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Avoid Mistakes of the Past

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In the December 2011 issue of *The Bankruptcy Strategist*, Thomas R. Fawkes and Wendy E. Morris discussed a recent Third Circuit Court of Appeals decision about the fiduciary duties that officers and directors of an insolvent company may owe their creditors. *See* Thomas R. Fawkes & Wendy E. Morris, Third Circuit Revives Committee's Deepening Insolvency and Breach of Fiduciary Duty Claims, available at www.lawjournalnewsletters.com/issues/ljn_bankruptcy/29_2/news/155971-1.html [hereinafter, Third Circuit Revives] (discussing *In re Lemington Home for the Aged*, 659 F.3d 282 (3d Cir. 2011)). In that decision, the Third Circuit reversed the district court's earlier grant of summary judgment to the officers and directors of the Lemington Home for the Aged (LHA), a non-profit provider of nursing home services. *Lemington*, 659 F.3d at 295. In doing so, the Third Circuit revived the plaintiff's claims that LHA's officers and directors had breached their fiduciary duties.

Lemington is the latest of a number of cases to have considered officer and director fiduciary duties in the context of insolvency. *See, e.g., In re The Brown Schools*, 386 B.R. 37 (Bankr. D.Del. 2008); *Clarkson Co. v. Shaheen*, 660 F.2d 506 (2d Cir. 1981); *New York Credit Men's Adjustment Bureau v. Weiss*, 305 N.Y. 1 (1953). Under these cases, director and officer fiduciary duties are generally viewed as being composed of two separate duties: a duty of due care and a duty of loyalty. *See, e.g., Lemington*, 659 F.3d at 291 (recognizing two distinct duties); *Brown Schools*, 386 B.R. at 46-47 (same). Each duty carries its own burden of proof. As Judge Mary F. Walrath explained in *Brown Schools*, "a plaintiff asserting a duty of care violation [at least in Delaware] must prove the defendant's conduct was grossly negligent in order to overcome the deferential business judgment rule." *Brown Schools*, 386 at 46 (citing *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), overruled on other grounds by *Brehm v. Eisner*, 746 A.2d 244, 254 (Del. 2000)). *But see Lemington*, 659 F.3d at 292 n.5 ("Pennsylvania … recognizes … liability for *negligent* breach of fiduciary duty." (emphasis in original)). "For breach of the duty of loyalty claims, on the other hand, the plaintiff need only prove that the defendant was on both sides of the transaction … The burden then shifts to the defendant to prove that the transaction was entirely fair." *Id.* at 47 (citing *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del.1983)). The obligations flowing from these duties may appear simple enough to satisfy, yet potential plaintiffs can often use the complexities of modern commerce to highlight and elevate to a cause of action any appearance of impropriety, forcing officers, directors, and others to defend themselves against breach of duty allegations.

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The Fawkes and Morris article concludes with the warning that actions taken by officers and directors "will be heavily scrutinized" in the context of insolvency. We agree with their admonition and thus offer some practical tips on how officers, directors, and other involved parties can increase the chances that a scrutinizing court will determine that their conduct not only was proper, but appeared proper. For, as the late Judge Henry Friendly once stated, "[t]he conduct of bankruptcy proceedings not only should be right but must seem right." *In re Ira Haupt & Co.*, 361 F.2d 164, 168 (2d Cir. 1966).

Avoid the Appearance of Being on Both Sides of a Transaction

In *Brown Schools*, the Delaware bankruptcy court ruled that the defendant private equity firm and certain of its affiliates and members would have to defend themselves against charges of self-dealing involving one of the firm's investments, The Brown Schools, Inc. (BSI). *Brown Schools*, 386 B.R. at 44-53 (denying motion to dismiss certain breach of fiduciary duty claims in Chapter 7 trustee's second amended complaint); *see also In re The Brown Schools*, 368 B.R. 394 (Bankr. D.Del. 2007) (addressing motions to dismiss trustee's original complaint). The Chapter 7 trustee alleged that the private equity firm "used its power as the majority and controlling shareholder … to cause its representatives to serve on [BSI's] [b]oard of [d]irectors … and on the executive committee of that [b]oard." *Id.* at 44-45. It used this influence to "wrongfully prolong[] the existence of [BSI] so that [the private equity firm] could profit at the expense of [BSI] and [its] creditors, in violation of its duties of good faith, honest governance, and loyalty which required a prompt bankruptcy filing and liquidation of [BSI]." *Id.* at 45.

