Wiggin & Dana

Wiggin & Dana
Counsellors at Law

One Century Tower
P.O. Box 1832
New Haven, Connecticut
06103-3402
Telephone 203.498.4400
Telefax 203.782.2889

Offices in:
New Haven, CT
Stamford, CT
Hartford, CT
Philadelphia, PA
Cherry Hill, NJ
New York, NY

October 3, 2003

Complacency Leads to Personal Liability for Officers and Directors of Private Corporations

During the current economic downturn, more and more officers and directors find themselves managing the affairs of financially strained corporations. Hardly a day passes where the news is not full of stories scrutinizing the actions or inactions of officers or directors of a troubled public corporation. For better or worse, the spotlight now shines brightly on the actions and omissions of officers and directors, and as a result, officers and directors are becoming increasingly concerned about personal liability for decisions that they have made on behalf of a financially troubled corporation. As discussed below, the recent decision in *Pereira v. Cogan*, 2003 WL 21039976 (S.D.N.Y.) delivers a timely reminder that the potential personal liabilities that lie in wait for officers and directors who fail to carry out their duties apply not only to officers and directors of public corporations but to those of private corporations as well.

Most officers and directors of public and private corporations are all too aware of their fiduciary duty to act in the best interest of the corporation's shareholders. Briefly, fiduciary obligations of officers and directors are threefold: obedience, diligence and loyalty. The duty of obedience and the duty of diligence are referred to, in combination, as the duty of care. The duty of care requires that, in making a decision, directors, and to a certain extent, officers, must be informed of all material information that is reasonably available to them and must act in good faith and with the care that a similarly situated ordinary prudent person would exercise under similar circumstances. The duty of loyalty prohibits directors from self-dealing or making secret profits from their positions as directors, and also requires that the corporation be afforded the opportunity to receive any advantages that directors may have been afforded as a result of their positions as directors.

When a corporation is insolvent or in the "vicinity of insolvency," courts have required officers and directors to consider the corporation's creditors when making decisions. Outside of the insolvency situation, creditors of a corporation are not entitled to any greater protections than those that are defined by the contract that binds the corporation and the creditor. Once insolvent, however, courts often take the view that the corporation is holding its assets for the benefit of its creditors, or that the creditors' interests have supplanted the equity interests of the shareholders. In this context, courts have afforded creditors greater protections than those defined by their contract, and have obligated officers and directors to consider the interests of the creditors.

The filing of a bankruptcy petition is usually an indication of insolvency. However, courts also scrutinize the actions or inactions of a corporation's board and officers during a corporation's times of financial uncertainty, whether or not a petition is ever filed. It is during this "zone" or "vicinity" of insolvency that officers and directors must exercise greater diligence and care in exercising their duties. While there is no bright line test as to when a corporation is insolvent or in the vicinity of insolvency, courts have applied several different tests to determine insolvency. For example, courts have looked to see if a corporation's liabilities exceeds its assets (the "balance sheet test") as well as whether a corporation can pay its debts as they come due (the "equitable insolvency test"). In addition, courts have used the Bankruptcy Code's standards for insolvency, as well as applicable state law definitions. Courts have also looked at the capital adequacy of a corporation and whether the corporation has the ability to secure cash sufficient to pay its indebtedness and fund its working capital and capital expenditure needs with a reasonable cushion. At least one court has further expanded the "zone" to include transactions of an otherwise solvent corporation, if after giving effect to a board approved transaction that benefited the corporation's shareholders, the transaction would render the corporation insolvent or within the zone of insolvency. The court held that in such an instance the board needed to consider the interests of the corporation's creditors as well as its shareholders in making its decisions.

While most of the discussion above is based upon cases interpreting duties owed by officers and directors of public companies, in *Pereira v. Cogan*, a federal district court in the southern district of New York (applying Delaware law) recently held that the foregoing rules also applied to the directors and certain officers of a closely-held private corporation. In 1999, Trace International Holdings, Inc. ("Trace") filed for bankruptcy. Trace was a holding company whose primary assets were the stock of two publicly traded companies. Trace had no operations and therefore no resulting cash flow or operating expenses. Trace did have certain administrative and general expenses, and for the four year period prior to its bankruptcy, Trace reported a total operating deficit of approximately $103 million. Trace borrowed against its stock holdings as a means of funding its cash flow deficits. Marshall Cogan, the chief executive office, chairman of the board, and the controlling shareholder of Trace, was, as the court noted, a "widely respected figure in the investment community." The remaining members of Trace's board also served as officers of Trace, and Cogan was their boss.

