The So-Called Business-Judgment "Rule" in the Chapter 11 Setting

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S.H. CASE

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I. *Introduction*

The most-developed judicial interpretations of the meaning of the term "business-judgment rule" come out of litigation against corporate directors in the Delaware Chancery and other Delaware courts. As used there, as more fully explained below, the so-called "rule" is not a substantive rule at all. Rather it is a set of evidentiary presumptions that directors in taking some action or omitting to take an action have complied with the relevant fiduciary duties of directors, primarily:

- the duty of care (*i.e.*, to arrive at a decision without being grossly negligent) and
- the duty of loyalty (*i.e.*, to arrive at a decision without any corrupting influence of the possibility of improper economic or personal benefit to the decision maker).

Under the business-judgment "rule," the director is presumed to have complied with these two duties unless the plaintiff comes forward with some *prima facie* showing of breach. If there is no showing, the complaint is dismissed without trial. If there is a showing, the case proceeds to trial.[1]

Accordingly, before discussing the so-called business-judgment "rule" (which, as stated, isn't really a standalone "rule"), this paper addresses the underlying fiduciary duties of directors.

II. *Role of Directors*

Section 141(a) of the Delaware General Corporation Law states:

> "The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . . "

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[1] There are of course numerous exceptions, wrinkles and defenses that operate to make the actual application of the rule much more complex than the foregoing oversimplified summary might suggest.

III. *BASIC DIRECTOR DUTIES: CARE, CANDOR AND UNDIVIDED LOYALTY.*[2]

It has long been settled that directors of Delaware corporations owe fiduciary duties.[3] These duties are:

(i) invariably, the duty of care,[4] usually measured by a gross negligence standard;

(ii) often, a duty of candor,[5] especially important in close corporations where shareholders do not benefit from SEC-required disclosure; and

(iii) invariably, the duty of undivided loyalty.[6]

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[2] For an excellent source of discussion and citations regarding the topics discussed under this heading, see generally, ANDREW D. SHAFER, *Corporate Fiduciary - Insolvent: The Fiduciary Relationship Your Corporate Law Professor (Should Have) Warned You About*, 8 AMERICAN BANKRUPTCY INSTITUTE LAW REVIEW 479 (2000).

[3] See *Guth v. Loft*, 5 A. 2d 503, 510 (Del. 1939). See also *SEC v. Chenery Corp.*, 318 U.S. 80, 85-86 (1943) (fiduciary duty only makes sense in context of identifying to whom fiduciary duty is owed and what precise duties are owed).

[4] *Graham v. Allis-Chalmers Mfg. Co.*, 188 A. 2d 125, 130 (Del. 1963); *Cede & Co. v. Technicolor, Inc.*, 634 A. 2d 345 (Del. 1993) (gross negligence standard); *Smith v. Van Gorkom*, 488 A. 2d 858 (Del. 1985) (directors held liable for negligent decision making). Many states now allow corporate charters to contain a provision exculpating directors from money-damage liability for breach of duty. Delaware, for example, says in §102(b)(7) that the charter may contain a provision "... limiting the personal liability of a director to the corporation or its stockholders *[nb: there is no reference to creditors]* for monetary damages for breach of fiduciary duty as a director..." except for "any breach of the director's duty of loyalty," "acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law," illegal dividends and transactions from which the director "derived an improper personal benefit." See also *St. James Capital Corp. v. Pallet Recycling Assoc. of N. America, Inc.*, 589 N.W.2d 511, 516 (Minn. Ct. App. 1999)(directors breached a confidentiality agreement, as a result of which the company lost a $10 million acquisition opportunity; creditors sued directors; court held "creditors are not owed a duty by an insolvent corporation's directors and officers to minimize any loss that may occur as a result of the corporation's insolvency. To hold otherwise would allow creditors... to interfere unduly and interject themselves in the day-to-day management of the corporation.")

[5] *See, e.g., Sealy Mattress Co. of New Jersey, Inc. v. Sealy, Inc.*, 532 A. 2d 1324, 1340 (Del. Ch. 1987).

[6] *Meinhard v. Salmon*, 249 N.Y. 458, 463-64 (N.Y. 1928) (the famous "not honesty alone but the punctilio of an honor the most sensitive" standard, stated in partnership case); *Aronson v. Lewis*, 473 A. 2d 805, 812 (Del. 1984); *Guth v. Loft*, 5 A. 2d 503, 510 (Del. 1939); *Haseotes v. Cumberland Farms, Inc. (In re Cumberland Farms, Inc.)*, 284 F.3d 216 (1st Cir. 2002) (director of debtor caused a nondebtor company, wholly owned by him, to repay a debt to him instead of a debt to debtor; this breached duties of loyalty and candor; as a consequence, debtor properly set off liability of director to it for these breaches of fiduciary duty against amounts owed by it to director), *Hollinger Int'l, Inc. v. Black*, 2004 Del. Ch. LEXIS 13 (Del. Ch.
(...continued)

IV. *The Duty of Undivided Loyalty: Some Detail*

The duty of loyalty is the basic rule designed to insure that fair decisions are made by directors of businesses which deploy money invested by non-directors. It declares, in effect, that beneficiaries of the rule (normally shareholders, but, in recent years, to an increasing extent, creditors) are entitled to have corporate action taken by individuals serving as directors whose decisions are free from the possibly corrupting influence of a material personal self interest in achieving, as a result of the decision, some material personal economic benefit not received by the beneficiaries generally.