The trustee pointed to two incidents of alleged self-dealing as examples of the private equity firm's wrongful conduct. The first occurred when BSI sold a significant share of its assets for $64 million and paid $1.7 million in "illegitimate 'fees'" to the private equity firm. *Id.* at 42, 45; Second Amended Complaint [Bankr D.Del. Adv. Proc. 06-50861, Docket No. 72] at ¶ 48-49. The second stemmed from events that began a month later when, "at the direction of" the private equity firm, BSI hired a major law firm to effectuate a restructuring of its remaining debt. *Id.* at 42, 45. As a consequence of the restructuring, the private equity firm was granted a junior security interest in substantially all of the BSI's assets and, under a separate intercreditor agreement, the right to receive up to $2.9 million from any monies received by the senior secured creditor. *Id.* at 42. Subsequently, BSI sold more than $18 million in assets, the proceeds of which were shared between the private equity firm and the senior creditor. Id. After BSI filed for relief under Chapter 7 of the Bankruptcy Code two years later, the trustee sued the private equity firm, the directors associated with the firm, and the law firm that advised BSI during the restructuring. *Id.*; *see also Id.* at 41 n.2. The bankruptcy court refused to dismiss the trustee's claims that the defendants had breached their fiduciary duties to BSI's creditors. *Id.* at 44-49 (holding, among other things, that Delaware's refusal to recognize a claim for self-dealing did not prohibit these claims). The defendants in *Lemington* similarly were denied summary relief against claims of self-dealing in approving the transfer of LHA's principal asset — the Lemington Home Fund — to another non-profit organization run by the same group of directors. *Lemington*, 659 F.3d at 287, 291-93.

Brown Schools and *Lemington* show that officers and directors must be able to demonstrate that they used independent judgment when considering transactions involving companies

affiliated with one or more directors or officers. Boards should appoint a committee of disinterested directors to assess such a transaction's merits and only disinterested directors should vote on the transaction. Boards also must ensure that company advisers are wholly disinterested. *See Brown Schools*, 368 B.R. at 411 (noting that the law firm's employment was allegedly urged by the private equity firm and that the law firm had previously advised the private equity firm); cf., *In re El Paso Corp. Shareholder Litigation*, 2012 WL 907781, *5-6 (Del. Ch. Feb. 9, 2012) (calling into doubt the independence of a financial adviser in the context of a merger because, among other things, the financial adviser owned 19% of the acquiring company).

Conduct Orderly Board Meetings, Document Deliberations and Decisions, and Encourage Broad Participation

In *Clarkson Co. v. Shaheen*, the Second Circuit upheld a jury verdict finding a company's directors liable for more than $50 million in damages when the company made unjustified loans to its parent company and its affiliates just prior to filing for bankruptcy. *Clarkson Co.*, 660 F.2d at 508, 513. The Second Circuit held that the jury was justified in holding the directors liable despite the directors' claims that they did not know the purpose of the loans or did not attend the meetings when the loans were discussed. *Id.* at 510, 512 ("[D]irectors have an affirmative duty to inform themselves about the affairs of the corporation.").

The Third Circuit in *Lemington* noted similarly that the LHA board was in complete "disarray" in the months leading up to its bankruptcy filing. *Lemington*, 659 F.3d at 287. Minutes of board meetings were "incomplete or non-existent" despite discussion of key issues. *Id.* Attendance at board meeting "often fell below 50%." *Id.*

"A cardinal precept of [corporate law] is that directors, rather than shareholders [or creditors], manage the business and affairs of the corporation." *Aronson*, 473 A.2d at 811. Management is accomplished through the board's actions at board meetings and otherwise. Directors must stay abreast of all issues facing their company. They must prepare for and attend board meetings, and actively participate in the board's deliberation and decision-making processes. Further, the board must appropriately document its deliberations and decision-making with a contemporaneous record of its proceedings. Absent preparation, participation, and preservation of a record, board members increase the risk of being subjected to claims of mismanagement or worse, even if only because of the appearance that "they must have been asleep at the wheel."

