Strafford

presents

D&O Fiduciary Duties When a Company Faces Insolvency

Avoiding and Defending Direct and Derivative Lawsuits

A Live 90-Minute Teleconference/Webinar with Interactive Q&A

Today's panel features:

Gardner F. Davis, Partner, **Foley & Lardner,** Jacksonville, Fla.
Michael E. Foreman, Of Counsel, **Haynes & Boone**, New York
Michael A. Rosenthal, Partner, **Gibson Dunn & Crutcher**, New York

Tuesday, December 15, 2009

The conference begins at:

1 pm Eastern
12 pm Central
11 am Mountain
10 am Pacific

You can access the audio portion of the conference on the telephone or by using your computer's speakers.
Please refer to the dial in/ log in instructions emailed to registrations.

CLICK ON EACH FILE IN THE LEFT HAND COLUMN TO SEE INDIVIDUAL PRESENTATIONS.

If no column is present: click **Bookmarks** or **Pages** on the left side of the window.

If no icons are present: Click **View**, select **Navigational Panels**, and chose either **Bookmarks** or **Pages**.

If you need assistance or to register for the audio portion, please call Strafford customer service at **800-926-7926 ext. 10**

For CLE purposes, please let us know how many people are listening at your location by

- closing the notification box
- and typing in the chat box your company name and the number of attendees.
- Then click the blue icon beside the box to send.

Strafford

Review of Bridgeport Holdings Inc. Liquidating Trust v. Boyer
388 B.R. 548 (Bankr. D. Del. May 30, 2008)

By

Gardner Davis

Foley & Lardner LLP

gdavis@foley.com

Factual Background

- LBO of Micro Warehouse at height of dot-com boom
- CS First Boston led Secured Lenders
- Company experiences financial distress as result of 2002 recession plus heavy debt load
- Secured Lenders urge Micro Warehouse to hire restructuring advisor

Factual Background – cont.

- Company hires Alix Partners, which furnishes Lawrence J. Ramaekers as interim COO
- Board *abdicated* crucial decision making authority to Ramaekers and failed to supervise Ramaekers adequately
- Ramaekers did not hire investment banker to "shop" the Company

Factual Background – cont.

- Ramaekers did not conduct a thorough search for potential strategic buyer
- Ramaekers did not even consider contacting potential financial buyer
- Resulted in *uninformed and hurried sale* in privately negotiated transaction for $28 million price

Factual Background – cont.

- Filed bankruptcy day after sale closed
- Litigation Trust recovers $25 million from purchaser on fraudulent transfer claim
- Litigation Trust sues board of directors, officers and Ramaekers

Trust asserts Directors breached duties of loyalty, care and good faith as a result of:

- Failing to sell earlier, before liquidity crisis ensued
- Failing to hire turn-around firm sooner
- Abdicating responsibility to Ramaekers and then failing to supervise him
- Acquiescing in Ramaekers' decision to sell assets quickly, immediately before filing a Chapter 11 petition, rather than in court-supervised § 363 auction

Count I –
Breach of Duty of Loyalty Claim

- "Acted in bad faith by consciously disregarding, i.e., abdicating, their duties to Company"

- See Ryan v. Lyondell Chemical Co., 2008 WL 2923427 (Del. Ch. July 29, 2008) on appeal to Supreme Court re "lack of good faith" in Revlon claim

- See Stone v. Ritter, 911 A.2d 362, 369 (Del. 2006)
  "failure to act in good faith requires conduct qualitatively different from, and more culpable then, the conduct giving rise to a violation of the fiduciary duty of care (i.e., gross negligence)"

Count II –
Breach of Duty of Care

Defenses

- Business Judgment Rule
- 102(b)(7) Exculpatory Charter Provision

- But see Trenwick America Litigation Trust v. Ernst & Young LLP, 906 A.2d 168 (Del. Ch. 2006) (aff'd by Del. Sup. Ct.)
  - "Delaware imposes no absolute obligation on board of company that is unable to pay its bills to cease operations and to liquidate"

- McPhadden v. Sidhu, 2008 WL 4017052 (Del. Ch. Aug. 29, 2008)
  - 102(b)(7) charter provision defeats similar claim against directors

D&O FIDUCIARY DUTIES WHEN A COMPANY FACES INSOLVENCY; AVOIDING AND DEFENDING DIRECT AND DERIVATIVE LAWSUITS

Strafford Publications CLE Teleconference / Webinar

December 15, 2009

Michael E. Foreman
Of Counsel
(212) 659-4976
michael.foreman@haynesboone.com

haynesboone
Setting precedent.

OVERVIEW

- In the midst of the current global economic crisis, directors and officers of companies that appeared relatively healthy only a few months ago may find themselves facing the slippery slope toward financial restructuring and workout. These times bring with them issues of fiduciary duties and responsibilities that many may not have seen before.
- Historically, two concepts have dominated restructuring practice and commentary on the duties of directors and officers of a company facing financial distress –
  - the "zone of insolvency" (as discussed herein, the period in which a company's financial performance is near but not quite at insolvency); and
  - "deepening insolvency" (as discussed herein, the worsening of an insolvent company's financial condition) – to suggest an expansion of director and officer duties, as a company approaches, or operates in, insolvency, for the benefit of the company's creditors.
- In 2006 and 2007, case law, particularly in the Delaware state courts and Third Circuit bankruptcy courts, appeared to signal a retreat from the expansion of duties suggested by the "zone of insolvency" and "deepening insolvency " models for fiduciary duties and liability, signaling that the prospect for exposure may not be as great as directors and officers regularly had been counseled.

