

Third Circuit Opens the Door to Breach of Fiduciary Duty Claims

CLIENT ALERT | 01.2006

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Recently, the Third Circuit Court of Appeals, in *In re Tower Air, Inc.*, 416 F.3d 229 (3rd Cir. 2005), queried: "How far will the federal courthouse door swing open for a direct suit against corporate directors and officers for Breaches of Fiduciary Duties?" In firmly answering this question, the Third Circuit has widened the door for bankruptcy trustees and creditors' committees, by making it easier, at the pleading stage, to assert a claim for breach of fiduciary duty in federal court. This decision comes at a time when plaintiffs are held to high pleading standards in federal securities cases (as a result of the Private Securities Litigation Reform Act, 15 U.S.C. § 78u-4 (1997)) and breach of fiduciary duty cases in state court, each of which have presented significant hurdles for plaintiffs. In *Tower Air*, the Third Circuit Court of Appeals reversed the District Court and held that it erred in assuming that Delaware state law pleading standards were "interchangeable" with federal notice pleading standards. Thus, *Tower Air* evidences a particularly unique opportunity for litigants in bankruptcy cases, as the Third Circuit has made it significantly easier for plaintiffs to succeed in defeating motions to dismiss, allowing them to proceed to discovery to build and support a claim.

The Facts

In *Tower Air*, the Chapter 7 Trustee commenced an action against certain officers and directors (the Defendants) for breach of fiduciary duty and corporate waste. The Trustee alleged that the Defendants of the debtor drove the company into bankruptcy through "indifference and egregious decision making." In *Tower*, defendant Morris Nachtomi was at relevant times the Chairman and CEO, President and a director of Tower. Nachtomi and his family also owned a substantial majority of the common stock of the debtors and he controlled the company. In 1996, the company lost \$23 million, at a time when

the company was expanding its international flight routes. The company allegedly added routes to Santo Domingo because Nachtomi's daughter expressed a "personal interest" in having the airline do so. The court noted that the Santo Domingo route never turned a profit. The Trustee further alleged that Nachtomi ran the debtors' Tel Aviv office with no oversight from the companies other officers and directors in the U.S. Eventually, the Tel Aviv office accumulated debt and its creditors forced it into a liquidation proceeding.

The Trustee alleged that in the late 1990s, Tower cut ticket prices so low that the company could not profit on certain flights, even if its planes were full. Nachtomi and certain other directors also failed to ensure that certain passenger tickets were processed for payment through credit card processing. After the petition date, unprocessed tickets valued at \$1 million were discovered in the debtors' U.S. offices.

The Trustee also alleged that the debtors' directors failed to act when in June, 1998 they received reports of several "serious incidents" including a ground collision from the company's Director of Safety.

The Trustee further alleged that the debtor "cannibalized" its engines to generate spare parts and that Nachtomi directed the company to lease or purchase new engines because doing so would be "cheaper than repairing old engines." At a board meeting, the directors agreed to borrow \$50 million to purchase eight new engines. The court noted that the board meetings minutes reflected "no discussion of the need for new engines, the state of the old engines or the financial impact of buying new engines." As a result of the financial deterioration of the business, the company filed for Chapter 11 in the District of Delaware. After conversion to Chapter 7, the Trustee was appointed and sued various of the directors and officers for monetary and punitive damages. The complaint alleged various counts sounding in breach of fiduciary duty of loyalty, good faith, due care, gross mismanagement and corporate waste.

The District Court Decision

In the context of a Motion to Dismiss, the District Court dismissed the action and ruled that the Trustee's amended complaint failed to state a claim, in light of the business judgment rule under Delaware law. The District Court began its analysis by declaring that under the Delaware business judgment rule, there is a "presumption that directors making a business decision, not involving self interest, act on an informed basis in good faith and in the honest belief that their actions are in the corporation's best interest." *Id.* at 234. According to the District Court, the only way a plaintiff could overcome the presumption of the business judgment was by alleging self-dealing or by pleading "with specificity" under Delaware Chancery Rule 8 facts showing that the decision was not the result of a valid business judgment.

The Third Circuit's Guideposts

In its decision, the Third Circuit laid out clear and specific guideposts for plaintiffs to follow in order to overcome a motion to dismiss in breach of fiduciary duty cases. First, regarding the nature of the factual allegations, the court made it clear that a plaintiff need only plead basic facts such that the defendant receives fair notice of the general factual background for the plaintiff's case. The court stressed that a complaint should not be dismissed under a Federal Rule 12 (b)(6) motion for lack of detailed facts. To the contrary, the court observed that by requiring factual allegations with a higher level of specificity it would effectively transform Rule 12(b)(6) motions "into multi-purpose summary judgment vehicles. That we will not do." *Id.* at 238.

Chancery Rule 8

Generally, Chancery Rule 8 requires plaintiffs to plead facts with specificity to support a demand for relief. In its analysis, the Third Circuit observed that the Delaware courts consider the Chancery Rule 8 specificity requirements as "consonant with notice pleading, but such notice pleading bears scant resemblance to the federal species." *Id.* at 237. In outlining the differences between the specificity requirements under Chancery Rule 8 and standards under federal law, the Third Circuit reiterated its view that "the federal rules of civil procedure do not require a claimant to set out in detail the facts upon which he bases his claim." *Id.* As a result, the Third Circuit reversed the District Court ruling that the District Court "erroneously preempted discovery on certain claims by imposing a heightened pleading standard [under Chancery Rule 8] not required by Federal Rule of Civil Procedure 8." *Id.*

Pleading 'Around the Business Judgment Rule'

The Third Circuit observed that overcoming the presumption of the business judgment rule was a "Herculean task." The court noted that the plaintiff may overcome the presumption, however, by establishing that a decision was "so egregious as to constitute corporate waste." *Id.* at 238. The court noted that the burden was to show irrationality, or conversely, that no reasonable business person could possibly authorize the action in good faith. Alternatively, the court ruled that a plaintiff may overcome the presumption that directors and officers acted on an informed basis by alleging facts establishing that a decision was a product of a "irrational process" or that the directors and officers failed to establish an information and reporting system reasonably designed to provide senior management and the board with information regarding the corporation's legal compliance and business performance. The court noted that inaction could lead to liability where "no red flag monitoring system" was installed to ensure compliance with applicable legal standards. *Id.* at 239.

