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Ruling Suggests 'Inattention' May Lead to Personal Liability

BY CORINNE BALL

In recent weeks, the courts in Delaware have issued several rulings that, although not ushering in a new era of personal liability, have stern messages for directors to take action and be accountable in their governance, which may ultimately accelerate directors' decisions to pursue a merger, sale, or other transaction in order to save a distressed company. Given the extensive media coverage and public interest in the events surrounding the hiring and firing of Michael Ovitz as President of the Walt Disney Company, it is of little surprise that the much anticipated ruling from the Delaware Court of Chancery,[1] handed down Aug. 9, has garnered the lion's share of the headlines lately. However, it is perhaps another recent ruling that is likely to raise more eyebrows in corporate board rooms across the country. In *Stanziale v. Nachtomi*,[2] the U.S. Court of Appeals for the Third Circuit unanimously ruled to allow a lawsuit brought by the bankruptcy trustee of Tower Air, Inc. against the former officers and directors of the company, thereby overruling an earlier decision by the district court that the plaintiff had not pleaded sufficient facts to overcome the protections of Delaware's business judgment rule (the rule that presumes that directors making business decisions, not involving their own self-interest, do so on an informed basis and in good faith and belief that they are acting in the best interests of the company).

Corinne Ball *is a partner at Jones Day. Associates* **Ross S. Barr** *and* **Steven M. Rininger** *assisted in the preparation of this article.*

CORINNE BALL

While a quick review of this Third Circuit decision arising from the bankruptcy of Tower Air might suggest that it is important to pleading requirements and federal civil procedure, the important impact of the decision is that there is now a substantial probability that a financially distressed company will find its way into federal court through the Bankruptcy Code, which will put corporate officers and directors on notice to take action, be accountable or risk personal liability. In that regard, *Tower Air* is consistent with the earlier decision by a federal district court reviewing the conduct of the board of financial troubled Delaware corporation in *Periera v. Cogan*.[3] Yet, there has been an increasing recognition by the courts that directors must be vigilant, and, even in the face of a controlling shareholder, nevertheless have a responsibility to protect the corporation and those to whom the board may be accountable. Given the potentially broader circle of constituents, such as creditors, to whom a director of a distressed company may be accountable, it may be prudent, if not advisable, for the board of such a company to explore options available to the corporation to address its potentially failing financial condition and obtain the benefits of the business judgment rule.[4]

The ruling in *Stanziale* may make it easier for a bankruptcy trustee to bring suit against officers and directors of a bankrupt company, particularly where the board has been passive as the corporation slipped further into insolvency. Inattention is regarded as the functional equivalent of bad faith. At the least, plaintiffs have a considerably easier hurdle to clear to avoid dismissal of such a suit at the pleading stage and to enjoy the potential benefits of the discovery process. Therefore, it is important to understand the *Stanziale* ruling and how it could affect future claims against officers and directors. It stands in contrast to the course of action adopted by the board in this summer's earlier decision, *In re Toys "R" Us, Inc.*[5] tracing through that board's decision to explore strategic alternatives and ultimately sell the entire company. With the release of *Disney* there is further noteworthy instruction for directors about how to abide by their duty of good faith and, in doing so, protect themselves from personal liability.

Until quite recently, the lawsuit against the officer and directors of Tower Air might have seemed a lost cause, having been dismissed by the district court. However, on appeal, the recent circuit court ruling has resurrected the lawsuit and allowed the plaintiff to proceed to the discovery stage of litigation against the officers and directors. At the crux of the *Stanziale* ruling is that the district court erred in exacting the more stringent standards of Delaware's Chancery Rule 8, which does not apply in federal court. Instead, the Circuit Court ruled that the more lenient federal notice pleading standard should have applied. By applying the federal standard, the Court of Appeals for the Third Circuit determined that the plaintiff had effectively stated four claims that, if proved by a preponderance of the evidence, would overcome the protections of Delaware's business judgment rule.[6]

The plaintiff trustee claimed that "Tower Air's directors and officers drove the company into insolvency by indifference and egregious decision-making [sic]."[7] These allegations were particularly pointed at the company's founder, Morris Nachtomi, who served as chairman of the board and chief executive officer from 1989 through 2000, and whose family owned a controlling interest in the company's stock. Among the allegations were that Nachtomi ran the company's Tel Aviv office independently and with no oversight by the other officers or directors, even going so far as to maintain separate financial records for the office, thus making it extremely difficult for the officers in New York to audit the Tel Aviv office.