OVERVIEW

- More recent cases out of the Delaware and Third Circuit courts have indicated that creditor and trustee plaintiffs continue to have an arsenal of potent weapons in seeking redress against officers and directors for losses resulting from their company's failure.
  - The zone of insolvency analysis continues to be relevant in light of uncertainties in determining with real-time precision the point when a company becomes insolvent.
  - Plaintiffs have sought to navigate around case law discrediting "deepening insolvency" as an independent cause of action by linking their allegations with more traditional breach of fiduciary duty claims.
- As an increasing number of companies find themselves in a restructuring mode, their directors must be careful to monitor and consider the company's changing economics, to determine the appropriate course of action in a particular set of circumstances and to understand the type of lawsuit that may arise by disgruntled stakeholders.
- To whom the directors of a corporation owe duties and the consequences of potential failings are not static. Accordingly, directors must keep a watchful eye on the solvency of the corporation and take great care to act in good faith and exercise reasonable business judgment appropriate for the circumstances notwithstanding the exigencies of the moment, for their fiduciary duties may be shifting right before their eyes.

BASIC INSOLVENCY CONCEPTS

- For a company in financial distress, directors should consider three different circumstances in which a company's financial distress may manifest:
- "<u>Insolvency</u>":
  - Under Delaware law, a corporation is insolvent if it "has either: 1) a deficiency of assets below liabilities with no reasonable prospect that the business can be successfully continued in the face thereof, or 2) an inability to meet maturing obligations as they fall due in the ordinary course of business." Prod. Res. Group, L.L.C. v. NCT Group, Inc., 863 A.2d 772, 782 (Del. Ch. 2004).
  - The U.S. Bankruptcy Code defines the term "insolvent", with reference to an entity other than a partnership or municipality, as a financial condition such that the sum of the entity's debts is greater than all of the entity's property, at a fair valuation, exclusive of property transferred, concealed or removed with intent to hinder, delay or defraud the entity's creditors. 11 U.S.C. § 101(32)(A)
    - i) "Debt" means liability on a claim. 11 U.S.C. § 101(12).
    - ii) "Claim" means (A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or (B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured. 11 U.S.C. § 101(5).

BASIC INSOLVENCY CONCEPTS

- The "Zone of Insolvency:" The concept of a "zone of insolvency" arose from the decisions of certain courts finding that directors may owe fiduciary duties to creditors *just before* a company reaches insolvency: i.e., when it is in the zone of insolvency. *See, e.g.*, *Weaver v. Kellogg*, 216 B.R. 563, 582-84 (S.D. Tex. 1997); *Official Comm. of Unsecured Creditors of Buckhead Am. Corp. v. Reliance Capital Group, Inc. (In re Buckhead Am. Corp.)*, 178 B.R. 956,968-69 (d. Del. 1994); *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, 1991 WL 277613 (Del. Ch. 1991).
  - However, courts generally have avoided developing a hard and fast definition for the "zone of insolvency." *see Prod. Res. Group, L.L.C.*, 863 A.2d at 790-91(Del. Ch. 2004)
- "Deepening Insolvency:" The concept of "deepening insolvency" refers to a situation where an already insolvent company becomes more insolvent as a result of actions taken or not taken by the company, or the impact of commercial industry, or economic conditions.
  - Some courts have concluded or suggested that once a company is insolvent, acts or inaction causing a company to assume greater debt and become more insolvent (or entering "deepening insolvency") are justification for a derivative suit. *See, e.g., Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc.*, 267 F.3d 340 (3d Cir. 2001).

BASIC INSOLVENCY CONCEPTS

- No bright-line “real-time” methods exist of determining when a company may be approaching insolvency or actually is insolvent, based on an insolvency test that aggregates all of a company’s known and potential liabilities and is based on the fair market value of a company’s assets.
  - A company’s reasonable prospects for successfully continuing a business cannot be assessed by an objective test.
  - A company may be unable to pay its most significant debts as they mature, such as loans and public or private bond debt, while it continues to pay its obligations arising in the ordinary course of business to trade vendors and service providers.
- The most recent trend in Delaware and Third Circuit case law suggests that directors should be less concerned with whether the company is almost insolvent or may become more insolvent, and more concerned with whether they are taking actions that reflect
  - their reasonable business judgment,
  - without regard for their personal interests,
  - in good faith and
  - in the best interests of all stakeholders in the company – shareholders, creditors, employees, suppliers.

BASIC INSOLVENCY CONCEPTS

- **Questions raised and answered by recent decisions**:
  - **What parties may pursue actions against directors when a company is moving towards insolvency, or in the "zone of insolvency"?**
    - When a company is solvent but in a financial condition that could be described as the "zone of insolvency," only shareholders may bring derivative suits against directors.
  - **May creditors sue directors when an insolvent company becomes more "insolvent" or is in the midst of "deepening insolvency"?**
    - "Deepening insolvency" is losing support as a claim and has been invalidated by the influential Delaware Supreme Court.
    - However, "deepening insolvency" may yet be considered by courts in determining traditional claims for breach of fiduciary duties of loyalty or care, or in determining damages resulting from such claims.
  - **When a company is insolvent, what sort of suits by creditors – direct or derivative – may directors be exposed to?**
    - Creditors may bring derivative suits only against directors of a corporation that is insolvent; but, generally, they may not bring direct suits against individual directors.