V. *To Whom the Duties are Owed: Expansion on Insolvency*

Normally: (i) the duties of care, candor and undivided loyalty are owed to the corporation and the shareholders, ***not*** to creditors; and (ii) directors owe creditors only a "contract duty",[7] not fiduciary duty. However, a number of Delaware cases in recent years have held that when a corporation is "in the vicinity of insolvency" (whatever that may mean), then directors owe fiduciary duties to creditors.[8] This author (with no support known to him in the case law to date) prefers to think of this as a "standing" issue, *i.e.*, until the "vicinity of insolvency", creditors have no "standing" to sue directors for breach of fiduciary duty; the "vicinity of insolvency", argues he, confers standing to sue.

VI. *Two Defenses to Charges of Breach of the Duty of Loyalty*

A. Approval by Majority of Disinterested Directors

Under Section 144 of the Delaware General Corporation Law, however, decisions of a board are not actionable just because one or more directors is "interested", *i.e.*, could receive an improper material personal economic benefit from the decision under consideration. There will be no liability as long as the self-interest has been fully disclosed and the decision made by vote of a majority of the disinterested directors, whether or not a quorum.

In financially-distressed privately held corporations, where all the directors own stock, and the stock is a material portion of their personal economic

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(continued...)

2004) (Vice Chancellor Strine funds numerous duty-of-loyalty violations by dominant person in controlling shareholder corporation.)

[7] See *Simons v. Cogan,* 549 A. 2d 300 (Del. 1988).

[8] *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, 1991 Del. Ch. LEXIS 215 (Del. Ch. 1991); *Geyer v. Ingersoll Publications Co.*, 621 A. 2d 784, 787 (Del. Ch. 1992). An example of an older, contrary precedent is *Allen v. Cochran,* 107 So. 292 (La. 1926).

positions, it can credibly be alleged that all their decisions are infected with duty-of-loyalty issues. Should such a group of directors elect a legitimately independent director to reduce the risks of breach-of-duty litigation brought by creditors?

B. Finding of "Intrinsic Fairness"

Importantly, if all directors are "interested," then under Delaware Section 144 no liability is incurred if either the shareholders ratify the action or the court finds that the action taken was intrinsically fair. The author knows of no decisions addressing whether *shareholder ratification* exonerates interested directors form liability for breach of duty to *creditors*.

Standards in the shareholder context for what constitutes "intrinsic fairness" are expressed differently, but usually, when valuation is the issue (as in whether a merger was allegedly done at too low a price) the courts look for fairness in the "price and process".[9] This author wishes the courts would express the following more generic standard of "intrinsic fairness", *i.e.*, "would a completely independent board have reached the same decision?"

VII. *When Fiduciary Duty is Owed to Creditors, Does that Trump the Duty to Shareholders? Or Do Both Groups Have "Equal Rights"?*

The first question stated in caption no. VII is not definitively answered in the present case law. While a few decisions say (or are cited to say) that on insolvency duty to creditors prevails over any responsibility of directors to shareholders,[10] this writer, as a matter of policy, disagrees with that conclusion.

The view advanced here is that the director owes duties to both shareholders and creditors, and each of those constituencies has rights only to an impartial, well-informed decision by disinterested directors. In other words, the often-differing desires of the two classes of beneficiaries, is "conflict among beneficiaries", a common problem in the administration of testamentary trusts and, also, an occasional problem in corporate law, as, for instance, where the interests of preferred stockholders conflict with those of common stockholders

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[9] *Weinberger v. UOP, Inc.*, 457 A. 2d 701, 711 (Del. 1983).

[10] *See Pepper v. Litton*, 308 U.S. 295 (1939); *McCandless v. Furlaud*, 296 U.S. 140 (1935); *Clarkson Co. Ltd. v. Shaheen*, 660 F.2d 506 (2d Cir. 1981); *Automatic Canteen Co. of Am. v. Wharton*, 358 F. 2d 587, 590 (2d Cir. 1966); *Davis v. Woolf*, 147 F.2d 629 (4th Cir. 1945); *In re Jersey Materials Co.*, 50 F. Supp. 428 (D.N.J. 1943); *New York Credit Men's Adjustment Bureau, Inc. v. Weiss*, 305 N.Y. 1, 110 N.E. 2d 397 (N.Y. 1953); *The Official Comm. of Unsecured Creditors of Buckhead America Corp. v. Reliance Capital Group, Inc. (In re Buckhead Am. Corp.)*, 178 B.R. 956, 968 (D. Del. 1994).

and where some or all directors hold material amounts of one class of such equity securities but not the other.[11]

To illustrate, consider a fairly common fiduciary problem arising in testamentary trusts. Suppose a recently deceased wealthy testator has left as survivors the umpteenth wife and the children of the first marriage. Assume that the widow, younger than the children, hates the children and *vice versa*. The will puts all the money in trust: income to the widow for life, remainder to the children. The trustees are the widow, one independent outsider and one of the remainderperson-children.

No one disputes the proposition that all of these trustees owe fiduciary duties to both the income beneficiary and the remainderpersons. No fiduciary laws known to this writer in these circumstances say that there is a "paramount" duty to either the income beneficiary or the remainderpersons.

