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Insolvency Litigation Risks For Directors And Officers

Defendants find sanctuary in Delaware Chancery Court, while federal procedures benefit plaintiffs.

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RECENT DECISIONS in Delaware Chancery Court and in the U.S. Court of Appeals for the Third Circuit reconfirm Delaware state courts as the venue of choice for defendants in litigation against directors and officers of insolvent companies. Moreover, these decisions highlight the greater risks that defendants face in federal courts.

In one recent decision, the Chancery Court rejected the Third Circuit's so-called doctrine of "deepening insolvency," as a source of liability for officers and directors under Delaware law. In another important decision, the Chancery Court established new requirements severely curtailing the ability of creditors to bring direct actions for breach of fiduciary duty against directors and officers of an insolvent company or a company in the "zone of insolvency."

By contrast, in recent federal decisions, courts have encouraged plaintiffs by refusing to dismiss complaints for breach of fiduciary duties against directors and officers of insolvent companies. These decisions have relied upon the Third Circuit's 2005 decision in *Tower Air* that applied relaxed federal pleading standards, standards that at least one federal court has opined are in conflict with the substantive requirements of Delaware's business judgment rule.

'Deepening Insolvency'

The so-called doctrine of "deepening insolvency" originated as a creditor remedy for decisions taken by corporate fiduciaries and others that "artificially" prolonged the life of an insolvent corporation experiencing operating losses, thereby diminishing recovery to creditors. Deepening insolvency, as a source of liability for directors and officers of insolvent corporations, gained prominence in 2001 when the Third Circuit, predicting Pennsylvania law in *Official Committee of Unsecured Creditors v. R.F. Lafferty & Co., Inc.*,[1] held the doctrine to be a viable and independent state law cause of action.

Since the 2001 *Lafferty* decision, complaints asserting claims based on deepening insolvency have been filed against directors and officers, lawyers, accountants, investment bankers, financial advisors, lenders, placement agents, underwriters and controlling shareholders of insolvent companies.

The doctrine has been criticized; the Chapter 11 process itself "artificially" prolongs the life of a company, and commentators have argued that defendants should not be liable for actions that favor reorganization rather than liquidation.[2] Nevertheless, some plaintiffs have had litigation successes.

A significant milestone in the doctrine's growth was its spread to Delaware, when the Delaware bankruptcy court, following the lead of the Third Circuit, predicted that Delaware law would also recognize deepening insolvency as an independent cause of action.[3]

Resisting the doctrine's spread, the bankruptcy court for the Southern District of New York rejected deepening insolvency as an independent cause of action. In two decisions, *RSL COM Primecall, Inc. v. Beckoff*[4] and *In re Global Service Group, LLC*,[5] the New York bankruptcy court reaffirmed the application of the business judgment rule in the insolvency context, holding that deepening insolvency liability should not apply to the good-faith decision of directors to extend the life of an insolvent company.

Other courts followed *Lafferty*, but found themselves mired in confusion as the scope of the decision remained undefined. For example, the Ninth Circuit seemed to suggest last year that negligent conduct, alone, could result in director liability for prolonging the life of an insolvent company.[6] This marked an apparent expansion of fiduciary duties since directors and officers could never be wholly certain whether, in hindsight, their conduct would be second-guessed.

Finally, in a decision in June of this year, *In re CITX Corporation, Inc.*,[7] the Third Circuit stepped in to curb further expansion of the doctrine. The *CITX* court clarified that the doctrine of deepening insolvency would not be expanded to encompass merely negligent, as opposed to intentional, conduct. More importantly, in candid recognition of criticism of the doctrine, the *CITX* court acknowledged that the *Lafferty* case should not be interpreted as compelling any extension of the doctrine to jurisdictions other than Pennsylvania.

If the *CITX* decision was a leash on the doctrine, then the Delaware Chancery Court's decision this past August in *Trenwick America Litigation Trust v. Ernst and Young, LLP*[8] was the noose. The *Trenwick* court unambiguously rejected the doctrine of deepening insolvency as a cause of action under Delaware law, holding that Delaware law does not impose an affirmative obligation on the board of an insolvent company to terminate operations and liquidate.

