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The Missing Piece of Accountability: Agency Liability for Corporate Officers

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Despite the power and influence that corporate officers have over a company's management, and the significant harm that can result from their dereliction of duty—including the bankruptcy of a once-healthy company—it was not until the most recent era of corporate greed that the Delaware Supreme Court made a pronouncement with respect to the duties of corporate officers. Bankruptcy trustees, creditors' committees and bankruptcy professionals had long awaited clarification of the fiduciary duties of those officers whose conduct often led to the downfall of bankrupt companies.



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With the words, "[w]e now explicitly so hold,"² the Delaware Supreme Court attempted to confirm what it had not squarely addressed before: the fiduciary duties owed by officers of a Delaware corporation. Prior to that declaration, courts had issued countless opinions on the duties owed by directors, but offered little guidance to shareholders, creditors and trustees on the distinct fiduciary duties of officers. Instead, officer duties were simply conflated within the discussion of director duties. While the Delaware Supreme Court confirmed in *Gantler v. Stephens* that officers owe at least the same duties

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owed by directors, it did not address the more stringent fiduciary duties of officers that are rooted in agency law.

Following the accounting and mismanagement scandals of Enron, Adelphia and WorldCom that shook Wall Street in the early 2000s—all of which led to mega-bankruptcy cases the effects of which are still felt today—many scholars began to emphasize that the legal scope of duties owed by officers

owe "the same"⁵ corporate fiduciary duties as the directors of their companies, it remains unclear whether plaintiffs, including trustees, can succeed in convincing courts that officers also owe additional

duties arising from their role as agents of the companies. The courts' adoption of this position would satisfy the need to increase officer accountability and would be consistent with the true relationship of officers to the companies they serve.

Do Officer Duties Mirror Director Duties?

It is "a fundamental precept of Delaware corporation law" that directors,

Feature

in corporate America should be expanded.³ Before the dust settles on the Great Recession of 2008 and the bankruptcy cases of major financial institutions, the officers (and directors) of those companies and other related businesses upon which many place blame likely will face litigation involving their alleged misconduct leading up to the economic collapse. Bankruptcy trustees, the Federal Deposit Insurance Corp. (FDIC) acting as receiver, and creditor committees have already filed lawsuits against officers of bankrupt debtors involved in the financial industry.⁴ Notwithstanding Delaware's pronouncement that officers

who are elected by a company's shareholders, are charged with the ultimate management of the business and affairs of the corporation.⁶ Officers, on the other hand, are appointed by the directors to act for the company and are not elect-

⁴ See, e.g., *Dexia Holdings v. Countrywide Financial Corp.*, 650185/2011, New York State Supreme Court Manhattan (asserting claims of negligent misrepresentation and omissions against Countrywide's officers, *inter alia*); *Federal Deposit Insurance Corp. v. Bryan*, 1:11-CV-2790 (N.D. Ga. 2011); *Lyon v. Magnus Corp.*, No. 4:09-ap-00211-JMM (Bankr. D. Ariz. 2009) (trustee sued four executives employed by lender's homebuilding division, among others, for \$300 million for breaches of fiduciary duty, corporate waste and fraudulent transfers); *Matson v. Alpert (In re LandAmerica Financial Group Inc.)*, No. 11-03168-KPH (Bankr. E.D. Va. 2011) (liquidating trustee sued former officers and directors for breaches of fiduciary duty in failing to properly inform themselves and mitigate effects of liquidity crisis and causing \$365 million in financial losses); *Silverton Financial Services Inc., by and through its Chapter 7 Trustee, Jeffrey K. Kerr, v. Porter Keadle Moore LLP, Insera and Bryan*, Case No. 2010-CV-199891 (filed Dec. 29, 2010, Superior Court of Fulton County, Ga.) (chapter 7 trustee brought breach-of-fiduciary-duty action against holding company's auditor and chief executive officer).

⁵ *Gantler*, 965 A.2d at 709.

⁶ See, e.g., *Kaplan v. Peat, Marwick, Mitchell & Co.*, 540 A.2d 726, 729 (Del. 1988).

¹ The opinions expressed in this article are those of the authors and not necessarily those of Whiteford, Taylor & Preston LLP.

² *Gantler v. Stephens*, 965 A.2d 695, 709 (Del. 2009).

³ See, e.g., Megan Wischmeier Shaner, "Restoring the Balance of Power in Corporate Management: Enforcing an Officer's Duty of Obedience," *The Business Lawyer*, Vol. 66, Issue 1 (November 2010); Lyman P. Q. Johnson and David Millon, "Recalling Why Corporate Officers Are Fiduciaries," 46 *Wm. & Mary L. Rev.* 1597 (2005).

ed. While directors are also ultimately responsible for the oversight and management of the corporation's affairs, officers are often delegated day-to-day management responsibilities and are charged with carrying out the directives of the board for the corporation. As a result, both directors *and* officers owe fiduciary duties to their companies, and depending on the specific misconduct and harm to the debtor, trustees and creditors' committees often seek recovery from either or both when a company is led into bankruptcy.

