financial advisory firm on or about August 5, 2003. The firm was not actually retained, however, for a period of almost two weeks after the concept was approved. In the meantime, two officers of Micro Warehouse had a meeting with the CEO of a competitor with whom one of the officers had a long-time acquaintance to discuss whether the competitor, CDW, would be interested in a transaction with the company. Aside from

discussions with CDW, no effort was made by the D&O Defendants to contact potential purchasers or to initiate a competitive bidding process for selling the company.

D. The Turnaround Manager Comes on Board

On or about August 18, 2003, Micro Warehouse retained a prominent financial advisory firm to provide it with restructuring professionals. Among those professionals was the Turnaround Manager. On or about August 19, 2003, the board of directors appointed the Turnaround Manager to the position of Chief Operating Officer of the company. According to the complaint, within 72 hours of commencing work at the company, on Friday, August 22, 2003, the Turnaround Manager recommended that the company's assets be sold. Instead of commencing an out-of-court competitive bidding process or recommending that Micro Warehouse file a chapter 11 petition and sell the assets pursuant to Section 363 of the Bankruptcy Code under competitive bidding procedures established in the bankruptcy case, however, he seized on the contact which already had been made by two of Micro Warehouse's officers with CDW. The Turnaround Manger did not hire investment bankers to identify and stimulate interest on the part of potential bidders. He made only a cursory effort to contact potential strategic buyers other than CDW and no attempt to contact potential financial buyers.

CDW alone was afforded a meaningful opportunity to perform due diligence. CDW's representatives arrived on-site to perform due diligence on or about August 27, 2003. It made its first offer at the close of the following day, and, over the course of the Labor Day weekend (August 30 – September 1, 2003), CDW and Micro Warehouse negotiated only small changes in the terms of the offer without substantial

improvement in the business terms over CDW's initial offer, arriving at a "handshake deal" on September 2, 2003. On that day Micro Warehouse entered into an agreement with CDW to negotiate exclusively with CDW until September 9, 2003, in effect precluding another interested potential buyer from completing its due diligence and submitting a competing offer.

During the period after the Turnaround Manager became the Chief Operating Officer, Micro Warehouse's directors deferred to him regarding the decision to sell the company and the process employed to effect the sale, They did not require that serious efforts be made to stimulate interest on the part of strategic buyers other than CDW or financial buyers or that other steps be taken to stimulate competitive bidding.

On September 4, 2003, the D&O Defendants approved the asset sale to CDW for $28,000,000 on the Turnaround Manager's recommendation. Agreement on the sale was announced on September 8, and the transaction closed on September 9, 2003. Micro Warehouse filed its chapter 11 proceedings on September 10, 2003.

E. The Fraudulent Transfer Litigation

Before commencing the adversary proceeding against the D&O Defendants and the Turnaround Manager, the liquidating trust sued CDW, alleging that the sale of assets to CDW constituted a fraudulent transfer. In the course of discovery, it was learned that, during the process of acquiring Micro Warehouse's United States assets, CDW's Vice President for Business Development had concluded, based on a discounted cash flow analysis, that the present value of Micro Warehouse's U.S. operations was $126,000,000, more than four times the purchase price CDW paid. CDW settled the

fraudulent transfer litigation by paying the liquidating trust $25,000,000 before the trust instituted the adversary proceeding against the D&O Defendants and the Turnaround Manager.

V. The Effect of the Exculpatory Provision in Micro Warehouse's Certificate of Incorporation

As one would expect, Micro Warehouse's certificate of incorporation contained an exculpatory provision, as authorized under Section 102(b)(7) of title 8 of Delaware's General Corporation Law. The provision read as follows:

> A director of the Corporation shall have no personal liability to the Corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, except (i) for any breach of the director's duty of loyalty to the Corporation or its stockholders, (ii) for any act or omission not in good faith or which involves intentional misconduct or a knowing violation of law, (iii) for the unlawful payment of dividends or unlawful stock repurchases under Section 174 of the General Corporation Law of the State of Delaware, as the same exists or hereafter may be amended or (iv) for any transaction from which the director derived an improper personal benefit.

In re Bridgeport Holdings, Inc., 388 B.R. at 567.

Not unexpectedly, the D&O Defendants who were directors (the "Director Defendants") sought, by 12(b)(6) motion, to have the complaint against them dismissed based on the exculpatory provision in Micro Warehouse's charter.[4] To accomplish this goal, they needed to establish that the facts alleged in the complaint failed to support breach of the duty of loyalty or bad faith claims and that, distilled to their essence, the allegations supported only claims of breach of the duty of care.

[4] The D&O Defendants also asserted that the claims against them were barred by the statute of limitations. They succeeded in having certain claims stricken on this ground but not the claims for abdication of responsibility to the Turnaround Manager and failure to monitor his execution of the "sell strategy." Id. at 560-63.