The widow demands that the money be invested in high-yield municipals to maximize what she receives. The children, as would be expected, demand investment in low-dividend growth stocks to maximize what they receive (and, of course, minimize what the widow receives).

What do the trustees do?

First, the two "interested" trustees, the widow and the remainderperson-child, have to be recused from decision making. Otherwise the fiduciary process is tainted with their self interest, in violation of the duty of undivided loyalty. Next, the independent fiduciary considers what standard of living the widow enjoyed before the testator died. Often, he or she will then invest the trust corpus in income-producing securities to an extent necessary to produce income sufficient to assure the widow that she will not have to suffer a reduction in her standard of living. The rest the independent trustee invests for growth for the remainderpersons. It is safe to forecast that no breach of fiduciary duty by the independent trustee will be found on the foregoing facts.[12]

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[11] See, e.g., *Jedwab v. MGM Grand Hotels, Inc.*, 509 A. 2d 584, (Del Ch. 1986) and *Eisenberg v. Chicago Milwaukee Corp.*, 537 A. 2d 1051 (Del. Ch. 1987).

[12] For news accounts of a real-life battle something like what is described here, see "Even the Estate of Henry Ford II Causes Controversy", THE WALL STREET JOURNAL, August 29, 1988, 1988 WL-WS 451648; "Bizarre and Melodramatic Fight over Ford Fortune Revs Up", THE DALLAS MORNING NEWS, September 25, 1988, 1988 WL 5327343; "A Bitter Family Fight Over Henry Ford II's Estate", THE SAN FRANCISCO CHRONICLE, October 6, 1988, 1988 WL 6099924; and "Ford Fortune Feud the Talk of Palm Beach", ATLANTA JOURNAL, October 6, 1988, 1988 WL 6001845. In the *Ford* case, the initial independent trustee, husband of a close friend of the widow, committed suicide. The widow believed that the alternative trustee named in the will was partial to the children. He denied that and alleged that she had told him she would support him only if he (...continued)

Now, translating the foregoing to the context of the insolvent corporation, the dispute between the widow and the children is not dissimilar to the dispute that sometimes exists between debt, wanting liquidation and payoff *now*, on the one hand, versus the equity, which wants time and patience so that equity value can be restored and grow, on the other hand.

It seems to this writer that the resolution of the conflict among beneficiaries, when seen in the insolvency setting, depends heavily on the facts, the quality of judgments made and the independence of the fiduciaries. In other words, the thoughtful and disinterested independent fiduciary, after examining the facts with care and discernment, can decide either on liquidation or "keep the thing running", depending on his or her best judgment about prospects, and regardless of the decision, will have no liability for breach of fiduciary duty.

An example is presented by *In re Central Ice Cream Co.*, 836 F.2d 1068 (7th Cir. 1987). There the operating assets of the debtor, Central Ice Cream, had been liquidated. Its principal asset was a suit against McDonald's Corp. The suit went to trial. As Judge Easterbrook put it, the debtor won a "big jackpot", *i.e.*, a $52 million verdict. While post-trial motions were pending, McDonald's offered a $15.5 million settlement. The Central bankruptcy trustee (whose independence was not questioned) accepted the "bird-in-hand." The $15.5 million covered the legal fees and Central's debts, at 100%, but left nothing for shareholders. Shareholders sought to persuade the bankruptcy judge to reject the settlement. Their witnesses said the discount from the verdict was too deep relative to their view of the strength of the verdict. 59 B.R. 476 (Bankr. N.D. Ill. 1985). The appeal arose because the district court had sanctioned the attorneys for the 49% shareholders for misrepresentations in their brief. Relying on testimony of the bankruptcy trustee at the settlement hearing that in negotiating the settlement he "did not consider the interest of shareholders", 836 F.2d at 1072, the 49% shareholders felt they had to intervene. In dicta, the Seventh Circuit declared that failure of the trustee to consider shareholder interests was "an unusual posture for a trustee, whose duty is to maximize the value of the estate, not of a particular group of claimants." *Id.* In a footnote on the same page, though, after having thus questioned the trustee's posture, the panel impliedly criticized the aggrieved shareholders for failure to substitute money for litigation, *i.e.*, the panel suggests that the trustee should have offered the shareholders the chance to put up enough of their own money to pay the creditors, so that on appeal of the McDonald's verdict, the shareholders would have been risking their own money, not the creditors' recovery. In other words, the panel addressed the

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(continued...)

would assure her he would favor her interests. This he refused to do, declaring he would act "evenhandedly." Nonetheless, the widow fought his appointment as the successor trustee in the courts.

conflict-among-beneficiaries issue and noted its complexity but did not need to resolve it in the context of the sanctions motion pending before it.

Reported decisions saying that the duty to creditors is "paramount" are unwise. This position is equivalent, in the testamentary example, of saying the remainderpersons had no rights to benefit from the judgment of an independent fiduciary.