FIDUCIARY DUTIES

- Generally, directors owe duties of care and loyalty to the corporation. Officers also owe the same fiduciary duties of care and loyalty as directors. *Gantler v. Stephens*, Case No. 132, 2008, C.A. No. 2392 (De. January 27, 2009.
  - The "duty of care" requires directors both to use that amount of care which ordinarily careful and prudent persons would use in similar circumstances, and to consider all material information reasonably available. *In Re Walt Disney Co. Deriv. Litig.*, 907 A.2d 693, 749 (Del. Ch. 2005); *See also Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985); Robert Clark, Corporate Law Section 3.4, 123 (Aspen Publishers, Inc. 1986).
    - There are two contexts in which duty of care liability can arise: (i) where liability may be said to follow from a board decision that results in a loss because that decision was ill advised, or negligent; or (ii) where liability for a loss arises from an unconsidered failure of the board to act in circumstances in which due attention would, arguably, have prevented the loss.
    - Directors generally will not be held liable for the consequences of their exercise of business judgment -- even for judgments that appear to have been clear mistakes – unless certain exceptions apply; such exceptions may include fraud, conflict of interest, or gross negligence. *In re Caremark Int'l Inc. v. Deriv. Litig.*, 698 A.2d 959, 967 (Del. Ch. 1996)
- Gross negligence is the proper standard for determining whether a business judgment reached by a board of directors was an informed one. *Smith V. Van Gorkom*, 488 A.2d 858, 873 (Del. 1986).
  - Business judgment rule protections do not apply where a loss results from director inaction. *Disney*, 907 A.2d at 748.
  - The mere fact that a company takes on business risk and suffers losses does not evidence misconduct, and is not a basis for director liability in and of itself. A Director's oversight duties under Delaware law are not designed to subject directors to personal liability for failure to predict the future and to properly evaluate business risk. *In re Citigroup Inc. Shareholder Deriv. Litig.*, C.A. No. 3338-CC (Del. Ch. Feb. 24, 2009).

FIDUCIARY DUTIES

- The "duty of loyalty" prohibits the fiduciaries from taking advantage of their beneficiaries by means of fraudulent or unfair transactions. Robert Clark, Section 4.1 at 141. *See also Lewis v. Vogelstein*, 699 A.2d 327 (Del. Ch. 327); *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983).
  - *Stone v. Ritter.* 911 A.2d 362, 370 (Del. 2006): The Delaware Supreme Court held that a breach of loyalty claim may be premised upon the failure of a fiduciary to act in good faith.
    - Where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation … only a sustained or systematic failure of the board to exercise oversight – such as an utter failure to attempt to assure a reasonable information and reporting system exists – will establish the lack of good faith that is a necessary condition to liability." *Lyondell Chem. Co. v. Ryan*, 2009 Del. LEXIS 152 at *11 (March 25, 2009) (*quoting In re Caremark Int'l Deriv. Litig.*, 698 A.2d at 971.
  - Bad faith encompasses not only an intent to harm but also intentional dereliction of duty, falling between subjective bad faith – i.e., fiduciary conduct motivated by an actual intent to do harm – and a lack of due care – i.e., action taken solely by reason of gross negligence without any malevolent intent. As a result, no comprehensive or exclusive definition of "bad faith" has been articulated. *In Re Walt Disney Co. Deriv. Litig.*, 907 A.2d at 64 – 66.
  - Fiduciaries breach their duty of loyalty by intentionally failing to act in the face of a known duty to act, demonstrating a conscious disregard for their duties. *In re Bridgeport Holdings, Inc.*, 388 B.R. 548, 564 (Bankr. D. Del. May 30, 2008, B. J. Walsh), *citing Stone*, 911 A.2d at 369.

FIDUCIARY DUTIES

- "*Revlon*" Duties: Under Delaware law, directors' duties of care and loyalty require that a board deciding to proceed with a change-of-control transaction must perform its fiduciary duties by taking reasonable measures to obtain the best available price in selling the company. *Revlon v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 182 (Del. 1986).
  - Delaware Corporate law permits a Delaware corporation to eliminate or limit, in its certificate of incorporation, the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty of care (with certain exceptions), but not for a breach of the duty of loyalty. 8 *Del. C.* § 107(b)(7). *Lyondell Chem. Co.*, 2009 Del. LEXIS 152.
  - Where directors have been exculpated from personal liability for breaches of the duty of care, and the board is found to have been independent and not motivated by self-interest or ill will, the sole issue under a *Revlon* claim is whether the directors breached their duty of loyalty by failing to act in good faith. *Lyondell Chem. Co.*, 2009 Del. LEXIS 152 at *10.

FIDUCIARY DUTIES

- "*Lyondell Chem. Co. v. Ryan*: In its decision of March 25, 2009, the Delaware Supreme Court re-affirmed the broad protections afforded disinterested directors from personal liability for damages in the face of *Revlon* claims of breach of fiduciary duties. Where directors have been exculpated by corporate charter provision from personal liability for duty of care claims, plaintiffs claim a non-exculpable breach of good faith must demonstrate that the directors "utterly failed" to attempt to obtain the best sale price. *Lyondell Chem. Co.*, 2009 Del. LEXIS 152 at *18-19.
  - *Revlon* duties do not arise when a third party puts the company "in play," but, rather, apply only once the company embarks on a change-of-control transaction on its own initiative or in response to an unsolicited offer.
  - No single blueprint or set of enumerated requirements exist for satisfying a directors *Revlon* duties. As a result, directors will be able to tailor their actions to the unique circumstances they face.
  - An imperfect attempt to comply with a board's *Revlon* duties does not equate to a conscious disregards of those duties so as to constitute a breach of the duty of loyalty.

FIDUCIARY DUTIES

- Derivative actions are more common than direct causes of action, which may be asserted by creditors only where the company is insolvent.
  - If directors breach either of the fiduciary duties of care or loyalty, a derivative suit – for an injury to the corporation – may be brought against the corporation by its shareholders on the corporation's behalf.
  - If the alleged wrong is not to the corporation, but to its shareholder(s), a direct suit (such as a suit to inspect a corporation's books, to enforce voting rights or to compel the declaration of dividends) may be brought against individual directors.
  - Whether a derivative action against directors may be asserted by creditors or shareholders is determined by a corporation's solvency: "When a corporation is *solvent,* [shareholders] have standing to bring *derivative* actions on behalf of the corporation because they are the ultimate beneficiaries of the corporation's growth and increased value… When a corporation is *insolvent,* however, its creditors [come before] shareholders as the…principal constituency injured by any fiduciary breaches that diminish the firm's value." *North Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 101-02, ((Del. 2007) (citations omitted) (emphasis in original).
  - According to recent case law, it appears that creditors may assert direct claims against directors only on very rare occasions: if such directors show a "marked degree of animus toward a particular creditor." *Prod. Res. Group, L.L.C.*, 863 A.2d at 798 (Del. Ch. 2004).

