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## Red Flags Part III: Director and Officer Liability

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The concept of constructive knowledge—knew or should have known—has become a popular feature of plaintiff's claims and court opinions to impose liability in a variety of insolvency contexts. Plaintiffs or bankruptcy trustees allege that there were the obvious red flags and that had the investors or officers and directors seen them and acted, the economic conflagration would not have occurred. The authors have explored this topic in two previous articles this year, where Ponzi scheme trustees posit "red flags" as a central allegation triggering investors' duties to return funds to the estate.<sup>1</sup> Red flags are also key allegations in director's and officer's (D&O) liability suits. Because trustees and creditors frequently examine the debtor's managements' and directors' potential liability, this article explores red flags in that context and the potential link in the concepts between these types of cases.



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In *In re Bayou Group LLC*,<sup>2</sup> the district court recently held that the red flags may negate a good-faith defense under § 548(c), but only if they suggest insolvency or a fraudulent purpose in making the trans-

fer. In reversing the opinion below, it held that red flags that merely suggested some infirmity in the investment

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a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability.<sup>6</sup> "In either case, imposition of liability requires a showing that the directors

knew that they were not discharging their fiduciary obligations"<sup>7</sup> and therefore, acted in "bad faith."<sup>8</sup>

### Red Flags in Citigroup

In *re Citigroup Inc. Shareholder Derivative Litigation*<sup>9</sup> delved into red flags after plaintiffs brought action against the D&Os of Citigroup alleging that defendants breached their fiduciary duties (1) by failing to properly monitor

fund or the integrity of management were not sufficient.

D&Os of corporations owe fiduciary duties of care, loyalty, good faith and candor to the corporation. In the context of D&O liability, plaintiffs cite red flags to demonstrate violations of the duty to monitor (falling within duty of care) rather than a loyalty issue. The semi-

## Feature

nal monitoring case is *In re Caremark International Inc. Derivative Litigation*.<sup>3</sup> The duty of care for an oversight or monitoring case is breached when (1) the directors knew or should have known that violations of law were occurring, (2) the directors took no steps in a good-faith effort to prevent or remedy the situation and (3) such failure proximately resulted in economic loss.<sup>4</sup> If a plaintiff can plead particularized facts that directors knew or should have known of red flags, then they can get past a motion to dismiss.

The "oversight" theory of director liability is "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."<sup>5</sup> Only a sustained or systematic failure of the board to exercise oversight—such as an utter failure to attempt to assure that

and manage the risks that the company faced from problems in the subprime lending markets, even in the face of red flags, and (2) for failing to ensure that its disclosures were thorough and accurate, causing billions in losses. The red flags in *Citigroup* included (1) the steady decline of the housing market, (2) receipt of guidance issued by the Financial Accounting Standards Board (FASB) in December 2005 that certain loan products may increase exposure, (3) the drastic rise in foreclosure rates in 2006, (4) reporting by several large subprime lenders of substantial losses in 2006 and (5) billions of dollars in losses reported by Bear Stearns and Merrill.<sup>10</sup> The court rejected the direc-

<sup>1</sup> Paul Sinclair and Brendan McPherson, "Red Flags of Fraud: Background for Due Diligence," *XXX ABI Journal* 4, 34-35, 69-70, May 2011; Sinclair and McPherson, "Red Flags of Fraud Part II: A Due-Diligence Checklist," *XXX ABI Journal* 5, 20, 72-73, June 2011.

<sup>2</sup> 439 B.R. 284 (S.D.N.Y. 2010) (*Bayou V*).

<sup>3</sup> 698 A.2d 959 (Del. Ch. 1996) (Allen, Ch.).

<sup>4</sup> *Id.* at 970-71.

<sup>5</sup> *Id.* at 967.

<sup>6</sup> *Id.* at 967, 970. See *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006) (approving *Caremark* standard).

<sup>7</sup> *Stone*, 911 A.2d at 370.

<sup>8</sup> *Desimone v. Barrows*, 924 A.2d 908, 935 (Del. Ch. 2007) ("[A] scienter-based standard applies to claims in the delicate monitoring context.")

<sup>9</sup> 964 A.2d 106 (Del. Ch. 2009) (Chandler, Ch.).

