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A legal update from Dechert's Business Restructuring and Reorganization Group

Delaware Bankruptcy Court Decision Illustrates that a Sound Decision-Making Process is Critical to Protect Directors

In *Bridgeport Holdings Inc. Liquidating Trust v. Boyer (In re Bridgeport Holdings, Inc.),*[1] the United States Bankruptcy Court for the District of Delaware denied a motion to dismiss certain breach of fiduciary duty claims asserted by the Bridgeport Holdings, Inc. Liquidating Trust (the "Liquidating Trust") against the former directors and officers (the "D&O Defendants") of Bridgeport Holdings, Inc. (together with certain of its affiliates, the "Company"). The Liquidating Trust alleged, among other things, that the D&O Defendants failed to consider potential restructuring or sale alternatives, abdicated their decision-making authority to the Company's restructuring advisor, and acquiesced to the restructuring advisor's decision to sell the assets of the Company on the eve of bankruptcy, rather than pursuant to a section 363 bankruptcy sale under court supervision.

In reaching its decision, the court found that the D&O Defendant's actions as alleged in the complaint were not taken in good faith and gave rise to a claim for the breach of the duty of loyalty even absent self-dealing by the D&O Defendants. Accordingly, the court determined that the appropriate standard of review was the "entire fairness standard" and thus, the D&O Defendants were not entitled to the protections of the business judgment rule or the exculpation provisions in the Company's charter.

In holding that a claim for breach of the duty of loyalty exists even without a finding of self-dealing, the court found that the protections of the business judgment rule otherwise available to directors and officers for due-care fiduciary duty claims were inapplicable. Opportunist plaintiffs asserting fiduciary duty claims may attempt to use this decision to further expand the scope of the duty of loyalty claim to strip directors and officers of the protections of the business judgment rule otherwise applicable under a due-care theory of liability.

Allegations in Bridgeport Holdings

The Company operated the "Micro Warehouse" computer-product catalogue company. The Liquidating Trust asserted claims against the D&O Defendants for, among other things, breach of duty of care and duty of loyalty. The Liquidating Trust alleged that following a leveraged buyout in 2000, the Company began to suffer liquidity problems causing various covenant defaults under their credit facility. In 2002, the Company defaulted on various financial obligations, suffered employee attrition, and lost the support of certain key vendors. The Liquidating Trust further alleged that at that time the Company had various options to preserve enterprise value, including finding a new equity investor, completing a strategic M&A transaction, or restructuring its debt obligations with an asset based lender. None of these alternatives was considered or pursued by the D&O Defendants.

[1] Adv. Proc. No. 07-51798 (PJW) (Bankr. D. Del. May 30, 2008).

In late 2002 and early 2003, the Company entered into numerous covenant default waivers with their secured lenders and restructured their secured credit facility. However, the Company's liquidity problems persisted, and business continued to deteriorate. In August 2003, the Company, at the secured lenders' repeated requests to hire a restructuring advisor, approved the retention of AlixPartners as restructuring advisor to the Company but did not retain AlixPartners until two weeks after the retention was approved.

Upon being retained, one of the professionals provided by AlixPartners was appointed as the Company's Chief Operating Officer (the "COO"). The COO immediately seized upon a sale strategy with CDW Corporation ("CDW"), which was previously identified by one of the D&O Defendants through the D&O Defendant's relationship with the Chief Executive Officer of CDW. No formal sale process was undertaken by the COO or the D&O Defendants, and the COO did not employ a process to seek competing bids despite a potential market for the assets.

Within one month of AlixPartners' retention, the D&O Defendants approved the sale of substantially all assets of the Company to CDW for $28 million—a fraction of the $126 million present value of the Company's operations. The Company filed for chapter 11 one day after the sale closed. In February 2007, CDW settled a fraudulent transfer action over the sale for $25 million.

The Claims and the Motion to Dismiss

The Liquidating Trust asserted that the D&O Defendants breached their duty of loyalty on the grounds that the board (a) did not attempt to sell the assets of the Company before a liquidity crisis ensued; (b) waited too long to hire a restructuring advisor despite the request to do so by the Company's secured lender; (c) abdicated its decision-making authority to the COO; and (d) acquiesced to the COO's decision to sell the assets of the Company on the eve of bankruptcy.

In their motion to dismiss, the D&O Defendants asserted, among other things, that the Liquidating Trust failed to properly state a claim for breach of duty of loyalty because the Liquidating Trust did not allege that the D&O Defendants acted out of any self-interest or that they lacked "independence" with respect to the CDW transaction. In addition, the D&O Defendants asserted that they were entitled to the protections of the business judgment rule with respect to asserted due-care claims because they approved the Company's hiring of a restructuring advisor and that the due-care claims were precluded by the charter's exculpation clause.

Holding

Duty of Loyalty Claims

The court denied dismissal of the breach of duty of loyalty claims, concluding that Delaware law provides that "a claim for breach of loyalty may be premised upon the failure of a fiduciary to act in good faith." Based on the facts alleged in the complaint, the court determined that the Liquidating Trust sufficiently alleged that the D&O Defendants acted in bad faith "by consciously disregarding, i.e., abdicating, their duties to the Company."

Duty of Care Claims

The court also determined that the mere existence of a director exculpation from liability clause failed to compel dismissal of the breach of duty of care claims. In doing so, the court held that absent exclusive reliance on a duty of care breach to support its complaint against a director-defendant, dismissal of a motion to dismiss solely based on an exculpation provision is not warranted. In other words, because the facts as alleged gave rise to a duty of loyalty claim (based on a bad faith disregard of duties), the due care claims could not be defeated by the exculpation clause.

Finally, the court determined that invocation of the business judgment rule was insufficient to compel dismissal of the claim premised upon the allegation that the board rushed the sale process without taking appropriate actions to ensure they were fully informed about the transaction and potential alternatives.

Conclusion

Bridgeport serves as a clear illustration that directors of companies within the zone of insolvency must affirmatively make reasonable, deliberate, and informed decisions to be afforded the protections of the business judgment rule. A failure to act or delegation of directorial duties, even to duly appointed corporate officers, can thus be highly problematic for directors. In addition, the *Bridgeport* decision may serve as a basis, in certain circumstances, for plaintiffs to assert breach of loyalty claims (as opposed to due care claims) even where

there is no self-dealing or other interested transaction to deprive directors of the protections of the business judgment rule.

Accordingly, directors and officers of financially distressed companies should consult with legal counsel and take great care to make informed reasoned decisions in a deliberate manner with the goal of maximizing enterprise value and to establish a firm record of the decision-making process.

Directors must bear in mind that any failure to establish a deliberative decision-making process may very well be identified in any subsequent insolvency proceeding resulting in the incurrence of otherwise unnecessary expenses in connection with actions brought by creditor representatives.

Practice group contacts

If you have questions regarding the information in this update, please contact the Dechert attorney with whom you regularly work, or any of the attorneys listed. Visit us at www.dechert.com/insolvency.

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