THE "ZONE OF INSOLVENCY"

- *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*: The concept of the "zone of insolvency" likely started with a footnote to this Delaware Court of Chancery case, which stated:
  - such directors will recognize that in managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act. *Credit Lyonnais Bank Nederland, N.V.*, 1991 WL 277613, at *34 n. 55.
- *Prod. Res. Group, L.L.C. v. NCT Group, Inc.*: The Delaware Court of Chancery noted that *Credit Lyonnais Bank Nederland, N.V* footnote 55 "was read more expansively by some, not to create a shield for directors from stockholder claims, but to expose directors to a new set of fiduciary duty claims, this time by creditors.
  - To the extent that a firm is in the zone of insolvency, some read this case as authorizing creditors to challenge directors' business judgments as breaches of a fiduciary duty owed to them." *Prod. Res. Group, L.L.C.*, 863 A.2d at 789.

THE "ZONE OF INSOLVENCY"

- *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla,* 930 A.2d 92 (Del. 2007). The Delaware Supreme Court put to rest the notion that, in Delaware, directors of a not-yet-insolvent company owed a duty both to shareholders and creditors.
  - As a matter of law, a corporation's creditors may not assert *direct* claims against directors for breach of fiduciary duties when the corporation is either insolvent or in the zone of insolvency." They may only assert derivative claims.
  - When a company is operating in the "zone of insolvency," directors owe their fiduciary duties to a corporation and its shareholders and not to creditors.
  - Thus, under current Delaware law, if a corporation is approaching insolvency, the fiduciary duties of directors do not shift from shareholders to creditors. Directors must continue to make decisions of business judgment based on what is best for the corporation and its shareholders and not necessarily what is best for the creditors.

"DEEPENING INSOLVENCY"

- *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc*. The genesis of the concept of "deepening insolvency" – "an injury to the Debtors' corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life"[1] 267 F.3d at 374. arose from the Third Circuit's holding that deepening insolvency constituted a valid cause of action under Pennsylvania law.
  - Deepening insolvency could harm a corporation in several ways: the incurrence of additional debt could force a company into bankruptcy, thereby creating additional administrative costs; bankruptcy stemming from deepening insolvency could harm a corporation's ability to conduct business in a profitable manner; it could harm relationships with and credibility with customers, suppliers, employees; and lastly, "prolonging an insolvent corporation's life through bad debt may simply cause the dissipation of corporate assets."
  - The "harms [stemming from deepening insolvency] can be averted, and the value within an insolvent corporation salvaged, if the corporation is dissolved in a timely manner, rather than kept afloat with spurious debt."
- *Seitz v. Detweiler, Hersey & Assocs., P.C.* (*In re CitX Corp.*), 448 F.3d 672 (3d Cir. 2006) The Third Circuit concluded that "deepening insolvency" could be a valid cause of action[5] but "should not be interpreted to create a novel theory of damages for an independent cause of action like malpractice."
  - Deepening insolvency beyond the *Lafferty* holding was determined to be limited, and would not sustain a claim of negligence or support an independent deepening-insolvency cause of action.
  - *Lafferty* did not extend the concept of deepening insolvency beyond Pennsylvania.

"DEEPENING INSOLVENCY"

- *Trenwick America Litigation Trust v. Ernst & Young, L.L.P.* 906 A.2d 168, 205 (Del. Ch. 2006). The Third Circuit held that Delaware law does not recognize an "independent cause of action for deepening insolvency."
  - The board of even an insolvent company "may pursue, in good faith, strategies to maximize the value of the firm."
  - When an insolvent corporation's board acts with due diligence and good faith in the pursuit of a "business strategy that it believes will increase the corporation's value, [even if the strategy] involves the incurrence of additional debt[,]... [t]hat the strategy results in continued insolvency and an even more insolvent entity does not in itself give rise to a cause of action."
  - In such circumstances, the directors will be protected by the business judgment rule because the "fact of insolvency does not render the concept of 'deepening insolvency' a more logical one than the concept of 'shallowing profitability."
  - The "proper role of insolvency [is] to act as an important contextual fact in the fiduciary duty matrix."

"DEEPENING INSOLVENCY"

- Deepening insolvency has been challenged outside of the Third Circuit as a valid cause of action.
  - *In re SI Restructuring, Inc.*, 532 F.3d 355, 362-64 (5th Cir. June 20, 2008) (agreeing in dicta with the Third Circuit's *Trenwick* decision, while finding that the trustee's deepening insolvency theory was not supported by the court's findings);
  - *Fehribach v. Ernst & Young LLP*, 493 F.3d 905, 909 (7th Cir. 2007) (refusing to accept plaintiff's deepening insolvency theory and stating that "the theory makes no sense when invoked to create a substantive duty of prompt liquidation that would punish corporate management for trying in the exercise of its business judgment to stave off a declaration of bankruptcy, even if there were no indication of fraud, breach of fiduciary duty, or other conventional wrongdoing.")
- Federal and state courts often follow Delaware's lead on such creditor issues, suggesting that it is likely that deepening insolvency will no longer be a credible alternative for plaintiffs elsewhere.
  - *See, e.g.*, *In re I.G. Services, Ltd.*, 2007 WL 2229650, at *3 (Bkrtcy.W.D.Tex. July 31, 2007) ("The Delaware courts' decisions have proved to be immensely influential in the national debate over the shape of causes of action that have their genesis in breach of fiduciary duties on the part of officers and directors….It seems fair to say…that both state and federal courts within this jurisdiction are likely to give weight to the court from whence creditor-initiated actions for breach of fiduciary duties have emerged.") (citation omitted).

haynesboone
Setting precedent.