<sup>10</sup> *Id.* at 127.

tors' liability, stating that "[t]he warning signs [of red flags] alleged by plaintiffs are not evidence that the directors consciously disregarded their duties or otherwise acted in bad faith; at most they evidence that the directors made bad business decisions."<sup>11</sup>

The court stated that "[n]othing about plaintiffs' 'red flags' supports plaintiffs' conclusory allegation that 'defendants have not made a good faith attempt to assure that adequate and proper corporate information and reporting systems existed that would enable them to be fully informed regarding Citigroup's risk to the subprime mortgage market.' Indeed, plaintiffs' allegations do not even specify how the board's oversight mechanisms were inadequate or how the defendant director knew of these inadequacies and consciously ignored them."<sup>12</sup> The court stated:

[T]he mere fact that a company takes on business risk and suffers losses—even catastrophic losses—does not evidence misconduct, and without more, is not a basis for personal director liability. That there were signs in the market that reflected worsening conditions and suggested that conditions may deteriorate even further is not an invitation for this Court to disregard the presumptions of the business-judgment rule and conclude that the directors are liable because they did not properly evaluate the business risk. What plaintiffs are asking the Court to conclude from the presence of these "red flags" is that the directors failed to see the extent of Citigroup's business risk and therefore made a "wrong" business decision by allowing Citigroup to be exposed to the subprime mortgage market.<sup>13</sup>

### Demand Futility

A critical prerequisite to a shareholder's or trustee's action is making a demand on the company is board and its subsequent refusal to pursue the issue, known as "demand futility."<sup>14</sup> Just as there is a distinction between a director's monitoring liability and liability for an active decision, there are differing standards for satisfying "demand futility." Red flags are again a key determinant

here. In the case of "claims involving a contested transaction, *i.e.*, where it is alleged that the directors made a conscious business decision in breach of their fiduciary duties," courts must apply the *Aronson* test to determine whether demand was futile.<sup>15</sup> Under *Aronson*, trial courts determine whether threshold presumptions of director disinterest or independence are rebutted by well-pleaded facts and if not, whether the complaint pleads particularized facts sufficient to create a reasonable doubt that the challenged transaction was the product of a valid exercise of business judgment.<sup>16</sup> These two inquiries are disjunctive, meaning that if either prong is met, demand is excused.<sup>17</sup> However, "where the subject of a derivative suit is not a business decision of the Board but rather a violation of the Board's oversight duties," the court uses the *Rales* test and considers whether the plaintiff has alleged "particularized facts establishing a reason to doubt that 'the board of directors could have properly exercised its independent and disinterested business judgment in responding to a demand.'"<sup>18</sup>

The seminal case where where demand on directors was deemed futile because of multiple, significant red flags is *In re Abbott Labs. Derivative Shareholders Litigation*.<sup>19</sup> In *Abbott*, the Food and Drug Administration (FDA) conducted 13 inspections of the company to determine whether it was in compliance with FDA regulations, sent four formal warning letters to the company (three directly to the chairman), implemented a "voluntary compliance plan" to remedy compliance problems, filed a complaint for an injunction, ordered the company to destroy noncompliant product inventory and met at least 10 times with company representatives, including the chairman of the board.<sup>20</sup> These events led to "the largest civil fine ever imposed by the FDA" and total losses of approximately \$250 million.<sup>21</sup>

*Abbott* held that *Aronson*, not *Rales*, provided the applicable test for demand futility because plaintiffs alleged that the directors "knowingly," and in an "intentional breach and/or reckless disregard" of their fiduciary duties, "'chose' not to address the FDA problems in a timely manner."<sup>22</sup> By pleading that the direc-

tors were aware of the noncompliance, *Abbott* distinguished the plaintiffs' claim from the typical *Caremark* theory, which is predicated on the directors' ignorance of the illegality.<sup>23</sup> Applying *Aronson*, the court held that the plaintiffs established that demand was futile. The extensive paper trail concerning the violations supported a reasonable assumption that there was a "sustained and systematic failure of the board to exercise oversight," and the directors took no steps to prevent or remedy the situation.<sup>24</sup>

