ALERTS

Fifth Circuit Rejects Breach of Fiduciary Duty and Fraudulent Transfer Claims

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"Officers and directors of [an operating corporate debtor] have fiduciary duties to the corporation — not the corporation's creditors" under Texas law, held the U.S. Court of Appeals for the Fifth Circuit on Oct. 27, 2017. *In re ATP Oil & Gas Corp.*, 2017 U.S. App. LEXIS 21337, *7 (5th Cir. Oct. 27, 2017). In affirming the district court's dismissal of a Chapter 7 bankruptcy trustee's complaint, the Fifth Circuit rejected the trustee's breach of fiduciary claims against officers and directors for permitting "the payment of . . . stock dividends at the time of [the debtor's] impending bankruptcy" in 2012 and for authorizing "the payment of cash bonuses to certain . . . officers" in the two years prior to bankruptcy. The decision can be read to rely on the trustee's failure to plead enough facts to make his case, but relevant case law shows why breach of fiduciary duty claims are generally hard to win.

Relevant Case Law Backdrop

Delaware corporate charters typically shield directors from personal liability for claims based on breaches of fiduciary duty except for any breach of their duty of loyalty, similar misconduct, or any claims based on their violation of Delaware's statute governing the payment of dividends. The Delaware General Corporation Law, 8 Del. C. § 102(b)(7), permits the inclusion of an exculpatory provision in a certificate of incorporation.

Moreover, Delaware courts have applied § 102(b)(7) to claims asserted by creditors such as those asserted by the trustee in *ATP*. *Continuing Creditors' Committee of Star Telecommunications Inc. v. Edgecomb*, 385

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F. Supp. 2d 449, 463 (D. Del. 2004) ("exculpation clauses . . . apply to prevent creditors as well as shareholders from bringing duty of care claims."), citing *Production Resources Group, L.L.C. v. NCT Group, Inc.*, 863 A. 2d 772, 793-94 (Del. Ch. 2004). *See also Pereira v. Farace*, 413 F.3d 330, 342 (2d Cir. 2005) (trustee in bankruptcy "may only assert claims of [corporate debtor], not its creditors . . .").

Courts have also barred negligence-based fiduciary duty claims. *See*, e.g., *IT Litigation Trust v. D'Aniello* (*In re IT Group Inc.*), 2005 WL 3050611, at *11 (D. Del. Nov. 15, 2005)("Once the § 102(b)(7) provision is raised against duty of care claims, that is 'the end of the case.'"). In other words, a trustee must show that the board breached its "duty of loyalty by engaging in intentional, bad faith, or self-interested conduct that is not immunized by the exculpatory charter provision." *McMillan v. Intercargo Corp.*, 768 A.2d 492, 495 (Del. Ch. 2000). Gross negligence or recklessness by directors will not overcome the exculpation provision. *Norfolk County Ret. System v. Joseph A. Bank Clothiers, Inc.*, 2009 WL 353746, * 12 n.104 (Del. Ch. Feb. 12, 2009) ("Delaware courts have held that recklessness by itself only amounts to gross negligence, which is not sufficient to demonstrate the state of mind necessary for finding a breach of the duty of loyalty.").

"[F]acts suggesting a fair inference that the directors breached their duty of loyalty" are essential to support a trustee's claim. *In re Lear Shareholder Litig.*, 967 A.2d 640, 641 (Del. Ch. 2008); *Emerald Partners v. Berlin*, 787 A.2d 85, 92 (Del. 2001) (when directors of a Delaware corporation are sued "with a Section 102(b)(7) charter provision, . . . facts" are necessary to show "breaches of loyalty or good faith.").

Directors have a "duty to maximize the value of the insolvent corporation for the benefit of all those having an interest in it," not just creditors. *North American Catholic Educ. Programming Foundation, Inc. v. Gheewalla*, 930 A.2d 92, 103 (Del. 2007) (affirmed dismissal of complaint; *held* creditors may not assert breach of fiduciary duty claims when corporation either in zone of insolvency or insolvent). As another Delaware court stated, a Board does "not have a duty to protect creditors of an insolvent corporation at the expense of the corporation and its shareholders . . . . [D]irectors are not liable for decisions they make and actions they take in an effort to prolong the corporation's viability, even in the face of insolvency." *In re Midway Games Inc.*, 428 B.R. 303, 315-316 (Bankr. D. Del. 2010), citing *Gheewalla*. *See Continuing Creditors' Committee of Star Telecomm. Inc. v. Edgecomb*, 385 F. Supp. 2d 449, 458 (D. Del. 2004)

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(national public policy driving economic growth is to "encourage others to assume entrepreneurial and risk-taking activities by protecting them against personal liability when they have performed in good faith and with due care, however unfortunate the consequence.") (quoting Duesenberg, "The Business Judgment Rule and Shareholder Derivative Suits; A View From Inside," 60 Wash. U.L. Qu. 311, 314 (1982)).