"DEEPENING INSOLVENCY"

- *In re Radnor Holdings Corp.,* 353 B.R. 820 (Bankr. D.Del. 2006): Where the creditors' committee was found to have tried its claims of recharacterization and breach of fiduciary duty as if it were a "deepening insolvency" case, the bankruptcy court held that, in light of *Trenwick*, "simply calling a discredited deepening insolvency cause of action by some other name does not make it a claim that passes muster."
  - Under Delaware law, a board is not required to wind down operations simply because a company is insolvent, but rather may conclude to take on additional debt in the hopes of turning operations around.
  - The making of a loan does not increase insolvency, but, rather, "increases liabilities (the amount of the loan) and assets (the cash provided by the loan) in the same amount."
  - "As a matter of law, there is no *per se* breach of fiduciary duty for an insider making a bid to purchase a company or its assets."

Significant Recent Developments on the Business Judgment Rule and Deepening Insolvency

- *In re Bridgeport Holdings, Inc*. The Debtor sold a substantial portion of its assets one day prior to filing its Chapter 11 petition. The Debtor's liquidating trust asserted a claim for breach of fiduciary duties based on. among other claims, the board's abdication of responsibility to the restructuring professional it hired, the board's failure to supervise the restructuring professional, and the board's acquiescence in the restructuring professional's decision to sell the assets in an allegedly rushed and uninformed manner. 388 B.R. at 554-61.
  - The cause of action for breach of fiduciary duty accrues when the wrongful act takes place, and the statue of limitations is only tolled for claims of wrongful self-dealing.
  - Where a breach of the duty of loyalty and lack of good faith is alleged as well as a breach of duty of care, an exculpatory provision in the company's articles of incorporation cannot justify a dismissal of the duty of care claims.
  - In the sale context, a board's failure to obtain a valuation of the company's assets and failure to adequately market those assets constitute breaches of the duty of care.
  - The Business Judgment Rule is rebutted if the plaintiff shows that the directors failed to exercise due care in informing themselves before making their decision.

Significant Recent Developments on the Business Judgment Rule and Deepening Insolvency

- *In re Troll Communications, LLC.,* 385 B.R. 110 (Bankr. D. Del. April 2, 2008, B.J. Carey): The Chapter 7 trustee alleged breach of fiduciary duties claims based on the directors' decision to use proceeds of an equity buy-in to pay debts owed to an equity holder of the company. The trustee also asserted that the directors failed to take reasonable actions to prevent the "ever-deepening insolvency" of the debtor entities.
  - Where the trustee pled facts sufficient to question the disinterestedness of a majority of the board of directors, the Business Judgment Rule presumption may not be used as a basis to dismiss a breach of loyalty claim.
  - Where the trustee's cause of action was not explicitly asserted as a "deepening insolvency" cause of action but was, in substance, a claim of deepening insolvency, the claim was dismissed as both a cause of action and a theory of damages.

Significant Recent Developments on the Business Judgment Rule and Deepening Insolvency

- *In re The Brown Schools,* 386 B.R. 37 (Bankr. D. Del. April 24, 2008, B.J. Walrath): The Chapter 7 trustee asserted against debtor's former majority equity holder and its affiliates (as well as former directors of the debtor and the former law firm representing the debtor) claims for breach of fiduciary duty, aiding and abetting breach of fiduciary duty, corporate waste and civil conspiracy, as well as a cause of action for deepening insolvency.
  - While *Trenwick* mandated the dismissal of the claim for deepening insolvency, it did not require dismissal of the other causes of action.
  - While duty of care violations may resemble causes of action for deepening insolvency, because the alleged injury in both is the result of the board of directors' poor business decision, claims for breach of the fiduciary duty of loyalty in the form of self-dealing are not deepening insolvency claims in disguise.
  - The *CitX* decision only held that deepening insolvency was not a viable theory of damages for the particular malpractice claim before the Third Circuit in that case, and was not a broad invalidation of deepening insolvency as a valid theory of damages for all independent causes of action. Accordingly, deepening insolvency was found to be a valid theory of damages for the trustee's breach of fiduciary duty claim.

Potential Fiduciary Liability During a Time of Insolvency

- Because the test for insolvency lies in a fairly gray area absent the requisite intensive review of a company's financial position, directors should be mindful of creditors and all other stakeholders of the company when they think a company is approaching insolvency but may not yet be insolvent.
  - Once a company reaches the point of insolvency, however measured, directors' fiduciary duties transfer from the corporation's shareholders to its creditors: "The directors continue to have the task of attempting to maximize the economic value of the firm. That much of their job does not change. But the fact of insolvency does necessarily affect the constituency on whose behalf the directors are pursuing that end. By definition, the fact of insolvency places the creditors in the shoes normally occupied by the shareholders – that of residual risk-bearers."
  - Because creditors are placed in the shoes of shareholders once the firm is insolvent, in theory, they may assert any of the same claims that previously belonged to shareholders, but such suits are generally limited to derivative suits.
  - Creditors may not be able to assert direct claims against a corporation's directors at all, but if they are, such claims could only arise in very narrow and unique circumstances if such directors "display such a marked degree of animus towards a particular creditor with a proven entitlement to payment that they expose themselves to a direct fiduciary duty claim by that creditor."

Potential Fiduciary Liability During a Time of Insolvency

- The question of whether a company is insolvent may be litigated within the context of a derivative suit, and the test for insolvency is more complicated than liabilities exceeding assets (there must also be “no reasonable prospect that the business can be successfully continued.”
- Even though directors may not simultaneously owe duties to creditors and shareholders, both groups, in theory, could bring simultaneous suits (although not both successfully).
  - The period when a corporation approaches insolvency or right after it enters insolvency is dangerous because it is a time when creditors and shareholders may take different positions on whether the corporation is solvent, and both groups may bring suits.
  - Although only one suit, at most, could stand, in order to avoid needless litigation, directors should take heed of potential duties to both groups.
- Once a company does reach the point of insolvency, directors may not be fearful of making good faith decisions for the company which result in the company accumulating greater corporate debt, or other decisions which may turn out to deepen the company’s insolvency.
- Nonetheless, directors must continue to be mindful that they continue to exert the degree of “skill, diligence, and care” that their constituents reasonably may demand.