### Delaware Analysis

The red flags cited by the plaintiff in *In re Intel Corp. Deriv. Litig.*,<sup>25</sup> in which the board was charged with failing to prevent the company from committing anticompetitive practices to monopolize the microprocessor market, included (1) a European Commission 2001 investigation, (2) the Japan Fair Trade Commission's 2004 investigation, (3) a South Korean Fair Trade Commission's 2005 inquiry and (4) *Business Week*'s 2008 report that the New York Attorney General sought information regarding whether Intel stifled competition.<sup>26</sup> The plaintiff alleged that it did not need to make a demand on the board because the board failed to respond to red flags and the directors faced a "substantial likelihood" of personal liability.<sup>27</sup>

Relying on the *Rales* test, the court held that the plaintiff failed to identify what the directors actually knew about the red flags and how they responded to them.<sup>28</sup> Similarly, no allegations were made as to how often and by whom the board was advised regarding the red flags and that any of the directors was a party to any of the proceedings or investigations that plaintiff alleged was a "red flag."<sup>29</sup> The court disagreed with the plaintiff's approach of cataloging the ongoing investigations into Intel's alleged wrongdoing, and then asserted that the thickness of the catalog demonstrated that Intel's conduct was so egregious that the directors must face at least a "substantial likelihood" of personal liability for having ignored the red flags.<sup>30</sup>

### Southern District of New York

Cases in the Southern District of New York have ruled both ways on the sufficiency of the red flags. In *In re*

<sup>11</sup> *Id.* at 128.

<sup>12</sup> *Id.* at 128.

<sup>13</sup> *Id.* at 130.

<sup>14</sup> 8 Del. C. § 141; Fed. R. Civ. P. 23.1(b); Del. Ch. Ct. Rule 23.1.

<sup>15</sup> *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984); *Wood v. Baum*, 953 A.2d 136, 140 (Del. 2008).

<sup>16</sup> *Lewine v. Smith*, 591 A.2d 194, 205 (Del. 1991) (overruled on other grounds).

<sup>17</sup> *In re JPMorgan Chase & Co. S'holder Litig.*, 906 A.2d 808, 820 (Del. Ch. 2005).

<sup>18</sup> *Rales v. Blasband*, 634 A.2d 927, 934 (Del. 1993).

<sup>19</sup> 325 F.3d 795 (7th Cir. 2003).

<sup>20</sup> *Id.* at 799-802.

<sup>21</sup> *Id.* at 808-9.

<sup>22</sup> *Id.* at 806.

<sup>23</sup> *Id.*

<sup>24</sup> *Id.*

<sup>25</sup> 621 F.Supp.2d 165 (D. Del. 2009).

<sup>26</sup> *Id.* at 169.

<sup>27</sup> *Id.* at 174.

<sup>28</sup> *Id.* at 174.

<sup>29</sup> *Id.*

<sup>30</sup> *Id.* at 175.

*Veeco Instruments Inc. Sec. Litig.*,<sup>31</sup> the plaintiff alleged *specific facts* regarding the role of the audit committee, including its duties to respond to whistleblowers and oversee regulatory compliance. The complaint detailed the company's failed response to two whistleblower reports and an internal audit that concluded that the company violated the law at least nine times.<sup>32</sup> With regard to accounting controls, the company allowed its accounting staff to be reduced to only two people and in light of several resulting accounting improprieties, acknowledged in its 10-K a deficiency "in the internal control over financial reporting."<sup>33</sup> Despite meeting 27 times, the audit committee, which included five director-defendants, took no action to correct the problems.<sup>34</sup>

In *In re ITT Corp. Derivative Litigation*,<sup>35</sup> the court held that the complaint's allegations were not sufficiently particularized to establish demand futility. The case arose out of a criminal proceeding in which ITT paid more than \$100 million in criminal fines, penalties and forfeitures.<sup>36</sup>

The plaintiffs alleged that the defendant directors failed to establish internal controls, but even the plaintiffs' own allegations showed that at least four board committees were responsible for maintaining and implementing internal controls.<sup>37</sup> The complaint also failed to allege with particularity that the committees failed to review and discuss information received from management, including information regarding the government investigations.<sup>38</sup> In fact, ITT even hired an export license manager to ensure compliance.<sup>39</sup> Indeed, "the fact that the controls put in place ultimately failed to prevent illegal conduct does not mean that 'the directors utterly failed to implement any reporting or information system or controls.'"<sup>40</sup>