The bankruptcy trustee brought suit against the directors and certain non-director officers of Trace, seeking repayment for certain of Cogan's alleged acts of self-dealing. Notwithstanding the fact that Trace was a closely-held corporation, the trustee alleged that the directors and officers owed an expanded duty to Trace's creditors because Trace was insolvent or in the vicinity of insolvency during the time of Cogan's acts of self-dealing. The alleged improprieties included loans to Cogan, his family and other employees and affiliates of Trace, excessive compensation awarded to Cogan, employment of Cogan's daughter, illegal declaration and distribution of dividends and an extravagant 60th birthday party for Cogan at the Museum of

Modern Art. Most of these alleged acts of self-dealing were unilaterally accomplished by Cogan without board action, or, if the board did act, it did so by unanimous written consent or by ratification retroactively. At trial, the evidence showed that the board did not have meetings during this time, nor did the board members or officers make any relevant inquiries, discuss, or investigate the transactions that they were approving.

The court addressed two issues in *Cogan*. The first was to what extent Cogan, as a controlling shareholder of a private corporation, could be held liable for acts of self-dealing. Recognizing that Trace borrowed money to support Cogan's transactions, the court, in finding Cogan liable, reasoned "[o]nce Cogan created the cookie jar- and obtained outside support for it – he could not without impunity take from it."

The more difficult question addressed by the court, was what roles and duties do officer-directors and non-director officers of a private corporation have when a "controlling shareholder (who also happens to be their boss) is acting in his own interests instead of those of the corporation." It is noteworthy that most of the Trace directors and officers did not personally profit from these acts of self-dealing.

After applying several of the insolvency tests described above, the court found that Trace was insolvent for all but one quarter of the four year period preceding the filing of the bankruptcy petition. As a result, the insolvency meant that the officers and directors were not only liable to Trace and its shareholders, but to Trace's creditors as well. The directors argued that they should not be liable because there was no board action, equating themselves to interested directors who are not liable for board action where such directors abstain from voting on transactions in which they have an interest. Finding the argument without merit, the court stated that under the directors' argument:

> "...the safest position would be for a director to hold his or her nose, close his or her eyes, and avoid attending Board meetings at all cost. Such action surely does not satisfy that director's fiduciary duties to the corporation. . . . Directors will not be excused from liability if they either (1) knew about the challenged expenditure yet unreasonably failed to take action; or (2) if they did not know, should have taken steps by which they would have been informed of the challenged expenditure."

Citing the complete lack of diligence in exercising their duties and the nature of the relationship that each director had with Cogan, the court found the directors liable for their breaches of both the duty of care and the duty of loyalty. The directors also argued that they should be afforded the protections of the exculpatory clause contained in Trace's articles of incorporation. The court summarily dismissed this argument, holding that such clause "would not provide protection for any directors who breached the duty of loyalty."

In determining the liability of the non-director officers, the court stated that a corporate officer may be personally liable if he or she had "discretionary authority in the relevant functional area and the ability to cause or prevent the complained-of action." Based upon this rule, the court found certain officers not liable for some complained-of acts, such as the declaration of illegal dividends. However, the court did find that these same officers were liable for certain loans, as the court found each of these officers was in a position to possibly prevent the loans by disclosing certain information to the board.

The rulings of the *Cogan* court serve as a warning to all officers and directors of privately held corporations as to how they should act, particularly when their corporation is in the zone of insolvency. As the court noted, it is especially true during this time that "officers and directors must at the very least be sure that the actions of the controlling shareholder (and their inattention thereto) do not run the privately held corporation into the ground." Officers and directors need to be cognizant that if their corporation is in the zone of insolvency, they need to consider the interests of the corporation's creditors along with the interests of shareholders. After *Cogan*, the scrutiny reserved for officers and directors of public companies may well now apply to the officers and directors of private companies, and therefore, similar precautions should be taken. Meetings need to be held regularly and detailed minutes of those meetings, including deliberations, should be kept. Officers and directors must be fully informed about the decisions they are to make. Officers and directors must raise the difficult questions and be prepared to make the unpopular decisions, even if such decisions are adverse to the wishes of his or her boss, the controlling shareholder. Finally, officers and directors cannot avoid personal liability if they bury their collective heads in the sand and fail to act or be informed, even if they personally will not profit from the particular transaction.

It is likely that courts will take a harder line with officers and directors of closely-held companies just as the courts have been doing with their public counterparts since the Enron debacle. It is imperative that officers and directors take their fiduciary duties seriously if they want to avoid liability. One potential roadmap that officers and directors of closely-held companies can look to as a way to help avoid potential liability is the Sarbanes-Oxley Act of 2002. Although this Act only applies to public companies, its emphasis on board and committee independence and its prohibitions on self-dealing could provide useful guidelines for the closely-held officers and directors who want to avoid personal liability.

William A. Perrone	203-363-7604	wperrone@wiggin.com
Michael Devine	860-297-3743	mdevine@wiggin.com
Michael Grundei	203-363-7630	mgrundei@wiggin.com