Although Tower Air lost $20 million in 1996, the company continued to expand. In 1998, the company added a route to Santo Domingo because, the plaintiff alleged, Nachtomi's daughter had a personal interest in having the company do so. Although the Santo Domingo line never became profitable, the company operated it until 2000. In the late 1990's, at a time when the company was in need of cash flow, the directors failed to ensure that used tickets were processed for payment from credit card companies. At the time the company filed for bankruptcy, unprocessed tickets totaling a value of $1 million were found in the company's New York offices.[8]

Further, the plaintiff alleged that the directors took no action when Nachtomi and other officers received reports from the company's director of safety of serious incidents that occurred in 1998, including a ground collision involving a Tower Air plane. Apparently, directors were not told of the reports or of other negative maintenance reports. Meanwhile, the company's jet engines were falling into disrepair. Initially, the company used parts from its own engines to create spare parts. In 1998, however, Nachtomi directed the company to purchase new engines because, at least initially, doing so would be cheaper than repairing old engines. The minutes from the board meetings did not reflect any discussion of the decision to buy new engines as opposed to repairing old engines.

The Court of Appeals reasoned that a plaintiff can overcome the business judgment rule by showing irrationality or inattention on the part of directors. The court concluded that an action may lead to liability "where the action or the process that led to it were irrational," and "inaction may lead to liability where no red flag monitoring system is installed."[9] Moreover, the court noted that "it is more accurate to say that successfully alleging inattention circumvents the business judgment rule."[10] Hence the standard applied by the Third Circuit is whether the complaint sets out a simple and brief statement of claims of irrationality or inattention and gives fair notice of the grounds of those claims. By applying a more lenient notice pleading standard, the ruling requires less of the plaintiff at this early stage of the litigation and enables a plaintiff to proceed with his claims to the discovery stage of litigation.

On that basis, the Third Circuit reversed the dismissal of four claims asserted by plaintiff. For example, the court determined that the plaintiff had pleaded a valid claim by alleging that the directors allowed Tower Air to establish a Santo Domingo route solely to please Nachtomi's daughter. Although the facts behind this allegation were not specific enough to meet Delaware Chancery Rule 8's pleading requirements, the court concluded that no business person acting in good faith could authorize creating the route for the pleasure of Nachtomi's daughter. Therefore, the court held that the plaintiff had pleaded sufficiently to overcome the business judgment rule. Similarly the plaintiff's allegations that the officers and directors ignored significant maintenance failures were sufficient to survive dismissal, whether characterized as "unconsidered inaction" or an "egregious decision".

The message to directors of a financially troubled company is clear: given the likelihood of a federal forum, they should be on guard to assure that they have taken action to address the potential insolvency of the corporation and assessed the options available to the company, thereby aligning their practices with the expectations of the court in terms of oversight and attention, or else they risk potential personal liability.

In all three of the recent rulings addressing directors' liabilities, the existence of a sufficient administrative procedure undertaken by directors to enable themselves to make informed decisions (or lack thereof) has been an important part of the court's analysis. That courts consider active participation in the decision making process a vital part of a director's good faith obligation is not surprising or new. Courts will consider the level of diligence exercised by directors (including attendance of meetings by all directors, frequency of meetings, knowledge of the subject matter, time spent deliberating, and reliance on expert advice) in determining that a good faith business decision was made.[11] The court in *Toys "R" Us* used several of these factors to determine that the board of directors had a reasonable basis for accepting a bid offer on the shares of the company.[12]

