VIABLE BREACH OF FIDUCIARY DUTY D&O LIABILITY CLAIMS: WHEN CORPORATE OFFICERS MISREPRESENT FACTS TO THE BOARD

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Introduction

It is well known that a major asset of a debtor's estate – sometimes the only asset - may be D&O liability insurance coverage.[1] Delaware's "business judgment rule," however, makes suing former board members of a company devolving toward bankruptcy challenging. Consequently, Trustees should focus on identifying covered claims against former corporate officers, and not board members. This article identifies a primary area that may result in viable breach of fiduciary duty claims covered by a D&O policy.

The "Business Judgment Rule" Protects Corporate Directors, But Not Necessarily Officers Who May Be Subject To A Lower Standard of Care

The "business judgment rule" is "a presumption that in making a business decision the directors of a corporation acted on an

KEY POINTS

1. Trustees should focus on D&O liability claims against corporate officers, rather than directors, because directors are typically protected by the presumptions of the "business judgment rule."
2. A fertile area to investigate is the difference between what the officers know or should know of a company's true financial condition and its future prospects, and what the officers tell the directors about those matters before or after a company enters the zone of insolvency.
3. With bankrupt public companies, trustees should pay particular attention to the information disparities involving major acquisitions and/or incurring large amounts of secured debt in advance of bankruptcy.

informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." *Gantler v. Stephens*, 965 A.2d 695, 705-06 (Del. 2009) (citing *Aronson v. Lewis,* 473 A.2d 805, 812 (Del.1984)). To overcome this presumption, a Trustee must show that board members failed to properly inform themselves, acted in bad faith or did not believe their actions were in the best interests of the company. This showing is difficult given that board minutes typically, if not purposefully, lack critical detail and directors will never willingly testify that they believed their actions were not in the best interests of the company. Moreover, bad faith is reserved for extreme conduct, such as self-dealing or outright theft from the company.

In contrast, breach of fiduciary duty actions against a company's former officers have a lower bar to clear. Under Delaware and most other state law, a corporate officer is an agent of the company and plainly owes a fiduciary duty to it. *See, e.g., Amalgamated Bank, Trustee v. YAHOO! Inc.*, 132 A.3d 752, 780, n.24 (Del. Ch. 2016). Yet there is no controlling Delaware decision holding that officers are entitled to the presumptions of the business judgment rule.

In *Amalgamated*, the Delaware Court of Chancery acknowledged that this key legal issue remains unresolved. 132 A.3d 752, 780, n.24 ("a vibrant debate exists over. . . whether officers should be liable for simple negligence, like agents generally, or whether. . . the business judgment rule[] should apply to their decisions.") (collecting law review articles debating issue).[2] Indeed, the District of Delaware recently refused to apply the business judgment rule to former officers of a bankrupt public company, acknowledging that "Defendants have cited to no cases where a Delaware court has held that the business judgment rule applies to corporate **officers;** therefore, the court will not address the business judgment rule . . . ." *John L. Palmer, As Liquidation Trustee for the Baxano Liquidation Trust v. Kenneth Reali, et al.*, 211 F. Supp.3d 655, Civ. No. 15-994-SLR, 2016 WL 5662008 at *8, n.8 (D. Del., Sept. 29, 2016) (emphasis in original) (denying officer defendants' motion to dismiss liquidating trustee complaint alleging breaches of fiduciary duty related to misinforming board of directors) (hereafter "*Baxano*").

The difference in establishing liability as between officers and directors makes good sense. Directors are not running the day to day affairs of the company and don't have the same ease of access to information, even if they have the right to demand it. And while directors generally are entitled to rely on the information provided to them by company officers, such information can be subject to filtering and manipulation because it is usually under the exclusive control of the company's officers.

Trustees Should Focus Investigations On What Corporate Officer's Know, Or Should Know, Compared To What They Tell The Board

Trustees must carefully examine officer conduct in the time period leading up to and during the zone of insolvency. One of the subjects of that examination ought to be the differences between what the officers know or should know of a company's true financial condition and future prospects, and what the officers actually tell the directors about those matters. There are at least two straightforward reasons for this: the officers' motive to maintain their livelihood and opportunity to manipulate information, and the directors' own potential liability relating to their duty to be informed.

First, unlike a director, a corporate officer's livelihood and personal finances are likely to be closely tied to the viability of the company that employs him. Officers often depend on a company's continued existence for their own cash compensation, perks and the value of their stock and stock option compensation. When a company is downsized or liquidated, the officer's livelihood may be adversely impacted, if not entirely eliminated. Out of self-preservation an officer may seek to inflate the company's future prospects to the board, or may delay presenting the board with adverse information when the company's true financial condition might require a board to embark on a corporate reorganization or liquidation.

Second, to fulfill their own fiduciary duties to the company, board members require timely, accurate and adequate information from the company's officers. As a general matter, they may be liable for breach of their own fiduciary duty when they don't make a reasonable effort to become informed or when they lack a reasonable basis to believe the information they are given. Moreover, in the context of public companies, they may be held liable for false information that is publicly disseminated.