The court was extremely troubled with the District Court's dismissal of the trustee's action which alleged officers irrationality and inattention to quality assurance problems with the aircraft. The District Court dismissed this count on the grounds that its Trustee alleged no specific facts that could characterize egregious actions. However, in the face of facts alleged that the officers did nothing when told by the Director of Safety of quality assurance problems with the aircraft, the Third Circuit chastised the lower court by opining that "Lives are on the line ... We could imagine few things more egregious." *Id.* at 239. The court also held that the officers alleged passivity in the face of negative maintenance reports was "far beyond the bounds of reasonable business judgment and its only explanation is bad faith." *Id.* at 239.

In reversing the District Court on the claim against directors for inattention, the Third Circuit held that the Trustee clearly stated a claim of inattention based on the irrational decision-making regarding the purchase and lease of jet engines. The court agreed with the Trustee's argument that the directors' "rubber stamping of major capital expenditures is consistent with bad faith." *Id.* at 240. The Third Circuit was very troubled with the "we don't care about the risk" attitudes of the board in its decision-making. *Id.*

In connection with the Trustee's count for irrational action and inaction against officers, the court was also troubled with the Trustee's allegation regarding failure to process the used airline tickets. The court held that if this was proved, such inaction could constitute gross negligence. Moreover, the Trustee's allegations regarding Nachtom's creation of a flight to Santo Domingo for the benefit of his daughter, seemed, at the pleading stage, as evidence of bad faith. The court held that no reasonable business person acting in good faith would create and maintain an unprofitable airline route for family purposes.

The Delaware District Court's Response to the Third Circuit

In a fascinating recent decision, *IT Litigation Trust v. D'Aniello*, 2005 WL 3050611 (D.Del Nov. 15, 2005) the District Court had the occasion to revisit the issues raised by *Tower Air*. While the court in *IT Litigation Trust* found the factual allegations in the complaint before it as "conclusory," it opined that "Given that the Third Circuit has emphasized the view [in *Tower Air*] that the Federal Rules of Civil Procedure do not require a plaintiff to plead detailed facts to make out a claim for breach of fiduciary duty under Delaware law," *Id.* at 8, the court was "bound to hold" the pleadings sufficient. Notwithstanding, in a remarkable footnote, which is approximately three pages in length, the District Court criticized, indeed attacks, the Third Circuit's reversal in *Tower Air*. First, the District Court observed that "the Delaware requirement that there be more than conclusory allegation to support fiduciary duty claims does not appear to me to be simply a matter of procedure. Rather, the pleading requirements shape the substance of fiduciary duty claims by enforcing the business judgment rule, which is fundamental to Delaware law." *Id.* The District Court distinguished the business judgment rule as a matter of "substantive corporate law," which it believed stood "independent ... of the notice purpose inherent in procedural rules of pleading." *Id.* The District Court observed that while the Third Circuit may be correct that the federal notice pleading bears "scant resemblance to simple notice pleading, but the difference is an entirely deliberate decision of substantive Delaware law, not a procedural peccadillo." *Id.*

The District Court then, largely on policy grounds, again criticizes the Third Circuit, arguing that "the *Tower Air* Holding requires directors to face greater expense and risk in a federal court than they would in state court, because plaintiffs in a bankruptcy adversary proceeding can now more easily survive a Rule 12(b)(6) motion and therefore will have easier access to litigation ..." *Id.*

Attacking on the ground that the outcome of state law should not differ between the state and federal courts, the District Court then argues that it made little sense to expand a directors risk "simply because a corporation is insolvent." *Id.*

Finally, the District Court in *IT Litigation* attacks the *Tower Air* decision by arguing that the Third Circuit's approach in *Tower Air* "does not merely make particularized pleading unnecessary; it actively penalizes it and, instead rewards obscurity." *Id.* Thus, the District Court concludes the footnote by conceding that while it was "uncomfortable changing the scope of fiduciary duty claims by weakening a substantive presumption ... given the ruling in *Tower Air* and the lack of Delaware authority directly stating that the *Tower Air* approach contravenes Delaware law, I must yield to the Third Circuit's interpretation." *Id.*

Conclusion

The *Tower Air* decision is very significant in its impact on committees and trustees in bankruptcy proceedings, as it makes clear the heightened pleading standards under Delaware state law will not be required in federal court. In ruling that Delaware Chancery Rule 8's heightened pleading requirements were "not consonant" with the notice pleading of the federal rule of civil procedure, the Third Circuit has paved the way for more actions to survive motions to dismiss, thereby permitting discovery and the development of facts necessary to prove a claim.

The *Tower* decision should also be a wake-up call to officers and directors, who should heed the Third Circuit's warning: the courthouse door to federal actions for breach of fiduciary duty claims is wide open. However, given the District Court's recent pronouncements in *IT Litigation*, it will indeed be interesting to see how these issues are further

developed in the future.

The authors are grateful for the assistance of Joshua S. Androphy, an associate at the firm.