The Delaware Supreme Court explained why "directors of an insolvent corporation owe [no] direct fiduciary duties to creditors" [: It] "would create uncertainty for directors who have a fiduciary duty to exercise their business judgment in the best interest of the insolvent corporation." *Gheewalla*, 930 A.2d at 103. Instead, creditors may only pursue fiduciary duty claims against directors derivatively, on the corporation's behalf. *Id.*, at 101. As the court explained, allowing creditors to bring direct fiduciary claims against directors "would create a conflict between those directors' duty to maximize the value of the insolvent corporation for the benefit of all those having an interest in it, and [a] direct fiduciary duty to individual creditors." *Id.*, at 103. In short, "creditors of a Delaware corporation that is either insolvent or in the zone of insolvency have no right, as a matter of law, to assert direct claims for breach of fiduciary duty against its directors." *Id.*, at 103. In the words of another Delaware court, the creditors' claims should be "limited to harm which Debtor, not the creditors directly, suffered from the Challenged Transactions. The issue, therefore, is how the Challenged Transactions . . . harmed Debtor, not how they directly harmed creditors." *Midway*, 428 B.R. at 314.

The liquidating trustee, in a case similar to *ATP*, alleged that the defendant directors had breached their fiduciary duties to the "creditors and shareholders" when the corporate debtor had entered the "zone of insolvency." *Torch Liquidating Trust v. Stockstill*, 561 F.3d 377, 381 (5th Cir. 2009). The trustee had cast its complaint as a derivative action. *Id.*, at 382. Dismissing the case, the District Court held that the complaint failed to state a claim by creditors for a breach of the directors' fiduciary duties, explaining that the trustee could not assert those claims on the creditors' behalf. *Torch Liquidating Trust v. Stockstill*, 2008 WL 696233, *7 (E.D. La. 2008).

The Fifth Circuit, in affirming, cut through the trustee's attempt to disguise his claim, noting the trustee's "ill-conceived pleading posture." 561 F.3d at 385. Because the bankruptcy court's confirmation order and reorganization plan had already given the trustee standing to sue on

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claims belonging to the debtor, it was thus unnecessary for the trustee to assert the claims as a derivative action.

More significant, the Court of Appeals, after reviewing the complaint, found that there was no damage to the debtor. Rather, the trustee only alleged harm to creditors resulting from misinformation about the debtor's financial status. The trustee also asserted that the corporate debtor should have sought bankruptcy relief earlier than it did, and that the defendant directors' actions had kept the debtor out of bankruptcy for too long a period of time — in other words, a "deepening insolvency" claim. 561 F.3d at 391 n.16.

First, explained the Fifth Circuit, the trustee's allegations turned on misrepresentations to creditors in order to induce them to provide additional credit or to refrain from suing on their claims. *Id.*, at 383. Because the trustee was unable to plead fraud with any particularity, as required by Federal Rule of Civil Procedure 9(b), this claim was insufficient. The trustee also lacked standing to bring fraud claims belonging only to certain creditors. *See*, e.g. *Caplin v. Marine Midland Grace Trust Co. of New York*, 406 U.S. 416 (1972).

The trustee in *Torch* thus had to claim a breach of fiduciary duty while alleging wrongdoing that directly harmed creditors and seeking recovery on behalf of specific creditors, a problem recognized by the district court. 2008 WL 696233, at *4-*5. Delaware law precludes individual creditors from asserting this kind of substantive direct claim against directors. *Gheewalla*. The trustee's casting his claims in *Torch* as derivative, moreover, did nothing to change the nature of the claims asserted. Delaware courts have stressed that the fiduciary duties of officers and directors are owed to the corporation, but not to individual creditors. *Gheewalla*, 930 A.2d at 101-102. As the Fifth Circuit noted, the trustee was "not attempting to recover for injury to [the corporate debtor] but instead attempting . . . to repackage creditor claims against the Directors that are defunct under Delaware law after *Gheewalla*." 561 F.3d at 392.

The real plaintiff in *Torch* should have been the corporation. Because the complaint, however, "allege[d] no actual quantifiable damages suffered by" the corporate debtor, 561 F.3d at 390, the trustee's action had to be dismissed. The defendants had not violated the corporate debtor's rights, and the trustee's pleadings could not cure the defect. Nor could the trustee in *Torch* assert a "deepening insolvency" claim under Delaware

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law, based on a purportedly delayed bankruptcy filing, because "Delaware does not recognize" such a claim. *Id.*, at 391 n.16.

ATP: Fifth Circuit

The trustee in *ATP* framed his claims in conclusory terms, asserting the defendants' gross negligence. The district court dismissed the trustee's claims "with prejudice," however, after the trustee had repeatedly amended his complaint.

