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Strategic Considerations in Seeking Recovery From Directors and Officers

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Chapter 11 trustees and post-confirmation liquidation or litigation trustees tasked with unraveling transactions and investigating the causes of an entity's demise often choose to pursue and sue management as one of their first initiatives. The directors and officers (D&Os) are targeted because (1) management is assumed to be closest to the decisions or misconduct that presumably caused the entity's failure; (2) it is assumed that D&O claims will take the least investigation and preparation time because the claims are based largely on company documents and the company's obvious downfall; and (3) D&O insurance coverage often exists, offering a seemingly definite source of loss recovery. However, the confluence of D&O liability protections and recent developments in the law surrounding the *in pari delicto* doctrine can make filing an early D&O suit a devastating tactical error.

D&O Protection Statutes and D&O Insurance Coverage: A Narrow Window

Since the advent of director protection statutes, the window for recovering for director liability under a D&O insurance policy is a very narrow one. State-enacted director-protection statutes either sanction corporate charter amendments to limit director liability or provide an automatic limitation of director liability (or a hybrid of the two). When a corporation adopts the charter limitations, or when it is incorporated in a state where the limitations are automatic, directors are effectively immune from liability to the company, shareholders and creditors[1] for any breach of the duty of care or acts of negligence. Effectively, directors are only liable for intentional misconduct and breaches of the duty of loyalty. Under Delaware statute, for example, director liability can be limited essentially to

breaches of the duty of loyalty, bad faith, intentional misconduct or omissions, or knowing violation of law.[2]

Although *liability* in most states only exists for intentional conduct and duty-of-loyalty breaches or self-dealing, D&O *insurance coverage* typically excludes coverage for intentional misconduct or fraud. Thus, to recover against a D&O insurance policy for directors' conduct requires pleading and proving the almost impossibly narrow circumstance of very serious malfeasance (usually disloyalty and improper self-dealing) that falls just short of intentional conduct exclusions.

Most states do not afford the same statutory protection to officers as to directors.[3] Although officers may not have the same statutory protections as directors, they still enjoy the business-judgment-rule presumption. Thus, as a practical matter, unless the claim is one for irrational or grossly uninformed decision-making, claims against officers require allegations and proof of a breach of the duty of loyalty or bad-faith conduct.[4] In short, a D&O suit will almost always require pleading and proving egregious conduct in the narrow (sometimes nonexistent) gap between bad faith or conscious disregard and intentional misconduct to (1) establish liability given the available protections and (2) have D&O insurance coverage for the damages.

Recent Aggressive Application of the *In Pari Delicto* Defense

When not only management but also the company's professionals (auditors, outside accountants, lawyers or advisors) are responsible for its losses, a trustee should expect to see the professionals trot out the *in pari delicto* defense. At its core, the defense is designed to prevent the unfairness of wrongdoers using the courts to recover from other wrongdoers. It precludes claims where the parties are "at equal fault."[5] A corporation is considered a "wrongdoer" when its employees and directors engage in wrongdoing while in their agent role. Traditionally, a corporate agent's conduct was imputed to the company unless, under the adverse-interest exception, the agent was acting *adversely* to the company.[6] The conduct of directors or officers that were engaged in fraud to line their pockets or for ill-gotten gains, for example, was not imputed to their employer.

Two developments in the law surrounding the *in pari delicto* defense commend that trustees take caution in how and whether they plead allegations of D&O misconduct. First, nationwide, courts have applied the *in pari delicto* defense, supposedly designed to prevent the inequitable result of wrongdoers prevailing, to innocent trustees and their innocent creditor constituencies.[7] Second, New York courts have held that regardless of whether the agent subjectively intended to benefit himself or the company, if there is even an illusory benefit to the company, the agent's conduct will be imputed to the company.[8] A Delaware court has recently applied the New York standard to preclude claims by a trustee alleging that the debtor was nothing more than an elaborate Ponzi scheme to defraud investors.[9] So even a looting scheme designed to line the D&O's pockets might be imputed to the debtor company.

An early filed, and sometimes therefore factually incomplete or inaccurate, complaint

against the D&Os that necessarily pleads serious malfeasance (to fit in the narrow recovery window) becomes exhibit A to all other professionals' *in pari delicto* defense, more so now than ever. Although a claim against a director or officer suspected of breaching duties of loyalty is a viscerally inviting target, the price for filing claims against such D&Os may be a complete bar to all other claims against professionals—even in case where the D&O misconduct was crippling to the company. When feasible, completing the investigation before filing, by use of tolling and/or cooperation agreements with D&Os, merits serious consideration. At the very least, the potential price paid should be considered when formulating a plan to recover for creditors.

1. *See In re Trinsum Group Inc.*, 466 B.R. 596, 612-13 (S.D.N.Y. 2012) (explicitly applying limits to creditors, citing *Production Resources Group L.L.C. v. NCT Group Inc.*, 863 A.2d 772, 776-77, 793-94 (Del. Ch. 2004)).

2. *See* 8 Del. C. §102(b)(7).

3. Delaware does not provide such protection for officers, nor does Texas, New York, California or Florida. *See* Dennis R. Honabach, *Smith v. Van Gorkom: Managerial Liability and Exculpatory Clauses – A Proposal to Fill the Gap of the Missing Officer Protection*, 45 Washburn L. J. 307, 324-25 (2006) (only seven states provide the same protection to officers: Louisiana, Maryland, Nevada, New Hampshire, New Jersey, Utah and Virginia).

4. The presumption applies and generally shields from liability unless there is evidence of fraud, bad faith or self-dealing, or if the director or officer's decision cannot be attributed to any rational business purpose. *See In re Walt Disney Co. Derivative Litigation*, 907 A.2d 693, 746–747 (Del. Ch. 2005); *see also* Michael Follett, *Gantler v. Stephens: Big Epiphany or Big Failure? A Look at the Current State of Officers' Fiduciary Duties and Advice for Potential Protection*, 35 Del. J. Corp. L. 563, 581 (2010) (overcoming business judgment rule requires proof of bad faith).

5. *Bateman Eichler, Hill Richards Inc. v. Berner*, 472 U.S. 299, 306 (1985).

6. For discussion of the applications, history and inner workings of the *in pari delicto* defense, *see* Allan Diamond and Max Beatty, "*In Pari Delicto:* The Inequitable Application of An Equitable Doctrine," May 2011 *Am. Bankr. Inst. J.* 36.

7. *See id.*

8. *See Kirschner v. KPMG LLP,* 938 N.E.2d 941, 952-53 (N.Y. 2010) (imputing wrongdoers' conduct to the company despite pleadings that employees' actions put company into bankruptcy); *Concord Capital Mgt. LLC v. Bank of America,* 2013 WL 28289 (Jan. 3, 2013) (imputing executives' wrongdoing despite allegations they looted the company because scheme allowed company to survive for a few years).

9. *Zazzali v. Hirschler Fleischer P.C.*, 482 B.R. 495, 512-513 (D. Del. 2012) (so holding

without determining whether Delaware, Idaho or Virginia law applies).