The plaintiffs also alleged that the directors consciously failed to oversee their operations, ignoring numerous red flags of felonious company conduct.<sup>41</sup> The first red flag was that the directors should have been alerted to wrongdoing when ITT engaged an outside law firm to prepare and send to the State Department voluntary disclosures regarding ITT's

failure to obtain temporary export licenses.<sup>42</sup> The court stated that these speculative and vague allegations were insufficient to establish that a majority of the defendants were aware of illegal conduct and consciously failed to act.<sup>43</sup>

The second red flag was the defendant's disregard of the initiation of the government's criminal investigation.<sup>44</sup> While the allegations specified what information the defendants received and when, it did nothing to show what response, if any, was taken by each individual director.

The final red flag was that the directors knew that the government possessed evidence of wrongdoing and decided to pursue criminal proceedings, but wrongdoing continued at ITT.<sup>45</sup> Sufficient facts were not alleged to show that a majority of the board had knowledge of the violations of the law and plaintiffs did not meet their burden of pleading that five of the director defendants faced a substantial likelihood of liability.<sup>46</sup>

In *In re Pfizer Inc. Shareholder Derivative Litigation*,<sup>47</sup> the court held that under *Rales*, there was a substantial likelihood that a majority of the board faced personal liability by excusing a pre-suit demand and overruled a motion to dismiss, finding that the complaint stated a claim for breach of fiduciary duty. Investors sought recovery from senior executives and current and former board members for misconduct that resulted in the imposition of \$2.3 billion in fines and penalties arising from illegal "off-label" marketing of various regulated drugs. Over seven years, Pfizer had entered into three different settlements with the government for illegal practices before the latest fine and promised to take significant steps to monitor and prevent further violations.<sup>48</sup>

The complaint detailed at great length (1) a large number of reports (including reports to the board of settlements) made to a majority of the board from which it could be inferred that they all knew of Pfizer's continued misconduct and disregarded it, (2) a large number of FDA violation notices and warning letters, (3) several reports to Pfizer's compliance personnel and senior executives of continuing kickbacks and off-label marketing, and (4) allegations of the *qui tam* lawsuits.<sup>49</sup> The complaint specifically

alleged conduct of such pervasiveness and magnitude, undertaken in the face of the board's own express formal undertakings to directly monitor and prevent such misconduct, that the inference of deliberate disregard by every member of the board was reasonable.<sup>50</sup>

## Conclusion

Just as red flags in Ponzi cases must point to insolvency or fraud in the investment, red flags in D&O oversight cases must plead particularized factual allegations demonstrating such knowledge as amounts to bad faith by the director defendants. This is an extremely hard standard to meet at the pleading stage before discovery commences. Plaintiffs have to show with specificity how the oversight mechanism was consistently inadequate, and how such inadequacies constituted a systemic failure, and that directors knew of these inadequacies and consciously ignored them. Significantly, Delaware courts have emphasized that red flags "are only useful when they are either waved in one's face or displayed so that they are visible to the careful observer."<sup>51</sup> ■

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<sup>31</sup> 434 F.Supp.2d 267 (S.D.N.Y. 2006).

<sup>32</sup> *Id.* at 277-78.

<sup>33</sup> *Id.* at 277.

<sup>34</sup> *Id.*

<sup>35</sup> 653 F.Supp.2d 453 (S.D.N.Y. 2009).

<sup>36</sup> *Id.*

<sup>37</sup> *Id.* at 461.

<sup>38</sup> *Id.*

<sup>39</sup> *Id.*

<sup>40</sup> *Id.* (citing *Stone*, 911 A.2d at 370, 372-73).

<sup>41</sup> *Id.* at 461.

<sup>42</sup> *Id.* at 461-62.

<sup>43</sup> *Id.*

<sup>44</sup> *Id.*

<sup>45</sup> *Id.* at 463.

<sup>46</sup> *Id.*

<sup>47</sup> 722 F.Supp.2d 453 (S.D.N.Y. 2010).

<sup>48</sup> *Id.* at 456.

<sup>49</sup> *Id.* at 460.

<sup>50</sup> *Id.* at 462.

<sup>51</sup> *Wood v. Baum*, 953 A.2d 136, 143 (Del. 2008).