The *Trenwick* decision does not grant directors and officers of an insolvent company carte blanche, but it reaffirms that a firm's stakeholders continue to be protected only by "the contents of their traditional toolkit, which contain, among other things, causes of action for breach of fiduciary duty and for fraud."[9] Most importantly, the *Trenwick* decision reaffirmed that the business judgment rule continues to protect directors and officers of insolvent corporations, consistent with the New York bankruptcy decisions in *RSL* and *Global Service Group*.

Because the cause of action for deepening insolvency is a matter of state, not federal, law, the *Trenwick* decision will eliminate deepening insolvency as an independent source of liability for defendants in cases controlled by Delaware law. Moreover, because Delaware law is a reference point for principles of corporate governance and because the Third Circuit, in *CITX*, itself expressed reservations about expansion of the doctrine, the *Trenwick* decision will likely have persuasive influence in other states and inhibit application of the doctrine in cases involving the corporate law of other jurisdictions.

Creditor Actions Limited

On Sept. 1, 2006, a Delaware Chancery Court decision, *North American Catholic Educational Programming, Inc. v. Gheewalla*,[10] dramatically limited the ability of creditors to assert direct claims under Delaware law against directors and officers of insolvent companies.

In *Gheewalla*, a licensor of FCC regulated radio wave spectrum sued directors and officers of its licensee, Clearwire Holdings, Inc., alleging breach of fiduciary duties in failing to liquidate the business and return valuable spectrum licenses when the licensee became insolvent or was in the "zone of insolvency."

The Chancery Court reviewed Delaware law related to fiduciary duties owed by directors and officers of a corporation in the zone of insolvency and held that:

(i) creditors have only contractual rights and may not sue directors and officers for breach of fiduciary duty if the debtor corporation is only in the "zone of insolvency" but is not actually insolvent; and

(ii) if the debtor corporation is insolvent, a creditor may have a direct breach of fiduciary duty claim against directors and officers, but only if a two step test is satisfied:

(a) the creditor must hold a claim that is "clearly and immediately" due and payable, and

(b) the defendant's conduct must be "invidious" and directed at a particular creditor or, in other words, demonstrate a "marked degree of animus" toward the creditor.[11]

Applying this test, the *Gheewalla* court dismissed the complaint because the plaintiff's contingent claims under its spectrum licenses were not clearly and immediately due and payable, failing to satisfy the first element of the test. Although not integral to its decision, the court explained further that the second step of the test would likely require "pure self-dealing" as "the only fiduciarily invidious reason that might justify a direct claim by a disadvantaged creditor."[12]

The *Gheewalla* decision does not limit derivative causes of action, claims held by the company itself against its directors and officers that may be brought in a bankruptcy case by a bankruptcy trustee, creditors' committee or a liquidating trustee administering a reorganization plan.

The *Gheewalla* case has important implications for Chapter 11 reorganizations.

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Many federal courts, including the Third Circuit, have held that Chapter 11 reorganization plans may not (with limited exceptions) effect non-consensual releases of direct claims held by third parties against a debtor's directors and officers.[13] By contrast, derivative claims against directors and officers can be settled and released under the terms of a Chapter 11 plan. The inability to obtain third party releases of direct creditor claims can make reorganization more difficult because ongoing litigation against directors and officers can increase indemnification claims against a debtor by directors and officers, claims that may need to be addressed in a reorganization plan.

The recent 'Trenwick' ruling unambiguously rejected deepening insolvency as a cause of action under Delaware law, which, the Court held, does not impose an affirmative obligation on the board of an insolvent company to terminate operations and liquidate.

In addition, the inability to resolve personal liability exposure to officers and directors can affect the independence of decision making by a debtor's management in Chapter 11. The *Gheewalla* case severely limits the ability of creditors to pursue the very types of direct claims that are most difficult to resolve in a Chapter 11 reorganization.

