ANDREWS LITIGATION REPORTER

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# Delaware Corporate

COMMENTARY

REPRINTED FROM VOLUME 22, ISSUE 26 / JULY 14, 2008

# Del. Bankruptcy Court Decision Illustrates That a Sound Decision-Making Process Is Critical To Protect Directors

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In *Bridgeport Holdings Inc. Liquidating Trust v. Boyer (In re Bridgeport Holdings Inc.),* Adv. Proc. No. 07-51798 (PJW), --- B.R. ---, 2008 WL 2235330 (Bankr. Del. May 30, 2008), the U.S. Bankruptcy Court for the District of Delaware denied a motion to dismiss certain breach-of-fiduciary-duty claims the Bridgeport Holdings Inc. Liquidating Trust asserted against the former officers and directors of Bridgeport Holdings Inc. and some of its affiliates. The 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 adviser, and acquiesced to the restructuring adviser's decision to sell the company's assets on the eve of bankruptcy, rather than in a bankruptcy sale under court supervision pursuant to Section 363 of the Bankruptcy Code.

In reaching its decision the court found that the D&O defendants' actions, as alleged in the complaint, were not taken in good faith and gave rise to a claim for breach of the duty of loyalty (even absent self-dealing by the defendants). Accordingly, the court determined that the appropriate standard of review was the "entire fairness" standard and that the D&O defendants thus 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 said 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*

Bridgeport Holdings operated the Micro Warehouse computer product catalogue company. The liquidating trust asserted claims against the D&O defendants for, among other things, breaches of the duty of care and the duty of loyalty. The trust alleged that, following a leveraged buyout in 2000, the company began to suffer liquidity problems, causing various covenant defaults under its credit facility. In 2002 the company defaulted on various financial obligations, suffered employee attrition and lost the support of certain key vendors.

The 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. The D&O defendants did not consider or pursue any of these alternatives. *See id.* at *1-3.

In late 2002 and early 2003 the company entered into numerous covenant default waivers with its secured lenders and restructured its secured-credit facility. However, the company's liquidity problems persisted, and its business continued to deteriorate. At the secured lenders' repeated requests to hire a restructuring adviser, the company approved the retention of AlixPartners in August 2003 but did not retain it until two weeks later. *Id.* at *4.

Upon being retained, one of the professionals provided by AlixPartners was appointed as the company's chief operating officer. The COO immediately seized upon a sale strategy with CDW Corp. that one of the D&O defendants previously identified through a relationship with CDW's CEO. 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. *Id.* at *4-5.

Within one month of AlixPartners' retention the D&O defendants approved the sale of substantially all assets to CDW for $28 million, a fraction of the $126 million present value of the company's operations. The company filed for Chapter 11 protection one day after the sale closed. CDW settled a fraudulent-transfer action over the sale for $25 million in February 2007. *Id.* at 6.

## 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:

- Did not attempt to sell the assets of the company before a liquidity crisis ensued;
- Waited too long to hire a restructuring adviser despite the company's secured lender's request that it do so;
- Abdicated its decision-making authority to the COO; and
- Acquiesced to the COO's decision to sell the company's assets on the eve of bankruptcy. *Id.* at *6-7.

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 the duty of loyalty because it did not allege that they acted out of any self-interest or that they lacked "independence" with respect to the CDW transaction. In addition they said they were entitled to the protections of the business judgment rule with respect to due-care claims because they approved the company's hiring of a restructuring adviser and because the due-care claims were precluded by the charter's exculpation clause.

## Holding

### *Duty-of-Loyalty Claims*

The court refused to dismiss the claims for breach of the duty of loyalty, holding that, under Delaware law, such claims can be sustained not only in situations when directors and officers acted out of self-interest or otherwise lacked independence, but also where directors and officers failed to act in good faith. *Id.* at *12 (citing *Stone v. Ritter,* 911 A.2d 362, 370 [Del. 2006]; *accord Guttman v. Huang*, 823 A.2d 492, 506 n. 34 [Del. Ch. 2003] ["A director cannot act loyally toward the corporation unless she acts in the good-faith belief that her actions are in the corporation's best interest."]).

Specifically, the court held that a fiduciary fails to act in good faith when he takes or fails to take any action that demonstrates a faithlessness or lack of true devotion to the interests of the corporation and its shareholders. *Bridgeport Holdings,* 2008 WL 2235330, at *12.

Based on the facts alleged in the complaint, the court said, 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." In particular, the court was concerned at the speed in which the sale was effectuated and the amount of consideration received. It accordingly held that the allegations in the complaint were sufficient to survive a motion to dismiss and denied dismissal of the claims for breach of the duty of loyalty. *Id.* at *13.

## Duty-of-Care Claims

The court also said the mere existence of a clause for director exculpation from liability failed to compel dismissal of the claims for breach of the duty of care. It held that, absent exclusive reliance on a duty-of-care breach to support a complaint against a director-defendant, dismissal of a motion to dismiss solely based on an exculpation provision is not warranted.

In particular the court held that where a "duty-of-loyalty [claim] remains … the due-care claim is not defeated by Section 102(b)(7)" of the Delaware Code, which empowers corporations to limit the liability of their directors. 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. *See id.* at *15-20.

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

> [The] business judgment rule is rebutted if the plaintiff shows that the directors failed to exercise due care in informing themselves before making their decision. The imposition of time constraints on a board's decision-making process may compromise the integrity of its deliberative

process. *Id.* at *21 (quoting *McMullin v. Beran*, 765 A.2d 910, 922 [Del. 2000]).

## 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.

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