Avoid Vacancies on Board Committees

The Third Circuit further faulted the LHA board for failing to fill a vacant Treasurer position. *Lemington*, 659 F.3d at 286-87. Indeed, the board allowed this position to remain open for at least 14 months despite a bylaw requirement that the board maintain a standing Finance Committee with the Treasurer as its chairperson. *Id.* This led the Third Circuit to conclude that it was possible that there was no "meaningful oversight of [LHA's] financial operations during this period." *Id.* at 286.

Courts are mindful that most boards employ a committee system as one means of fulfilling the board's oversight function. *Lemington* shows how a court may view the prolonged vacancy of a committee position as an indication that the board has failed to meet its obligation to adequately supervise the company.

Keep Creditors Informed

Failing to keep creditors informed may be viewed as a violation of the trust they have placed in a company's officers and directors. *See, e.g., Weiss*, 305 N.Y. at 9-10. In *Weiss*, the New York Court of Appeals faulted two directors for failing to provide the insolvent company's creditors with notice of a sale of the company's assets, a sale that recovered less than 40% of the aggregate amount owed the creditors. *Id.* at 8, 10 ("While it is true … that notice to the creditors was not required, nevertheless, the failure to so notify the persons primarily interested in the assets requires the imposition … upon the defendants of the burden of going forward to show that their action[s] … resulted in obtaining full value … ").

Failing to keep creditors informed also may lead to defaults or events of default under credit agreements. For instance, in *Lemington*, the Third Circuit faulted the board for failing to perform a viability study even though LHA's lender had required such a study as a condition to providing further financing. *See Lemington*, 659 F.3d at 286. Further, a court may view a creditor's concern about the company's financial health as an independent, third-party assessment of the company's viability and may fault officers and directors for ignoring the creditor's unease. *See Id.* at 292 (board's failure to have study done "calls into question the adequacy of [the board's] pre-bankruptcy investigation").

Any time insolvency is even a remote concern, officers and directors should keep creditors informed. If the company ultimately is found to be insolvent, the directors and officers may be viewed as holding the company's assets in trust for the creditors.

Ensure That Company Officers Are Well-Qualified, Actively Managing the Organization and Take Swift Action

The board in *Lemington* "received *numerous red flags* as to the competence and diligence of" the administrator it had hired to manage LHA. *Lemington*, 659 F.3d at 292 (emphasis added); *see also Id.* at 286 (despite state law requirements that LHA have a full-time administrator, the administrator in fact worked part-time due to health reasons and was completely absent from the organization for periods of six to eight weeks at a time). For instance, four years prior to LHA seeking bankruptcy relief, The Pittsburgh Foundation (the Foundation) recommended that LHA replace its administrator with a "qualified, seasoned nursing home administrator and review, revamp and re-staff each department." *Id.* at 286. The Foundation even went so far as to provide a grant of $175,000 so that LHA could hire a new administrator. *Id.* LHA's board, however, failed to act; the inept administrator stayed and quickly re-allocated the foundation's grant to other purposes. *Id.*

Three years later, the Pennsylvania Department of Health investigated LHA after two of its residents died in a five month period. *Id.* at 286-87. The department "determined that the Administrator … lack[ed] the qualifications, the knowledge of the [personal care] regulations and the ability to direct staff to perform personal care services as required." *Id.* at 287. The department also noted that "[i]n the administrator's frequent absence, staff are confused as to whom is to be in charge of the [personal care u]nit." *Id.* Still, the board did not terminate the administrator for another three months. *Id.* This all factored into the Third Circuit's assessment that the board may have violated its duty of due care in failing to react to the administrator's ineptitude. *See Id.* at 291-92.

Lemington thus stands as a warning that Boards must be diligent about hiring capable officers and must ensure that they are actively managing the organization. What is more, boards must quickly respond to any "red flags."

Conclusion

By avoiding the appearance of self-dealing, conducting board meetings in an orderly manner with broad participation, keeping creditors informed, and monitoring the efficacy of those charged with oversight, officers and directors can meet their fiduciary obligations and, perhaps even more importantly, instill confidence in a company's creditor constituency, thus avoiding not only liability but, perhaps, even litigation itself. In the end, officers and directors must be mindful of their duties and should seek the advice of independent counsel whenever questions arise.

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