The Fifth Circuit affirmed, stressing the "three broad fiduciary duties" required by corporate officers and directors under Texas law: "the duty of care . . . of loyalty, and . . . of obedience. *Id.* at *7. As in Delaware, they "owe fiduciary duties to the corporation — not the corporation's creditors." *Id.* Finally, the "business judgment rule in Texas generally protects corporate officers and directors, who owe fiduciary duties to the corporation, from liability for acts that are within the honest exercise of their business judgment and discretion." *Id.*, at *7-8. Courts therefore, "will not interfere with decisions made by . . . officers or directors based on allegations of mismanagement, neglect, or abuse of discretion." *Id.* at *8. Nor do they typically "intervene in corporate affairs unless officers or directors commit acts that are ultra vires, fraudulent, or oppressive to minority shareholder rights." *Id.* The Court of Appeals rejected the trustee's claims that the authorization of stock dividends and bonuses was "grossly negligent," an argument that would take them out of the protection of the business judgment rule. *Id.* at *9.

1. *Stock Dividends.* Failing to "distinguish between the different roles and responsibilities of the Officers and Directors," the trustee had failed "to allege with specificity which [officers or directors] authorized the . . ." dividend payment." *Id.* Nor did the trustee "explain why the stock dividend payment would 'necessarily harm' [the debtor's] 'long-term viability and any chance of emerging from bankruptcy.'" *Id.* In other words, the trustee "failed to plead any facts explaining why [the] stock dividend payment necessarily harmed the corporation itself — the entity to which [they] owed a fiduciary duty." *Id.* at *10.

2. *Bonus Payments.* Applying the same reasoning as for the dividend payments, the court stressed that the trustee lacked any "evidentiary support that the bonuses . . . were excessive." *Id.* at *10. Nor had the Trustee explained why the compensation "was excessive in comparison

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to other similarly sized public companies in the oil and gas industry at the time." *Id.* at *11. Also missing was any "metric or explanation for finding the bonuses 'exorbitant.'" *Id.* Because "a corporate fiduciary's decision to receive or award compensation in exchange for performing corporate services does not constitute a per se duty of loyalty breach," the trustee could offer "no persuasive explanation for why paying large cash bonuses constitutes a fiduciary duty breach," a claim that would probably be barred by the business judgment rule in any event. *Id.* As the court reasoned, "continuing to compensate corporate management during times of financial hardship may be necessary to retain those employees. And during a time of potential insolvency, retaining corporate leadership may be the best way to revitalize the corporation." *Id.* at *11-*12.

3. *Fraudulent Transfer Claims.* The Fifth Circuit rejected the fraudulent transfer claims relating to the cash bonuses because of the trustee's failure to allege "plausibly" that the officers had "not honestly and diligently perform[ed] their jobs." at *13. Moreover, the trustee had "failed to present any financial data showing that [the debtor] was actually insolvent or had little capital when making the complained-of bonus payments." *Id.* at *13.

4. *Conspiracy, Aiding and Abetting Claims.* The Fifth Circuit agreed with the district court's dismissal of "a plausible claim for civil conspiracy," for the trustee failed to allege "any meeting of the minds" to breach their fiduciary duty. *Id.*, at *14-*15. Nor had the trustee's "aiding and abetting" claim any merit: he had "failed to plausibly allege a fiduciary duty breach." *Id.*, at *15.

5. *Denial of Leave to Amend Complaint*. Because the trustee's claims "failed as a matter of law," his "pursuing these claims . . . would [have been] futile." *Id.*, at *17. The trustee "had a number of previous opportunities to plead his claims" and had "ample access to ATP's books and records." *Id.* Still, the trustee relied "almost exclusively on vague, conclusory allegations of wrongdoing," leveled "at all eighteen defendants without distinction." *Id.* The lower court, therefore, had not abused its discretion in denying the trustee leave to amend his complaint again.

Comment

ATP confirms that a trustee will need hard, persuasive facts to prevail in a suit to recover for breach of fiduciary duty. The Third Circuit had those

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facts in a recent case, affirming a jury verdict imposing compensatory and punitive damages under Pennsylvania law against two officers plus compensatory damages against directors based on their breaching duties of care and loyalty. *In re Lemington Home for the Aged*, 777 F.3d 620, 626-30 (3d Cir. 2015) (one unqualified officer mismanaged by violating federal and state regulations; drew full salary while working part-time; chief financial officer failed to keep basic records, failed to collect receivables, failed to report regularly; failed to respond to creditors and tried to effect a merger with another entity and obtain a better position for himself; and directors failed to remove officers after learning of their mismanagement from independent sources: "stuck their heads in the sand.").

Authored by Michael L. Cook.

If you have any questions concerning this *Alert*, please contact your attorney at Schulte Roth & Zabel or the author.

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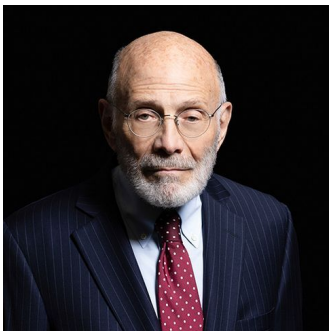

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