VIII. *PROTECTION OF DIRECTORS: THE SO-CALLED BUSINESS-JUDGMENT "RULE" (WHICH IS REALLY A SET OF EVIDENTIARY PROCEDURES, NOT A SUBSTANTIVE RULE OF CONDUCT)*

The Delaware Chancery Courts frequently hear lawsuits contending that directors have breached fiduciary duty to shareholders or the corporation. In Delaware, it has long been settled that the directors are protected by the "business–judgment rule."[13] This is, in fact, not a "rule" prescribing conduct, but a set of evidentiary presumptions, namely, that directors have acted in good faith, made adequately informed decisions, made full disclosure, and the process was free of taint arising from improper, economic, material self-interest in the outcome of the decision. The effect of these presumptions is to require the plaintiff to come forward with enough evidence to rebut the presumptions. If the plaintiff fails to meet this burden, then the case is dismissed with no trial. If the presumptions are overcome, then trial preparation goes forward, the burden switches, and the directors must prove compliance with their fiduciary duties.

IX. *OPERATION OF THE DUTY OF UNDIVIDED LOYALTY: INSIDER TAKEOVER EXAMPLE*

It is now routine for Delaware publicly-traded corporations to adopt some variant of the following procedures when an insider makes an offer to buy out the other shareholders. The board, in effect, removes the insider from the board for purposes of the offer. It insists that the offeror (who now by participating in decisions would be violating the duty of undivided loyalty because he or she has a personal interest in getting the other shares cheap, which conflicts with the interest of the other shareholders to sell dear) recuse himself or herself from all deliberations about the offer. Then, a special committee of disinterested directors[14] is created to which is delegated the task of studying the insider's offer

[13] *Aronson v. Lewis*, 473 A. 2d 805, 812 (Del. 1984).

[14] Sometimes apparently disinterested directors, on close review, are found to lack the requisite independence. *See In re Oracle Corp. Derivative Litigation*, 824 A. 2d 917, 942 (Del. Ch. 2003) (ties among allegedly independent members of special litigation committee, the defendants in the derivative case and Stanford University "are so substantial that they cause reasonable doubt" as to independence of the special committee members.)

(and that of any others that come along) to see if a transaction makes sense. Often, as additional protection, the committee will hire a banking firm to advise on the intrinsic fairness of the offer or offers made[15].

X. *Operation of the Rule of the Duty of Undivided Loyalty: High-level Scrutiny Against Entrenchment*

In *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985), a third party made an unsolicited takeover offer to Unocal, at a price per share of Unocal stock higher than that at which the stock was trading. The target board rejected the offer and launched a counteroffer to buy in its own shares, but the counteroffer excluded shares held by the third party that had initiated the whole thing. The Delaware Supreme Court upheld the Unocal Board's approval of the exclusionary offer but only after holding:

> "Given the foregoing principles, we turn to the standards by which director action is to be measured. In [citation omitted] we held that the business judgment rule, including the standards by which director conduct is judged, is applicable in the context of a takeover. [citation omitted]. The business judgment rule is a 'presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.' [citation omitted] A hallmark of the business judgment rule is that a court will not substitute its judgment for that of the board if the latter's decision can be 'attributed to any rational business purpose.' [citation omitted]. When a board addresses a pending takeover bid it has an obligation to determine whether the offer is in the best interests of the corporation and its shareholders. . . . There are, however, certain caveats to a proper exercise of this function. Because of the *omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders, there is an enhanced duty* which calls for judicial examination at the threshold before the protections of the business judgment rule may be conferred.
>
> This Court has long recognized that:
>
> 'We must bear in mind the inherent danger in the purchase of shares with corporate funds to remove a threat to corporate policy when a threat to control is involved. The directors are of

[15] *In re RJR Nabisco, Inc. Shareholders Litigation*, 1989 Del. Ch. LEXIS 9 (Del. Ch. 1989).

necessity confronted with a conflict of interest, and an objective decision is difficult.' [citation omitted]. In the face of this inherent conflict directors must show that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed because of another person's stock ownership. [citation omitted]. However, they satisfy that burden "by showing good faith and reasonable investigation. . . .' [citation omitted] Furthermore, such proof is materially enhanced, as here, by the approval of a board comprised of a majority of outside independent directors who have acted in accordance with the foregoing standards. . . .'" 493 A.2d 954-955. (emphasis added.)

XI. *HOW THESE PROCEDURES PROTECT THE DIRECTORS*

Given these procedures, when minority shareholders unhappy, for example, about a price at which a controlling shareholder attempts to "squeeze them out," seek in court to enjoin the transaction, the members of the special committee of disinterested directors have the following defenses: First, they are entitled to the business-judgment rule's presumptions, for decisions made by fully informed, disinterested directors. Second, even if some "interest" or lack of due care in investigation is found, the efforts of banking advisers in delivering a written "fairness" opinion offers – and the directors are entitled to rely on -- independent advice as to the entire fairness of the decision.[16]

XII. *CHAPTER 7 TRUSTEE RECOVERS HUGE JUDGMENTS AGAINST CORPORATE INSIDERS FOR BREACH OF FIDUCIARY DUTIES*

Personal liability in multi-million dollar amounts was imposed in May 2003, in an action brought by a chapter 7 trustee, on directors and officers of a privately-held company. The non-director general counsel, for example, was held liable for $21.3 million, in part for his personal failure to protect the corporation against excessive pay to the chief executive.[17] Said the court: the ". . .General Counsel . . . had the obligation to direct the Board to supervise [the CEO] and to ensure the financial integrity of [the Company]."[18] The decision, *Pereira v.*

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[16] *See, e.g., Paramount Communications, Inc. v. Time Incorporated,* 571 A. 2d 1140 (Del. 1989).

[17] *See Pereira v. Cogan, et al.*, 294 B.R. 449, 523-24 (S.D.N.Y. 2003).