D&O Fiduciary Duties When a Company Faces Insolvency: Strategies to Avoid and Defend

Michael Rosenthal, Partner
Gibson, Dunn & Crutcher LLP
December 15, 2009

When can directors and officers be sued in Delaware by shareholders and creditors?

- Zone of Insolvency
  - Shareholders may bring derivative claims
- Insolvency
  - Shareholders may bring derivative claims
  - Creditors may bring derivative claims (*Gheewalla*)
    - Creditors may also bring other claims directly under contract or other law

Business Judgment Rule and Entire Fairness Test

- Business Judgment Rule
  - Deference is given to the directors and officers if they:
    - are informed of all material information reasonably available
    - act in good faith
    - have a reasonable belief their acts are in the company's best interests
  - To rebut, a plaintiff must show that the directors or officers breached the duty of care or loyalty or acted in bad faith
- Entire Fairness
  - Fair dealing and fair price

Strategies to Avoid and Defend

- Do not engage in actions that could cause loss of the business judgment rule
  - Conflicts of interest
  - Insider issues
  - Preferences
  - Failure to be informed
  - Abdication of decision-making authority to advisors
  - Failure to supervise advisors
  - Rush to judgment
- Assume all actions will be scrutinized and second guessed
  - Review all transactions from the outside looking in

Strategies to Avoid and Defend

- Focus on process and documentation
  - Act on an informed basis
  - Devote time and attention; thoroughly discuss major decisions
  - Heightened inquiry; follow up until satisfactory answers are provided
  - Fully participate, particularly independent directors
  - Consider all options and seek multiple offers in connection with potential transactions
  - Evaluate decisions for the impact on shareholders and/or creditors

Strategies to Avoid and Defend

- Focus on process and documentation (cont.)
  - Obtain adequate professional and expert advice on a timely basis
    - Where appropriate, obtain fairness opinions and/or solvency opinions
    - See that advisors have knowledge of the situation and professional competence
  - Consider all available alternatives where appropriate
  - Directors with particularized knowledge should make use of that knowledge where appropriate

Strategies to Avoid and Defend

- Focus on process and documentation (cont.)
  - Observe corporate formalities
  - Address significant matters at a meeting rather than by written consent
  - See that the paper trail reflects an acknowledgement of the duties during financial distress
  - Document the materials provided to the board or a committee
  - Document board and committee actions in appropriately detailed minutes

Strategies to Avoid and Defend

- Disclose all material facts
- Listen to the concerns of creditors when insolvent
- Treat like creditors alike
- Pay close attention to transactions with management and other insiders
  - Obtain approval by independent directors
  - Obtain advice from independent advisors
  - See that any such transaction is fair to the company

Strategies to Avoid and Defend

- Establish an early warning system to detect the first signs of financial distress so that directors and officers may take appropriate action as soon as possible
  - MD&A
  - Risk factors
  - Significant competitor actions
  - Technological advances affecting the corporation's business model or obsolescence of assets
  - Economic variables that may impose financial distress
  - Level of revenues needed to sustain debt services and other fixed costs
- Assess other potential risks

Indemnification

- Limitation of Liability
  - Delaware law (§102(b)(7)) (directors only)
    - Not for breach of the duty of loyalty
    - Not for acts or omissions not in good faith, involving intentional misconduct, or a knowing violation of law
    - Not for willful or negligent conduct in paying dividends or repurchasing stock
    - Not for improper personal benefit or self-dealing

Insurance

- Policy may be considered an asset of the company with proceeds unavailable to directors and officers
  - Consider an "order of payments" provision, which requires payments to be made first to directors and officers and then to the company
- Ensure that bankruptcy is not a "change in control" or a change in the "insured"
- Insert a severability clause, which preserves the coverage for innocent individuals where another insured engaged in misrepresentation or fraudulent conduct
- Provide that the "insured vs. insured" exclusion does not apply to claims by the bankruptcy trustee, receivers, etc.
- Allow insurer to cancel coverage only if the company fails to pay

Indemnification

- Indemnification and advancement of expenses
  - Delaware law (§145)
    - Mandated indemnification if successful (including partial)
    - Third party suits - permitted indemnification (if acted in good faith; best interests of the corporation; no reasonable cause to believe conduct unlawful)
    - Suits by or in right of corporation – permitted indemnification for expenses if met standards of conduct; no indemnification for judgments or settlements or even expenses if found liable unless court says otherwise
    - Permitted advancement of expenses if current director

Indemnification

- Charter and/or bylaws
  - Enforced as written
  - Consider having rights vest upon commencement of service without the possibility of being retroactively diminished
- Contractual indemnity
  - Fewer enforceability issues
  - Protection against unilateral amendment
  - Allows parties to address rights in more detail

Insurance

- Consider review by insurance and legal experts
- Consider Side A D&O coverage or policies for individual directors
- If excess policies "follow form," be careful of what exclusions may apply
- Possible coverage gap if excess policy only pays when primary is exhausted and the company settles with the primary insurer for less than the limit
- Carefully follow the terms of the policy – do not settle if policy requires insurer's consent

Bridgeport Holdings, Inc. Liquidating Trust v. Boyer
388 BR 548 (Bankr. D. Del. May 30, 2008)
(Bankruptcy Judge Peter Walsh)

Directors Exposed to Personal Liability for Sale of Insolvent Company

by

Gardner Davis
Foley & Lardner LLP
gdavis @foley.com

Independent directors face substantially greater personal risk in selling the financially distressed company as a result of a controversial Delaware Bankruptcy Court decision refusing to grant summary judgment in favor of the directors of Bridgeport Holdings, Inc. despite the board's reliance on advice from its restructuring advisor, Alix Partners, who was hired at the repeated urgings of the secured lenders, and the secured lenders' apparent support for the sale notwithstanding the fact they received substantially less than their secured debt. *Bridgeport Holdings, Inc. Liquidating Trust v. Boyer*, 388 BR 548 (Bankr. D. Del. May 30, 2008) (Bankr. Judge Peter Walsh).