Not surprisingly, when board action or inaction based on incorrect or incomplete information has detrimental consequences to a company, board members should be more likely to agree to the obvious – that their decision might have been different had the correct information been provided – rather than the implausible

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– that they would have proceeded along the same course knowing that they were misled by the information they had. This is because the latter would amount to a tacit admission that the directors breached their own fiduciary duties to be informed and act in the best interests of the company.

Thus, to identify possible causes of action against corporate officers during the period leading to insolvency, Trustees need to undertake a careful examination of what the officers knew or should have known, when they knew or should have known it and what they actually told the board relative to their knowledge. That task often requires expertise in evaluating financial information under Generally Accepted Accounting Principles ("GAAP"), which sets standards for how financial information usually must be reported. It also requires the ability to cull through email, financial information and board materials – a time consuming process – to identify any patterns of conduct that support viable causes of action.

Investigation of Officer Conduct At Public Companies Is Aided By Public Disclosure

Public companies falling into bankruptcy provide an ideal opportunity for this type of investigation. The advantage is that a public company's reported financial statements and other material information – i.e., as reported to and approved by the board – is readily available on the Securities and Exchange Commission's website. A comparison of a company's public disclosures with internal management communications, as well as board minutes and board packages, can be used to identify fiduciary breaches leading to bankruptcy.

The *Baxano* Case – An Often Repeated Story

The *Baxano* case noted above provides a good example of officer fiduciary duty claims arising in the context of a company heading toward bankruptcy. The facts alleged highlight the inherent conflict between an officer's duty to properly inform a company's board and the impact that critical misinformation can have on a board's ability to timely act to restructure a failing company. *See Baxano*, 2016 WL 5662008 at *1-7. It is a story that repeats itself with surprising frequency in companies with declining future prospects.

In *Baxano*, the company's former chief executive and chief financial officers were alleged to have misled the board with grossly optimistic projections of the company's future revenue. These projections lacked any reasonable basis, as evidenced by the officer's own internal email. Nevertheless, the inflated future revenue projections led the board away from timely and adequately considering reorganization because the prospects of potential rapid future revenue growth mitigated against the company's poor historical results, deteriorating financial condition and lack of an adequate capitalization plan.

According to the allegations of the complaint, over the two year period leading to bankruptcy the company burned through about $70 million to fund its ongoing operations, including the officers' continued high compensation levels tied to the size of the company and its relative peer group. Rather than right size the operations to achieve positive cash flow and save at least some shareholder value, the officers allegedly led the board to undertake a risky acquisition, premised on the inflated future revenue projections. These projections were incorporated into both the associated fairness opinion for the acquisition price and the proxy statement soliciting shareholder approval for the transaction. Subsequent revenue projections that allegedly lacked a reasonable basis led the board to approve a large credit facility, secured against all of the company's assets, when there was no adequate long term capital plan in place. This enabled the company to meet a year-end available cash position that allegedly allowed the defendant CEO to earn a substantial cash bonus.

In short, the company's acquisition and subsequent secured credit facility were akin to adding a cargo of lead to a barely buoyant ship and then anchoring it in a storm. As a result, the company ran out of funding and creditors were, of course, left holding the bag.

Addressing the extensive evidentiary support alleged in the complaint, particularly the email between the officer-defendants, the court in *Baxano* denied the defendants' motion to dismiss. The court found that the plaintiff adequately pled breach of duty of care claims against the defendants on the basis that they had presented the board with inflated future revenue forecasts that lacked a reasonable basis and, indeed, conflicted with information apparently known to the defendants at the time they made their projections. The court also found that the plaintiff adequately pled breach of duty of loyalty claims based on the allegations that defendants put their personal financial interests in maintaining their compensation levels ahead of the best interests of the company. Among other things, the court sustained Plaintiff's claim that the former CEO defendant allegedly wasted the company's assets by undertaking an expensive and unnecessary corporate relocation that shortened his commute.

Future Trends Suggest A Watchful Eye

According to BankruptcyData, filings of publicly traded companies in 2016 increased 25% from 2015 on top of a 46% rise in 2015. This included a significant increase in Chapter 7 filings. Bankruptcy Data predicts a shift in activity toward companies that have taken on too much debt since 2009.

These trends suggest that Trustees may face a corresponding increase in opportunities to recover funds from breach of fiduciary claims covered by D&O liability policies. As such, Trustees of bankrupt companies should be prepared to hire experienced counsel to dig into the motivations and truth behind managements' representations to a company's board, the resulting actions taken by the board, and the impacts on that company's financial condition.

FOOTNOTES:

1 While the preservation of such claims and coverage issues are beyond the scope of this article, it is standard practice that D&O policies should be maintained at least until after an investigation can be undertaken and notice of a potential claim can be provided to the carrier. Without doubt, a Trustee must carefully evaluate the coverage and coverage limits under any existing D&O liability policy.

2 *See, e.g.,* Lyman Johnson, *Unsettledness in Delaware Corporate Law: Business Judgment Rule, Corporate Purpose*, 38 Del. J. Corp. L. 405, 414 (2013) ("Conspicuously absent in [*Gantler's*] analysis of officer duties, however, was the business judgment rule.").