[18] *Id.* at 524.

Cogan,[19] (handed down after a two-week bench trial) seems likely to be regarded as significant.

A. Amounts of Judgments Entered

Judgment amounts entered against each defendant appear in the following chart.

JUDGMENT DEBTOR	AMOUNT OF JUDGMENT[20]
The CEO	$44,374,824.16 (includes prejudgment interest of $9,252,203.66)
Mr. Andrea Farace, at various times, director and officer of Trace; also CEO of Foamex for a period	$27,308,841.12 (includes prejudgment interest of $10,484,881.12)
Mr. Frederick Marcus, at various times, director and officer of Trace; member of Trace compensation committee	$37,360,290.70 (includes prejudgment interest of $13,910,286.18)
Mr. Robert H. Nelson, at various times, director and officer of Trace	$38,321,643.30 (includes prejudgment interest of $14,300,638.78)
Mr. Philip Smith, vice president, general counsel and secretary of Trace	$21,392,974.45 (includes prejudgment interest of $7,408,261.93)
Mr. Karl Winters, at various times, an officer of Trace	$21,350,774.60 (includes prejudgment interest of $7,381,062.08)

B. Overview of Facts

Plaintiff was the chapter 7 trustee ("Trustee") of Trace International Holdings, Inc. ("Trace"). The CEO, the principal judgment debtor, had been, until bankruptcy, Trace's majority shareholder and chief executive officer

[19] *See Pereira v. Cogan, et al.*, 294 B.R. 449 (S.D.N.Y. 2003) ("**Pereira V**") and five of its reported predecessors, **Pereira I** – 00 Civ. 619 (RWS), 2001 U.S. Dist. LEXIS 2461 (S.D.N.Y. Mar. 8, 2001) (motion to dismiss denied); **Pereira II** -267 B.R. 500 (S.D.N.Y. 2001) (granting summary judgment for default on notes by one defendant); **Pereira III** - 275 B.R. 472 (S.D.N.Y. 2002) (approving early entry of partial judgment under Fed. R. Civ. P. 54(b)); **Pereira IV[A]** - 200 F. Supp. 2d 367 (S.D.N.Y.), aff'd, 02-7625, 2002 U.S. App. LEXIS 24123 (2d Cir. Nov. 25, 2002) (motion for partial summary judgment granted in part and denied in part); and **Pereira IV[B]** - 2002 U.S. Dist. LEXIS 8513, 2002 WL 989460 (S.D.N.Y. May 10, 2002) (denying right to jury trial).

[20] The numbers in the chart are taken from the Final Judgment signed June 20, 2003 and entered on June 25, 2003, 00 Civ. 619 (RWS) Document No. 249 #03, 1294. Excluded from the numbers are certain fairly small credits and accretions to interest. Costs (not quantified in the chart) were also awarded to plaintiff. The author cannot tell from what has been published (and has not studied) whether or not the judgment is based on concepts of joint and several liability. The author does not know whether each defendant is liable for 100% of the judgment against him or for a part only based on what other defendants were to pay.

("CEO"). The other judgment debtors are a group of five inside directors and officers.[21]

At one level (recapture of funds taken from the company for personal use by the CEO in the late stages of its financial distress) there is nothing especially unusual about the decision. However, what appears to be noteworthy are two things:

- *First,* the money was recaptured in part on a legal theory of breach of fiduciary duty of directors and officers to *creditors*; and

- *Second*, liability was imposed on officers and directors (all of whom were employees) for breach of duty, even though their shareholdings apparently were negligible or zero. For instance, the general counsel was found liable for certain uncollectible loans to the CEO, on the following reasoning:

> "[H]e should have taken steps to advise the Board that any such loans had to be approved by them, in keeping with his obligation to discuss with the Board its duty to establish compliance and monitoring programs or an audit committee, the obligation to supervise and evaluate [the] CEO . . . "[22]

In all, eight transaction activities were scrutinized. Five of the eight (*e.g.*, excessive compensation to controlling shareholder and loans to controlling shareholder's wife) were plain-vanilla self-dealing transactions with an insider. The sixth and seventh transactions were improper dividends and improper redemption of preferred stock, each of which violated Delaware law and/or the corporate charter. The eighth category of transactions was loans to employees.[23]

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[21] The one outside director, Mr. Saul Sherman, settled before trial for $2,000,000. 294 B.R. at 548.

[22] 294 B.R. at 523-24.

[23] The eight activities were:

1. Redemption of preferred stock while capital was impaired through the ruse of a loan to the controlling shareholder.
2. Payment of dividends while capital was impaired.
3. Excessive compensation to the CEO and improper extension of his contract.
4. Unjustifiable loans to the CEO.
5. Unjustifiable loans to the CEO's wife.
6. Unjustifiable loans (and forgiveness of loans) to five insiders.

(...continued)

C. Notable Statements and Questions by the Court

Eleven examples of the many legally interesting statements made, and questions asked, by the court are listed on Annex A.