The opinion converted a run-of-the-mill gross negligence claim, for which directors would have immunity under the Company's charter and Delaware law, into a bad faith claim, for which money damages can be personally assessed against the directors.

Under the *Revlon* doctrine, when directors propose to sell a company, they must take reasonable measures to ensure that the stockholders receive the highest value reasonably attainable. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986). The Delaware Chancery Court has recently issued a series of decisions addressing the sale process, including the desirability of "go-shop" provisions. *In re Lear Corp. Shareholder Litigation*, 926 A.2d 94 (Del. Ch. 2007); *In re Topps Co. Shareholders Litigation*, 926 A.2d, 58 (Del. Ch. 2007); *In re Netsmart Technologies, Inc. Shareholders Litigation*, 924 A.2d 171 (Del. Ch. 2007).

In line with these cases, the Bankruptcy Court criticized the Bridgeport board, which voted to authorize a hurried "fire sale" of the company in a transaction negotiated and structured by the restructuring professionals without competitive bidding or engaging an investment banker to "shop" the deal. None of those criticisms of board conduct is new or unusual. What is surprising is the Bankruptcy Court's conclusion that a procedurally deficient sale process, albeit one conducted by the company's outside restructuring advisor and presumably approved by the secured lenders notwithstanding that it resulted in a large loss for the secured lenders, may give rise to a lack of good faith claim.

In order to encourage individuals to serve as directors in an increasingly litigious environment, Section 102(b)(7) of the Delaware General Corporation Law permits a Delaware corporation to adopt a charter provision limiting the personal liability of a director for monetary damages for breach of fiduciary duty unless the director breached his or her duty of loyalty (e.g., because of a conflict of interest), derived an improper personal benefit from the transaction, or engaged in an act or omission not in good faith or involving intentional misconduct or a knowing violation of law. Bridgeport Holdings' charter includes an exculpatory provision of this type. Despite the absence of any conflicts of interest or any improper personal benefit on the part of Bridgeport's independent directors, the Court held that Bridgeport's directors may not be entitled to immunity from monetary damages under this charter provision because deficient conduct under the *Revlon* standard could very well be found at trial to constitute lack of good faith.

The Bridgeport Holdings case appears inconsistent with the Delaware Supreme Court's recent holding in *Stone v. Ritter*, 911 A.2d 362, 369 (Del. 2006), that "a failure to act in good faith requires conduct that is qualitatively different from, and more culpable than, the conduct giving rise to a violation of the fiduciary duty of care (i.e. gross negligence)." It is hard to see how a board of independent directors, who after receiving presentations from the outside restructuring advisor that a deal is the best course of action, with the support of the secured lenders who are taking a loss on the sale, may be guilty of more than gross negligence and therefore subject to personal liability notwithstanding the protection of an exculpatory charter provision adopted in accordance with Delaware law.

The case against the Bridgeport directors will proceed to trial for a determination on the merits as to whether the facts and circumstances warrant a finding of lack of good faith on the part of the directors. However, the Bridgeport directors may very well not want to face the time and expense of discovery and a trial on the merits, to say nothing of the risk of an adverse verdict, and may seek to settle the case. An exculpatory charter provision provides scant comfort to directors or prospective directors if claims for money damages can survive a motion to dismiss or a motion for summary judgment under the Bridgeport Bankruptcy Court's expansive view of what can constitute lack of good faith.

I. FACTS OF BRIDGEPORT HOLDINGS

In a January 2000 LBO, at the height of the dot-com boom, Bridgeport Holdings acquired Micro Warehouse with debt from a syndicate of eighteen lenders led by CS First Boston. A year after the LBO, the technology sector suffered a significant downturn due to the bursting of the dot-com bubble and a decrease in consumer demand following the terrorist attacks of

September 11, 2001. The recession, coupled with Micro Warehouse's debt load, resulted in difficult financial times for the Company.

The Company negotiated a series of amendments and default waivers with its secured lenders but its financial condition continued to deteriorate. The key vendors restricted the Company's trade credit.

In June 2003, at the urging of the secured lender, the Company hired Alix Partners as its restructuring advisor. The turn-around firm furnished the Company with restructuring professionals, including Lawrence Ramaekers, who was appointed by the Company board of directors as Chief Operating Officer.

Ramaekers quickly arranged for a privately negotiated sale of the Company's primary assets to CDW Corporation for $28 million. Ramaekers did not hire investment bankers to "shop" the deal. He did not conduct a thorough search for potential strategic buyers. He did not even consider contacting potential financial buyers. The board of directors approved the sale. The day after the sale closed, the Company filed a petition under Chapter 11 of the Bankruptcy Code.

In the subsequent lawsuit brought against Bridgeport's board of directors, the allegations of wrongdoing include:

- "the D&O Defendants ignored their responsibilities to the Company and its shareholders to act in their best interest [by failing to hire a restructuring advisor]."

- "D&O Defendants again disregarded the financial 'red flags' and painted an unjustifiably rosy picture of the Company's future [to the Lenders]."

- "D&O Defendants *abdicated* crucial decision-making authority to [turnaround professional hired as COO]." From this point until their resignations, in breach of their fiduciary duties, the D&O Defendants failed to supervise [the turnaround expert] adequately.

- The D&O Defendants' failure to either sell or restructure the Company earlier, and their *abdication* of responsibility to [the turnaround professional brought in as COO] finally culminated in the *uninformed and hurried sale* of a substantial portion of the company's North American Assets to CDW for a grossly low price on September 9, 2003. In breach of their fiduciary duties of loyalty, care and good faith, the D&O Defendants acted on an *uninformed* basis, and failed to act in good faith by approving the "fire sale" of Assets to CDW on September 9, 2003.