Finally, the *Gheewalla* case establishes clear factual predicates for the types of conduct by directors and officers that give rise to direct creditor claims under Delaware law. As a result, the decision should moderate concerns that personal liability of directors and officers for actions taken prior to bankruptcy will survive after a company has successfully reorganized.

Bad News in Federal Court

While the Delaware Chancery Court's decisions have disarmed some putative plaintiffs, the Third Circuit has punched some holes in the protective armor of officer and director defendants.

Just over one year ago, the Third Circuit, in the case of *Stanziale v. Nachtomi (In re Tower Air, Inc.)*,[14] greatly diminished the level of protection that the business judgment rule affords directors and officers in federal court. Before the *Tower Air* decision, it was understood that plaintiffs alleging breach of fiduciary duties were required to plead specific facts to overcome the business judgment rule's presumption that the defendants had acted in good faith and in the best interests of the company.

In *Tower Air*, the Third Circuit, on an appeal from a case decided by Judge Kent Jordan in the Delaware District Court, lowered that threshold for actions brought in federal court. The Third Circuit held that, to survive a motion to dismiss, plaintiffs asserting a violation of the duty of care need only meet the liberal notice pleading standard of the Federal Rules of Civil Procedure.

In stark contrast to the detailed pleading required by Delaware courts, the *Tower Air* decision determined that plaintiffs in federal court need only advance a "simple and brief statement of irrationality or inattention [that] gives the directors and officers fair notice of the grounds of those claims."[15] The *Tower Air* court firmly stated that it would generally not rely on the business judgment rule, just as it would generally not rely on any other affirmative defenses, as cause to dismiss a complaint on a 12(b)(6) motion.

As a result of *Tower Air*, complaints that previously would not have survived past the pleading stages of litigation may now advance to discovery, virtually eliminating the procedural protections previously afforded by the business judgment rule at the initial stages of litigation.

A few months after the *Tower Air* decision, Judge Jordan was again called upon to face the identical issue in the case of *IT Litigation Trust v. D'Aniello (In re IT Group, Inc.)*.[16] Bound by *Tower Air*, Judge Jordan dutifully applied the newly articulated rule, albeit reluctantly. In *IT Group*, the plaintiff, a litigation trust established under the reorganization plan, filed claims against former directors, officers and shareholders of the IT Group alleging breaches of fiduciary duties and corporate waste.

Applying *Tower Air*, Judge Jordan refused to dismiss claims alleging violations of the defendants' fiduciary duties. But in an extraordinary three-page footnote, he criticized the *Tower Air* decision.[17] The Third Circuit's decision, Judge Jordan noted, rested on the premise that Delaware's detailed pleading requirements were merely procedural requirements, and as such were superseded in federal court by the more liberal pleading standards of the Federal Rules.

Judge Jordan rejected this premise, asserting that the business judgment rule, far from being a simple rule of procedure, is a fundamental, substantive element of Delaware corporate law that, under *Erie R.R. Co. v. Tompkins*, must be enforced in federal court. The rule's firmly established purpose is to prevent "the courts from second-guessing the decisions of directors and officers based on results of those decisions rather than on the care, loyalty, and good faith of the directors making the decision."[18]

In 'Tower Air,' the Third Circuit held that, to survive a motion to dismiss, plaintiffs asserting a breach of fiduciary duty need only meet the liberal notice pleading standard of the Federal Rules of Civil Procedure, thus stifling application of the business judgment rule in the early procedural stages of cases brought in federal court.

Judge Jordan expressed concern that *Tower Air* will encourage an increase in litigation sustainable well into fact discovery and will chill management decisions and discourage the types of risk-taking that are desirable in the management of corporate enterprises (a critique that mirrors concerns expressed by the *Trenwick* court and by New York courts in the deepening insolvency cases). Overall, Judge Jordan's *IT Group* decision follows the precedent of *Tower Air*, but he candidly offers a rationale for federal courts in other jurisdictions to reach a different result.