More interesting commentary on a director's duty to participate in an informed process can be found in *Stanziale* and *Disney*. Chancellor William B. Chandler III, writing for the *Disney* court, made it abundantly clear that if a plaintiff can successfully portray as intentional the acts on the part of directors that show inattention or irrationality, such director is not acting in good faith. Specifically, Chancellor Chandler stated that "[u]pon long and careful consideration, I am of the opinion that the concept of intentional dereliction of duty, a conscious disregard for one's responsibilities, is an appropriate (although not the only) standard for determining whether fiduciaries have acted in good faith. Deliberate indifference and inaction in the face of a duty to act is, in my mind, conduct that is clearly disloyal to the corporation. It is the epitome of faithless conduct."[13] It is, of course, duly noted that Chancellor Chandler entered a judgment for the defendants on all counts and ruled that Disney's directors did not act in bad faith. However, his admonitions about intentional neglect of duties will undoubtedly serve well any future plaintiffs who believe they can state such an allegation. If a court can be convinced that inattention to a director's duties is so systemic or pervasive as to be intentional, the protection afforded by the good faith assumption of the business judgment rule may be all but forfeited.

The *Stanziale* court differentiated between an allegation against a decision made by a board of directors and an allegation made against the process by which the board arrived at such a decision. The court allowed the plaintiff to proceed with a cause of action alleging that the directors were inattentive when "rubber-stamping" multi-million dollar checks for the leasing of jet engines. However, the decision itself, i.e. the decision to lease the jet engines, was ruled to fall under the exception of the business judgment rule. This apparent contradiction was addressed by the court in that "the merits of a business decision are considered separately from the process used to reach that decision… an unsuccessful attack on an allegedly egregious decision does not preclude an attack on the process used to reach that decision."[14] It is not enough that directors have made a business decision; if the process by which the decision was reached is flawed, directors still risk personal liability. In making this distinction, *Stanziale* emphasizes the importance of the decision making process as a concern for directors, separate from the end result of their decisions.

Directors and officers can take some comfort in the fact that the courts do not expect them to make perfect decisions. In fact, the *Disney* court repeatedly drew attention to the poor decisions made by Michael Eisner and others. However, the *Disney* court never found that any decision made by the Disney leadership was made in bad faith.[15] However, the recent rulings regarding directors' liabilities under Delaware law provide at least one new twist for future litigation. The federal pleading requirements outlined in *Stanziale* provide a somewhat easier route for a plaintiff wishing to "plead around" the business judgment rule in federal court. However, it remains to be seen whether other courts will choose to follow the Third Circuit on this issue. Nevertheless, inattention as a basis for liability should ring some board room warning bells. As a result, the probable impact of *Stanziale* is greater distressed M&A opportunities for purchasers as directors of distressed companies are forced to become increasingly more active in pursuing strategies to save those companies.

1. 2005 Del. Ch. LEXIS 113 (Del. Ch. Aug. 9, 2005).
2. 2005 U.S. App. LEXIS 15942 (3d Cir. Aug. 3, 2005).
3. 249 B.R. 449 (S.D.N.Y. May 8, 2003).
4. See e.g., *Production Resources Group, LLC v. NCT Group, Inc.*, 863 A.2d 772 (Del. Ch. 2004).
5. 2005 Del. Ch. LEXIS 90 (Del. Ch. June 24, 2005).
6. 2005 U.S. App. LEXIS 15942, at *2.
7. Id.
8. Id. at 4.
9. Id at 18 (citing *In re Caremark Int'l Derivative Litig.*, 698 A. 2d 959,967-70 (Del. Ch. 1996)).
10. Id. at n.13 (citing *Disney*, 825 A 2d at 286).
11. See, e.g., *Smith v. Van Gorkom*, 488 A.2d 858, 874 (finding gross negligence in board's approval of sale of company after two hour discussion); *Kahn v. Tremont Corp.*, 694 A.2d 422, 430 (finding lack of requisite care for failure of all three board directors to attend the informational meetings with the Special Committee's advisors).
12. 2005 Del. Ch. LEXIS 90, at 87.
13. 2005 Del. Ch. LEXIS 113, at 175.
14. 2005 U.S. App. LEXIS 15942, at 27.
15. Chancellor Chandler wrote, rather derisively, that "[d]espite all of the legitimate criticisms that may be leveled at Eisner, especially at having enthroned himself as the omnipotent and infallible monarch of his personal Magic Kingdom, I nonetheless conclude, after carefully considering and weighing all the evidence, that Eisner's actions were taken in good faith." 2005 Del. Ch. LEXIS 113, at 199.