In asserting that the facts pled in the complaint failed to state claims for breach of the duty of loyalty or bad faith, the Director Defendants pointed out that there was no suggestion in the complaint that they had acted in any way out of self-interest or that they lacked independence with respect to the sale to CDW. They asserted further that there were no allegations in the complaint that they received any unjust benefit or any personal benefit at all from the sale. Id. at 564.

The Bankruptcy Court rejected the argument that a claim for breach of the duty of loyalty must be predicated on a self-interested transaction or a lack of independence and held that Count I of the complaint stated a viable claim for breach of the Director Defendants' fiduciary duty of loyalty, not a breach of the duty of care claim masquerading as a duty of loyalty claim.

> A fiduciary acts in bad faith when, among other things, he takes or fails to take any action that demonstrates a "faithlessness or lack of true devotion to the interests of the corporation and its shareholders."
>
> Here, taking the facts alleged as true and viewing all inferences in the light most favorable to the Trust, the allegations support the claim that the D&O Defendants breached their fiduciary duty of loyalty and failed to act in good faith by *abdicating* crucial decision-making authority to [the Turnaround Manager], and then failing adequately to monitor his execution of a "sell strategy," resulting in an abbreviated and uninformed sale process; and approving the sale to CDW for grossly inadequate consideration.

Id. at 564-65. (internal citations omitted) (emphasis in original).

Thus, the Bankruptcy Court refused to dismiss Count I of the complaint, which alleged breach of the fiduciary duty of loyalty and lack of good faith, apparently rejecting the idea that some element of scienter is necessary to support such claims. The

exculpatory provision in the corporate charter therefore afforded the Director Defendants no insulation from the Count I claims.

In contrast with Count I, Count II asserted claims for breach of the duty of **care** and lack of good faith. The Director Defendants sought dismissal of the duty of care claim in Count II based on the exculpatory provision in the certificate of incorporation and the business judgment rule. Again, they were unsuccessful.

With respect to the effect of the exculpatory provision on the duty of care claim, the Bankruptcy Court interpreted Delaware law to preclude dismissal of a duty of care claim based on such a provision if the duty of care claim is combined with a viable claim that is not exculpated under the provision, such as a duty of loyalty claim. Id. at 571. ("Here I am holding that the duty of loyalty remains, so that the due care claim is not defeated by §102(b)(7)").

The Bankruptcy Court also held that the duty of care claim was not defeated by the business judgment rule because the complaint adequately alleged that the Director Defendants did not inform themselves, prior to approving the sale, of all material information reasonably available to them and effectively abdicated their responsibilities with respect to the sale.

> It is puzzling as to how the D&O Defendants could have decided to proceed with the CDW sale without knowing what price other prospective purchasers such as Office Depot, would have been willing to pay. Ordinarily careful and prudent directors would have worked to ensure that any sale process was entirely competitive in an effort to collect the highest price for the company's assets. Instead, as alleged, the D&O Defendants simply approved the CDW deal that arose out of [a Micro Warehouse officer's] long-time acquaintance with the CEO of CDW.

* * *

> Here, the facts alleged in the Complaint show anything but directors who were "especially diligent." To the contrary, drawing reasonable inferences in the light most favorable to the Trust, it shows directors who decided to conduct a rushed sale without informing themselves, prior to making that decision, of all material information reasonably available to them.

Id. at 569-70.

VI. The Claims Against the Turnaround Manager

The Bankruptcy Court also refused to dismiss the claims against the Turnaround Manager, essentially for the reasons that the court refused to dismiss Counts I and II. In rejecting the Turnaround Manager's assertion that his actions were not the proximate cause of any harm to the company because the board of directors approved the sale transaction, the court stated:

> This position ignores the fact that the Complaint repeatedly asserts that the board of directors abdicated in favor of [the Turnaround Manager]. The allegation could easily lead to the conclusion that [the Turnaround Manager] caused the transaction to be approved and effected.

Id. at 576.

VII. Conclusion

The Bridgeport Holdings case demonstrates that corporate fiduciaries risk liability if they simply turn over the making of critical management decisions to restructuring professionals in times of financial distress and rubber stamp the decisions made by such professionals. Though directors may reasonably rely on advice from qualified professionals, they must inform themselves of all material information reasonably available to them before deciding to accept the professional's

recommendation on strategic matters and exercise oversight with respect to the professional's execution of strategic initiatives.

The case also shows that when a board of directors is not adequately informed and essentially abdicates the responsibility for making strategic decisions to a restructuring professional, the professional will not necessarily be insulated from exposure for decisions that turn out poorly just because the board formally approved the decision.