Notwithstanding Judge Jordan's criticism, the key holding of *Tower Air* is gaining acceptance in other federal jurisdictions. Recently, the bankruptcy court for the District of Massachusetts endorsed the reduced pleading standard advanced in *Tower Air*.

In this case, *In re Sabine, Inc.*,[19] the defendant was both an officer and the sole director of the debtor and an officer of the debtor's parent company. The complaint alleged that the defendant breached his fiduciary duty of care to the debtor by delegating all decision making to personnel of the debtor's parent and abdicating his responsibilities as officer and director of the debtor.

The defendant moved to dismiss the complaint, in part, because his actions were protected by the Delaware business judgment rule. The Massachusetts bankruptcy court, not bound by the *Tower Air* decision, nevertheless applied its less rigorous standard and denied the motion to dismiss, finding *Tower Air* to be "persuasive authority as the Third Circuit is the Court of Appeals which most frequently deals with Delaware law."[20]

The *Tower Air* decision greatly benefits plaintiffs in federal litigation against directors and officers for breach of state law fiduciary duties. If meritless cases cannot be dismissed at the pleadings stage, these cases will have enhanced settlement value for plaintiffs.

Early indications are that, although defendants may have a substantial basis for arguing that *Tower Air* was wrongly decided, the decision is binding in federal courts in the Third Circuit and will have substantial persuasive authority in other federal circuits.

Conclusion

Recent decisions in the area of director and officer litigation offer plaintiffs and defendants a mixed bag.

The Delaware Chancery Court has helped defendants by unambiguously affirming application of the business judgment rule in the insolvency context. In doing so, Delaware courts have rejected the Third Circuit's doctrine of "deepening insolvency" and have severely limited the ability of creditors to directly sue directors and officers for breach of fiduciary duties.

The Third Circuit, on the other hand, has stifled application of the business judgment rule in the early procedural stages of cases brought in federal court.

These decisions affirm Delaware Chancery Court as the venue of choice for defendants and federal court as the venue of choice for plaintiffs in litigation involving directors and officers.

1. 267 F.3d 340 (3d Cir. 2001).
2. See Sabin Willett, "The Shallows of Deepening Insolvency," 60 Bus. Law. 549, 575 (2005).
3. *In re Exide Technologies*, 299 B.R. 732, 752 (Bankr. Del. 2003).
4. No. 03-2176, 2003 WL 22989669, at *1 (Bankr. S.D.N.Y. 2003) (hereinafter *RSL*).
5. 316 B.R. 451 (Bankr. S.D.N.Y. 2004) (hereinafter *Global Service Group*).
6. See *Smith v. Arthur Andersen LLP*, 421 F.3d 989, 995 (9th Cir. 2005) (upholding trustee standing to pursue deepening insolvency based on defendants "misrepresenting (not necessarily intentionally) the firm's financial condition to its outside directors and investors").
7. 448 F.3d 672 (3rd Cir. 2006).
8. No. 1571-N, 2006 WL 2434228, at *1 (Del. Ch. Aug. 10, 2006).
9. Id. at *29.
10. No. Civ.A. 1456-N, 2006 WL 2588971, at *1 (Del. Ch. Sept. 1, 2006) (hereinafter *Gheewalla*).
11. Id. at *15, 16.
12. Id. at *16 n.148 (quoting *Production Resources Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772, 798 (Del. Ch. 2004)).
13. See *In re Continental Airlines, Inc.*, 203 F.3d 203 (3d Cir. 2000).
14. 416 F.3d 229, 237 (3rd Cir. 2005) (hereinafter *Tower Air*).
15. Id. at 239.
16. No. Civ.A. 04-1268-KAJ, 2005 WL 3050611, at *1 (D. Del. Nov. 15, 2005) (hereinafter *IT Group*).
17. Id. at *8 n.10.
18. Id.
19. No. 05-1019-JNF, 2006 WL 1045712, at *2 (Bankr. D. Mass. Feb. 27, 2006).
20. Id. at *4 n.2.

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