XIII. *INSOLVENT-CORPORATION EXAMPLE OF BREACH OF THE DUTY OF UNDIVIDED LOYALTY*

In *Geyer v. Ingersoll,* 621 A. 2d 784 (Del. Ch. 1992), Geyer in 1988 sold stock in a corporation owned and controlled by Ingersoll, who was the sole director, to the issuing corporation, which paid by giving a corporate note to Geyer. Thereafter, Ingersoll pulled $50 million of assets out of the corporation, which then defaulted on the note held by Geyer. Geyer sued Ingersoll personally for the unpaid balance of the note, alleging breach of the duty of loyalty, *i.e.*, that Ingersoll as a director breached a duty of loyalty to Geyer by pulling out assets for his personal benefit as a shareholder. Ingersoll moved to dismiss, contending he owed no fiduciary duty to Geyer, a creditor. The court found the existence of a fiduciary duty of loyalty to Geyer. The court denied the motion to dismiss. The court noted that the right of the charter to exculpate directors from liability to shareholders and the corporation under 102(b)(7) discussed above in note 3 did not apply to rights of creditors. No further proceedings were reported. This writer suspects that Mr. Ingersoll long ago settled the case.

XIV. ALLIED RISER *CASE: EXAMPLE OF APPLICATION OF INSOLVENCY-RELATED SUIT IN DELAWARE COURT – DIRECTORS ABSOLVED*

On January 30, 2002, Vice Chancellor Lamb of the Delaware Chancery Court issued his decision in *Angelo, Gordon & Co., L.P., et al. v. Allied Riser Communications Corp.*, 805 A. 2d 221.

A. The Facts

The Merger. Allied Riser proposed to merge with Cogent Communications Group, Inc. ("Cogent").

The Plaintiffs' Debt Holdings. Plaintiffs owned 59% of an Allied Riser convertible subordinated debt issue.

(continued...)

7. Company payment for a $108,000 movie about the CEO's life shown at a $1.0 million 60th birthday party held for him at the Museum of Modern Art. (No liability was imposed for the cost of the party; only the movie was liability producing.)

8. No-show job for the CEO's daughter.

The Subordinated Debt Issue. These debt securities had never had an investment-grade rating and were trading at "a deep discount to their face value" (at 223). Interest was current. Principal was all payable as a balloon, at maturity, in 2007. The debt could be accelerated for the usual default reasons. Event-risk clauses gave holders a put for certain change-in-control events. The court found that no default existed.

Allied Riser Insolvency. Owing to a loss reported for the quarter ended 30 September 2001, the Allied Riser balance sheet showed a deficit net worth, or to use other words, balance-sheet insolvency, at least on a book-value basis.

The Merger. On October 13, 2001, the Allied Riser board approved amendments to a previously executed merger agreement with Cogent, which set the stage for the litigation. Under the merger:

(i) Allied Riser stock would become Cogent stock at a negotiated ratio,

(ii) Cogent's creditors would get a lien on all assets of Allied Riser, and

(iii) the plaintiffs' debt issue would stay in place, with Cogent as a new co-obligor. At all relevant, material times, the board was advised by the Houlihan Lokey banking firm, which had advised the board, in writing, that the transaction was fair.

The Lawsuit. On December 7, 2002, plaintiffs' filed their complaint, alleging "breach of fiduciary duty, breach of covenants of good faith and fair dealing, fraudulent conveyance, and constructive trust" (at 227). The plaintiffs also sent a notice of default to Allied Riser and the indenture trustee (which declined to join the suit as a co-plaintiff). On January 3, plaintiffs amended the complaint to allege default under the indenture for the subordinated debt.

B. *The Motion for Preliminary Injunction*

The Motion. On January 14, 2002, plaintiffs moved for a preliminary injunction against the merger.

Indenture Counts Rejected. The court rejected the indenture-default allegations, all of which were highly technical and sounded in "de facto liquidation", "put" rights and technicalities about the execution of a supplemental indenture (at 227-28).

C. *The Fiduciary-Duty Count*

As noted above, the plaintiffs in *Allied Riser* made the following two charges:

(i) allegedly, the directors owed fiduciary duties of loyalty to the note holders and were breaching them because the size of their stock holdings gave them an improper, economic, material self interest in the outcome of their vote; and

(ii) because, again allegedly, the "structure and business prospects of the [post-merger] entity are so risky as to support a conclusion that the directors were not acting in good faith with respect to the [sub debt] holders in entering into the merger agreement." (at 229).

The outcome of the case turned on how much stock the directors had.

The plaintiffs charged that the directors owned or represented 28% of the common stock. The court rejected this contention and accepted the directors' contention that they owned or controlled only 3.5% of the common stock "the value of which is insignificant, both to them and absolutely" (at 228). In effect, in other words, the court found that the directors lacked a "material" personal self interest in the outcome of the decision to merge. Lack of this "materiality" destroyed the breach-of-the-duty-of-loyalty charge.

In reaching this result, the court determined that, in a case where directors of an insolvent corporation were sued by creditors, the directors were entitled to the benefits of the evidentiary presumptions of the business-judgment rule. (at 229). This author believes (without the benefit of any special research) that this decision at the time was the first judicial ruling on this point in this context in the Delaware case law.

This determination about the business-judgment rule mandated the decision on issue (ii), *i.e.*, no breach of director duty. Given that the plaintiff creditors failed to show that the directors had a material self interest in the decision or that they were ill informed in the process, the presumptions of the business-judgment rule were not overcome.

Hence, the injunction was denied.

