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Delaware Bankruptcy Court Extends Caremark Duty of Oversight to Corporate Officers and General Counsel

By: Tom Morante and Gita Timmerman

Introduction

The Delaware Supreme Court has long held that directors of Delaware corporations have various primary fiduciary duties: loyalty, due care, and good faith. *Emerald Partners v. Berlin*, 787 A.2d 85, 90 (Del. 2001). In a recent Delaware Bankruptcy case (*Miller v. McDonald (In re World Health Alternatives, Inc.)*, B.R., 2008 WL 1002035 (Bkrcty D. Del. April 2008) involving the liquidation of World Health Alternatives Inc. (the “Company”), the Court appears to have extended some of these corporate fiduciary duties to corporate officers and even general counsel.

The bankruptcy trustee, George L. Miller (the “Trustee”)¹, sued various directors and corporate officers of the Company, including the general counsel (“General Counsel”), who was also a corporate officer (hereinafter, collectively, the “Defendants”) on several counts alleging that the Defendants had either engaged in and/or had allowed to occur various types of corporate waste² and fraudulent activities³. The claims against the General Counsel⁴ included a breach of fiduciary duty, negligent misrepresentation, and waste of corporate assets, among others. The Court determined that the General Counsel had failed to affirmatively act when he knew or should have known about corporate wrongdoings, and thus denied the General Counsel’s motions to dismiss with respect to the above claims notwithstanding that it was never alleged that the General Counsel had engaged in any fraud/corporate waste/misrepresentation, or had benefited from any fraud/corporate waste.

Breach of Fiduciary Duty Claim

The Court determined that the Trustee successfully pleaded a claim for breach of fiduciary duty of care against the General Counsel by alleging that the General Counsel failed to implement an adequate monitoring system and/or failed to utilize such system to safeguard against corporate wrongdoing and that the misrepresentations contained in the Company’s U.S. Securities and Exchange Commission (“SEC”) filings were examples of such failure, noting: “the Trustee appropriately asserts that [General

¹ The Company filed its chapter 11 petition in February of 2006 and the case was converted to a chapter 7 case on October 31, 2006, with the Trustee appointed the chapter 7 trustee.

² The Trustee alleged that at a time when the Company was operating at a net loss, excessive amounts of money were being spent on unnecessary luxuries such as private jets and luxury cars.

³ The Trustee alleged a broad array of corporate fraudulent conduct, including: (i) creating unauthorized related party loan accounts; (ii) a scheme to manipulate payments intended for the IRS; (iii) a scheme to “borrow” twice on certain accounts receivable; and (iv) various misrepresentations and misleading statements in SEC filings and financial statements.

⁴ For purposes of this article, we are focusing only on some of the claims brought against the General Counsel and not the other Defendants.

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Counsel] as the in-house general counsel and the only lawyer in top management of World Health during the relevant period, had a duty to know or should have known of these corporate wrongdoings and reported such breaches of fiduciary duties by management.”

In support of this argument, the court cited *In re Caremark Int’l Inc. Derivative Litig.*, 698 A.2d 959, 967-71 (Del. Ch. 1996) (which articulates the standard for determining director oversight liability). The *Caremark* court stated: “a director’s obligations includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists.”⁵ The Court in *Miller v. McDonald* rejected the General Counsel’s assertion that since the *Caremark* line of cases involved the fiduciary duties of directors and not of officers, Delaware law does not support a breach of fiduciary duty claim against him by noting: “It is correct that Delaware law does not impose fiduciary duty on “employees” generally, but it is incorrect that it does not impose failure of oversight (fiduciary duty) as to officers. Of course, [General Counsel] was not just an “employee;” he was an officer in two respects, vice president of operations and general counsel.” The Court further cited several other Delaware and Florida cases for the proposition that officers owe similar fiduciary duties to the corporation as directors.⁶

In addition, the Court noted that the General Counsel had an affirmative duty to “report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the issuer up-the-ladder within the Company” which arises under the final rule adopted by the SEC pursuant to section 307 of the Sarbanes-Oxley Act outlining the minimum standards of professional conduct for attorneys. The Court cites to the applicable SEC rule (17 C.F.R. Part 205) adopted pursuant to section 307 stating: “since the SEC adopted a final rule pursuant to [Section] 307 of the Sarbanes-Oxley Act... a general counsel has an affirmative duty to inspect the truthfulness of the SEC filings.”

Corporate Waste Claim

The Court cited to the Delaware Supreme Court (*Brehm v. Eisner*, 746 A.2d 244, 263 (Del. 2000)) for the standard for adjudicating a claim of wasting corporate assets: “[W]aste entails an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade.” Although acknowledging that maintaining a claim for waste of corporate

⁵ The Court also cited the Delaware Supreme Court’s *Stone v. Ritter*, 911 A.2d 362 (Del. 2006) for the elements establishing a *Caremark* directors liability claim. The *Stone v. Ritter* case states as follows: “*Caremark* articulates the necessary conditions predicated for director oversight liability: (a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented a such system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.”

⁶ For example, the Court specifically cited to *In re Walt Disney Co. Derivative Litigation*, 2004 WL 2050138 (Del. Ch. Sept. 10, 2004) which states: “To date, the fiduciary duties of officers have been assumed to be identical to those of directors.”

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assets against the General Counsel was a close call since it was not alleged that he was directly involved and/or had benefited from any corporate waste, the Court nevertheless denied the General Counsel's motion to dismiss noting in particular that the General Counsel knew or should have known about the corporate waste and took no action as fiduciary to prevent such waste. The Court notes: "it is conceivable that no person acting in good faith in pursuit of World Health's interest would approve chartering expensive flights, leasing luxury automobiles, and granting large bonuses to certain directors and officers while World Health was experiencing negative income. Thus, the motion to dismiss will be denied as to the corporate waste count."

Negligent Representation Claim

The Court stated that the Trustee's complaint properly pled a cause of action for negligent misrepresentation against the General Counsel for the Company's misrepresentations in SEC filings by alleging that had the General Counsel properly discharged his duties as general counsel to review SEC filings to "ascertain the truthfulness of these disclosures," the misrepresentations would not have been made.

Conclusion

Corporate officers and general counsel of Delaware companies in particular may find themselves at increased risk for liability for a failure to affirmatively implement reporting or information systems or controls to detect corporate wrongdoings or by failing to adequately monitor such reporting and information systems.

Please remember that these legal principles may change and vary widely in their application to specific factual circumstances. You should consult with counsel about your individual circumstances. For further information regarding these issues you may contact the head of our Corporate and Securities Practice Group:

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