- The D&O Defendants acquiesced in [turnaround consultant COO's] decision to sell the Assets in a hurried manner outside the supervision of the Bankruptcy Court.

II. <u>DUTY OF LOYALTY CLAIM</u>

Bridgeport Holdings decision quotes the Delaware Supreme Court's decision in *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006):

> [T]he directors duty of loyalty is not limited to cases involving a financial or other cognizable fiduciary conflict of interest. It also encompasses cases where the fiduciary fails to act in good faith.
>
> ….
>
> Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith.

The Bridgeport Holdings decision found that:

> 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 restructuring advisor] 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.

The Bridgeport Holdings opinion glosses over the Delaware Supreme Court's statement in *Stone v. Ritter*, 911 A.2d 362, 369 (Del. 2006) that "a failure to act in good faith requires conduct that is qualitatively different from, and more culpable than, the conduct giving rise to a violation of the fiduciary duty of care (i.e., gross negligence)." Notwithstanding the Bankruptcy Court's repeated use of words like "abdicating" and "acquiesced," the facts are pretty clear that the board hired a recognized restructuring adviser, at the request of the secured lenders who were the true economic owners of the firm, and followed the expert's advice in a transaction supported by the secured creditors. To suggest this conduct is beyond "reckless" is a stretch. One could argue that the support of the secured lenders, led by CS First Boston, should be a pretty reasonable confirmation to the board of directors that the transaction made economic sense for the company and its creditors. After all, "when a corporation is *insolvent*, … its creditors take the place of the shareholders as the residual beneficiaries of any increase in value." *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007).

The Delaware Supreme Court recently reversed the Delaware Chancery Court's denial of summary judgment in favor of the directors of Lyondell Chemical Company on a "bad faith" claim arising from an allegedly flawed sale process. *Lyondell Chem. Co. v. Ryan*, 2009 WL 790477 (Del. Mar. 25, 2009). The high court noted that directors' decisions "must be reasonable, not perfect." *Lyondell* is distinguishable from *Bridgeport Holdings*, however, because the Lyondell Chemical Company sale process was conducted with the advice of investment bankers and produced an undeniably fair price.

The Bridgeport Holdings "lack of good faith" claims relating to failure to hire a restructuring advisor sooner and failure to seek Bankruptcy Court supervision should be considered in light of the Delaware Supreme Court's decision in *Trenwick America Litigation Trust v. Billett*, 931 A.2d 438 (Del. 2007) which adopted the Delaware Chancery Court's decision in *Trenwick America Litigation Trust v. Ernst & Young LLP*, 906 A.2d 168 (Del. Ch. 2006):

> Delaware law imposes no absolute obligation on the board of a company that is unable to pay its bills to cease operations and to liquidate. Even when the company is insolvent, the board may pursue, in good faith, strategies to maximize the value of the firm.
>
> ….
>
> If the board of an insolvent corporation, acting with due diligence and good faith, pursues a business strategy that it believes will increase the corporation's value, but that also involves the incurrence of additional debt, it does not become a guarantor of that strategy's success. That the strategy results in continued insolvency and an even more insolvent entity does not in itself give rise to a cause of action. Rather, in such a scenario the directors are protected by the business judgment rule. To conclude otherwise would fundamentally transform Delaware law.

906 A.2d at 204-5.

III. BREACH OF DUTY OF CARE AND EXCULPATORY CHARTER PROVISION

The Bridgeport Holdings decision also involved a breach of duty of care claim and the directors' defenses based on the exculpatory provision of the company's certificate of incorporation adopted under 10 Del. C. § 102(b)(7) and the business judgment rule. The Bridgeport Holdings decision held that neither the exculpatory charter provision nor the business judgment rule vitiates the duty of care claim against the directors. The basis of the Court's ruling appears to be the directors failure to adequately inform themselves about the transaction.

To be frank, the court's ruling does not provide a satisfying explanation as to why the Section 102(b)(7) charter provision does not bar the claim.

McPadden v. Sidhu, 2008 WL 4017052 (Del. Ch. Aug. 29, 2008) reached a very different conclusion in another case involving the board's alleged mishandling of the sale of the company:

> Delaware's current understanding of gross negligence is conduct that constitutes reckless indifference or actions that are without the bounds of reason.
>
> The conduct of the Director Defendants here fits precisely within this revised understanding of gross negligence…. [T]he

> Director Defendants' actions, beginning with placing Dubreville in charge of the sale process of TSC and continuing through their failure to act in any way so as to ensure that the sale process employed was through and complete, are properly characterized as either recklessly indifferent or unreasonable. Plaintiff has not, however, sufficiently alleged that the Defendant Directors acted in bad faith through a conscious disregard for their duties. Instead, plaintiff has ably pleaded that the Director Defendants quite clearly were not careful enough in the discharge of their duties – that is, they acted with gross negligence or else reckless indifference. Because such conduct breaches the Director Defendants' duty of care, this violation is exculpated by the Section 102(b)(7) provision in the Company's charter and therefore the Director Defendants' motion to dismiss for failure to state a claim must be granted.

2008 WL 4017052 at 10.

In short, *Bridgeport Holdings* appears to expose outside directors, acting without a conflict of interest, to substantially greater risk of personal liability in connection with the sale of a financially troubled company. *Bridgeport Holdings* illustrates the need for the board of directors to be actively engaged in the sale of the financially troubled company and to exercise meaningful supervision and control over the turnaround advisor. The board should seriously consider hiring an investment banker to actively shop the company and filing Chapter 11 prior to closing the sale in order to take advantage of the additional insulation from liability provided by Bankruptcy Court supervision. If the board determines, in the exercise of its informed business judgment, that engaging an investment banker and filing bankruptcy are not in the best interest of the company and its shareholders and creditors under the circumstances, the minutes should reflect the board's careful consideration of the issues and the reasons for the board's decision.