XV. *SELECTED ISSUES ARISING IN CHAPTER 11 UNDER THE BUSINESS-JUDGMENT RULE*

A. Is there a Need for Director Compliance with Normal Corporate-Type Fiduciary Duties in Chapter 11 Cases?

Code §1107 states that "a debtor in possession shall . . . perform all the . . . duties . . . of a trustee serving in a case under this chapter." Beyond doubt, these duties include the fiduciary duties of care and undivided loyalty. Are these duties needed in chapter 11?

In a functioning business corporation, out of bankruptcy, one in which hypothetical, comatose Widow Brown has invested all her life savings, there are:

- no requirements for out-of-ordinary-course transactions to be approved by a court
- no committees of investors, and
- no corporation-paid bankers and professionals looking at things from the outside, as there is in a chapter 11 case.

Hence, fairly strict application of fiduciary principles or self-discipline on insiders seems important. However, when, in the chapter 11 environment the protections not provided in the three above bullet points *are* provided, one can at least ask: why go through the expensive, duplicative requirements of requiring director fulfillment of fiduciary duty to begin with?

B. Should There be Delaware-Style Presumptions in Chapter 11 Cases?

As noted above, in litigation against directors in Delaware, the defendant directors enjoy a presumption that they have fulfilled the duties of care and loyalty. The plaintiff must make some showing indicative of violation; otherwise, the complaint should be dismissed. This writer is aware of no bankruptcy cases which describe "business judgment" in terms of there existing in bankruptcy any "presumptions". Should there be such presumptions?

C. Business Judgment in the Lease-and-Contract Affirmance Setting

In a case decided in 1984,[24] the court summarized as follows how the "business-judgment rule" is applied in the lease-and-contract rejection setting:

> "Section 365 of the Bankruptcy Code provides for the assumption or rejection of executory contracts and unexpired leases. As stated in Section 365:
>
> '(a) Except as provided in section 765 and 766 of this title and in subsection (b)(c) and (d) of this section, the trustee, subject to the court's approval may assume or reject any executory contract or unexpired lease of the debtor.'
>
> The Court will generally apply a 'business judgment' test in determining whether an executory lease may be rejected, [citation omitted]; and, a

[24] In re Air Vermont, Inc., 40 B.R. 61, 63 (Bankr. D. Vt. 1984).

similar standard was reviewed summarily and restated as to the rejection of an executory contract in . . . [citation omitted] and In re Minges, 602 F.2d 38, 42 (2d Cir. 1979).

The application of the 'business judgment' test must be exercised in a manner that allows flexibility, and that provides due deliberation to the interests of all creditors of the debtor. The Court in reviewing the "business judgment' as to acceptance or rejection, must further consider the substantive agreement; the subject matter of the agreement and its necessity to the debtor; and, the implications of such acceptance or rejection."

D. Section 363 Sales.

In *The Committee of Equity Security Holders v. The Lionel Corp.* (*In re Lionel Corp.*, 722 F.2d 1063 (2d Cir. 1983), debtor sought to sell a major asset under Code §363. On the witness stand, debtor's CEO was asked why the debtor had put the assets up for sale. His answer (paraphrased by the court): was "the Creditors' Committee's insistence upon it." 722 F.2d 1065. On appeal, the Second Circuit found that this was inadequate basis for the trial court to have approved the sale. Expressed in business-judgment terms not used by the Second Circuit, the finding was that there may have been a breach of the duty of care by the directors, *i.e.*, they had simply reacted to creditor pressure rather than reaching their own decision, free of gross negligence, that it was in the best interests of the corporation to conduct the sale.

E. Would the Time-Paramount *Case Be Decided the Same Way in Bankruptcy Court? With or Without the Business-Judgment Presumptions?*

In the following case, Delaware reliance on the business-judgment presumptions permitted a low-price all-paper deal to go forward in lieu of a much higher all-cash offer. Would use of normal, state-law "business judgment" presumption in bankruptcy permit the same result?

Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140 (Del. 1989), arose in a contested takeover. Time had agreed to merge with Warner. Under the merger, Time shareholders would receive *securities* of the merged enterprise valued at around $125 per share. Paramount tried to break up the deal by offering more than $200 in *cash* for each share of Time stock.

The higher offer always wins, right?

Wrong.

The Time directors rejected the Paramount offer and moved forward to close the lower-priced Warner deal. The Delaware Supreme Court rejected contentions by shareholders eager to receive the cash that this was a breach of duty by the Time directors. These directors had concluded, among other things, after careful study, that the Warner merger was a better way for Time to preserve its valuable traditions of editorial independence and to integrate Time's cable TV business with Warner's entertainment products.

In other words, the Delaware court, finding no breaches by Time's directors of either the duty of care or the duty of loyalty, found no basis to substitute its own judgment for that of the directors. Although this decision did not involve fiduciary duty to creditors, it did involve conflict among beneficiaries (*i.e.*, cash-hungry shareholders versus patient shareholders) and holds that directors who are free of improper personal conflicts will have their diligently arrived at decisions upheld even if some beneficiaries (*i.e.*, shareholders wanting the higher cash-now deal) are left disappointed.[25]

To similar effect is *In re Xonics, Inc.*, 99 B.R. 870 (Bankr. N.D. Ill. 1989) (applying Delaware law). In that case, the creditors of an insolvent corporation claimed that one of the company's directors had breached his duty of loyalty by allegedly failing to investigate a transaction entered into by the corporation and by profiting personally from the transaction. The court rejected the plaintiffs' contentions, holding the director protected in effect by the business-judgment rule, since he had fully disclosed the proposed transaction to the independent board, and the board had approved it. The court wrote: "This court must be able to rely on officers' and directors' actions, even for an insolvent corporation unless those seeking damages show that such actions are venal. To require less in assessing breach of fiduciary duty on the [creditors'] record in this case would constrain the commercial world in developing means to aid the floundering corporation." *Id.* at 876.

[25] *See also Herd v. Major Realty Corp.*, 1990 Del. Ch. LEXIS 211 (Del. Ch. 1990).

Annex A

Eleven legally interesting statements made, and questions asked, by Judge Sweet in *Pereira v. Cogan* are:

- *Delaware Charter Exculpation Ineffective:* Pereira I held that the chapter 7 "Trustee is not bound by Section 102(b)(7) of Delaware's General Corporation Law and Article IX of Trace's Articles of Incorporation. . . which shield directors from liability for the breach of a duty of care."[26]

- *What is the Standard for Holding the Non-Director General Counsel Liable for Breach of Fiduciary Duty?* The ". . . General Counsel. . . had the obligation to direct the Board to supervise [the CEO] and to ensure the financial integrity of Trace." The court held the General Counsel liable for certain improper loans to the CEO and for an improper preferred-stock redemption.[27]

- *What is the Standard for Holding Directors Liable?* ". . . Directors will not be excused from liability if they either (1) knew about the challenged expenditure yet unreasonably failed to take action or (2) if they did not know, should have taken steps by which they would have been informed of the challenged expenditure."[28]

- *Does Privately-Held Status Reduce Liability Risk for the Controlling Shareholder?* "[C]an a controlling shareholder and founder of a privately held corporation be held liable for, colloquially speaking, taking money out of one pocket and putting it into another?" Answer? Yes.[29]

- *Does Privately-Held Status Reduce Liability Risk for the Employed Directors and Officers?* "[W]hat role [should] the officers and directors . . . play when confronted by, or at least peripherally aware of, the possibility that a controlling shareholder (who also happens to be their boss) is acting in his own best interests instead of those of the corporation. Given the lack of a public accountability present in a closely held private corporation, it is

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[26] 294 B.R. at 533-34. This result was reached on grounds that "102(b)(7) of the Delaware General Corporation Law, which provides the basis for the exculpatory provision in the charter of Trace, does not preclude a chapter 7 trustee from 'bringing these claims for the benefit of the creditors. . ."

[27] *Id.* at 524.

[28] *Id.* at 526.

[29] *Id.* at 462-63.

arguable that such officers and directors owe a greater duty to the corporation and its shareholders to keep a sharp eye on the controlling shareholder. At the very least, they must uphold the same standard of care as required of officers and directors of public companies or private companies that are not so dominated by a founder/controlling shareholder."[30]

- *When Does "Vicinity of Insolvency" Exist?* "Vicinity of insolvency" was determined on the basis of solvency measured by either of two tests: (test 1, used by all expert witnesses) a "mark-to-market" version of the GAAP balance sheet or (test 2, variants used by each witness) a "Cash Flow and Capital Adequacy Test", *i.e.*, a determination whether the corporation had the "ability to pay its current maturing obligations as they came due, but also the ability to meet cash and capital requirements in the future, including those required to repay the additional borrowings that were being incurred to fund Trace's cash flow deficits."[31]

  The court concluded that "vicinity of insolvency" exists when the company flunks test (2), even if there is balance-sheet solvency under test (1). The court said that the company flunks test (2) – and lives "in the vicinity" — unless it has the "ability to obtain enough cash to pay for its projected obligations and fund its business requirements for working capital and capital expenditures with a reasonable cushion to cover the variability of its business needs over time."[32]

- *What is the Standard for Holding an Officer Liable for Breach of Fiduciary Duty?* In order for an officer to be held liable for breach of fiduciary duty, "it will have to be concluded for each of the alleged breaches that [the officer charged] had discretionary authority in the relevant functional area and the ability to cause or prevent the complained-of action."[33]

- *There is Plain, Flat Liability to Creditors for Improper Dividends and Improper Redemptions:* "Under Section 174(a) of the Delaware General Corporation Law, the directors of a corporation are jointly and severally liable to the corporation's creditors for any illegal dividends or illegal redemptions they allow. . . Therefore, the Director-Defendants are liable

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[30] *Id.* at 463.

[31] *Id.* at 501.

[32] *Id.* at 521.

[33] *Id.* at 522.

for the illegal dividends in the amount of $4,309,823 and the illegal redemption in the amount of $ 3 million, or a total of $7,309,823."[34]

- *The Directors and Officers Were Not Entitled to a Jury Trial:* ". . . a right to jury trial did not attach in this case because breach of fiduciary duty was historically treated as an equitable cause of action and because the Trustee had limited his relief to restitution."[35]

- *Pre-Judgment Interest Is a "Matter of Right":* "Under Delaware law, prejudgment interest is available 'as a matter of right' in breach of fiduciary duty cases."[36]

- *Pre-Judgment Interest Runs from the Date of the Wrongdoing:* "Prejudgment interest shall be calculated from the dates Trace was wrongfully deprived of its funds by the multiple wrong acts."[37]

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[34] *Id.* at 544.

[35] *Id.*

[36] *Id.* at 550.

[37] *Id.*