The traditional, primary corporate fiduciary duties are duties of due care, good faith and loyalty.⁷ The duty of care requires that directors and officers inform themselves of "all material information reasonably available to them" before making a business decision.⁸ Directors and officers must also "act in an informed and deliberate manner" before making a business decision.⁹ "To act in good faith, a director [or officer] must act at all times with an honesty of purpose and in the best interests and welfare of the corporation."¹⁰ Primary examples of a lack of good faith are (1) "consciously and intentionally disregarding their responsibilities" by adopting a "we-don't-care-about-the-risks" attitude concerning a material corporate decision,¹¹ (2) "intentionally act[ing] with a purpose other than that of advancing the best interest of the corporation"¹² and (3) "act[ing] with the intent to violate... law."¹³ The duty of loyalty requires the officer and director to act solely for the benefit of the corporation and not "use their position of trust and confidence to further their private interests" or the interests of another.¹⁴

"Director Duties" Owed by Officers

Officers who fail to fulfill their responsibility of proper management of companies and either cause the filing of bankruptcy or a decline in enterprise value are governed by duties set forth in the Model Business Corporation Act, or a similar statutory provision, in many states. Section 8.42 of the Act provides:

An officer with discretionary authority shall discharge his

duties under that authority: (i) in good faith, (ii) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and (iii) in a manner he reasonably believes to be in the best interests of the corporation.

Officers of bankrupt debtors or financially distressed companies that are incorporated in Delaware, or other states that have not adopted the Model Business Corporation Act or a statutory variance thereof, are governed by common law fiduciary duties.

While Delaware courts have routinely discussed and applied the common law duties of care, good faith and loyalty to claims of director misconduct, the Delaware Supreme Court, prior to the *Gantler* decision, had only mentioned in *dicta* that corporate officers hold positions giving rise to a fiduciary relationship.¹⁵ In both *Guth v. Loft* and *Lynch v. Vickers Energy*, the scope of an officer's fiduciary duties was not before the court, and therefore, the court provided little guidance, thereby leaving a hole in common law corporate governance jurisprudence for more than 70 years. Notwithstanding the absence of an express affirmation by the Delaware courts, other courts dealing with officers of bankrupt companies have nonetheless ascribed the traditional directorial fiduciary duties to officers, and practitioners have assumed that at least such duties applied to officers.¹⁶

Halfway There in Gantler v. Stephens

In *Gantler*, the Delaware Supreme Court had occasion to examine directly the conduct of a non-director officer. There, the plaintiff shareholders alleged, among other things, that the officers sabotaged the sales process by wrongfully interfering with the due-diligence efforts of a potential buyer. The Delaware Court of Chancery held that the non-director officer owed "fiduciary duties of loyalty and care" to the company and its shareholders. On appeal, the Delaware Supreme Court stated:

The Court of Chancery has held, and the parties do not dispute, that corporate officers owe fiduciary duties that are identical to those owed by corporate

directors. That issue—whether or not officers owe fiduciary duties identical to those of directors—has been characterized as a matter of first impression for this Court. In the past, we have implied that officers of Delaware corporations, like directors, owe fiduciary duties of care and loyalty, and that the fiduciary duties of officers are the same as those of directors. We now explicitly so hold.¹⁷

Thus, the scope and extent of the duties of officers of Delaware corporations was presumably resolved. Notably, however, the court did not address the full scope, application and extent of officers' duties, including whether they owe agency duties in addition to and different from the traditional corporate fiduciary duties of directors.

The Unspoken Agency Duties of Officers

Although the basic duties of officers are rooted in agency law, those legal principles have a virtually unexplained absence from corporate governance analyses. An agency relationship is a fiduciary relationship that arises when one person (a "principal") manifests assent to another person (an "agent") that the agent shall act on the principal's behalf and be subject to the principal's control, and the agent manifests assent or otherwise consents so to act.¹⁸ Officers are agents of the corporation because they are appointed to carry out the corporation's directives.¹⁹ The comment to the Model Business Corporation Act mentions "principles of agency" and references the Restatement (Second) of Agency in setting forth the duties of officers.²⁰ Moreover, when addressing conflicts of interest for non-director officers, the Model Business Corporation Act suggests that such conflict should be "dealt with by the law of agency prescribing loyalty of agent to principal."²¹

Under agency principles, an officer agent owes a duty of ordinary care, which applies a simple negligence standard for purposes of determining a breach of that duty.²² This standard is contrasted with the duty of due care under corporate fiduciary principles that applies a gross-

⁷ See *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 370 (Del. 2006) (duty of good faith is subset of duty of loyalty).

⁸ *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985); *In re Walt Disney Co. Derivative Litig.*, 907 A.2d 693, 749 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006).

⁹ *Id.* at 873.

¹⁰ *Walt Disney Co.*, 907 A.2d at 755.

¹¹ *Id.*

¹² *Id.*

¹³ *Id.*

¹⁴ *Id.* at 751 (citing *Guth v. Loft Inc.*, 23 Del. Ch. 255, 5 A.2d 503, 510 (Del. 1939)).

¹⁵ See *Guth v. Loft*, 5 A.2d 503, 510 (Del. 1939); *Lynch v. Vickers Energy Corp.*, 429 A.2d 497, 502-3 (Del. 1981).

¹⁶ See, e.g., *In re Tower Air Inc.*, 416 F.3d 229 n. 12 (3d Cir. 2005); *Miller v. McDonald*, 385 B.R. 576, 591-92 (Bankr. D. Del. 2008); *In re Bridgeport Holdings Inc.*, 388 B.R. 548, 563-73 (Bankr. D. Del. 2008).

¹⁷ *Gantler*, 965 A.2d at 708-09 (citations omitted).

¹⁸ *Restatement (Third) of Agency* § 1.01 (2006).

¹⁹ See Model Bus. Corp. Act § 8.42 cmt. (4th ed. Supp. 2008).

²⁰ See *id.*

²¹ See *id.* at § 8-374 cmt.

²² See *Restatement (Third) of Agency* § 8.08 (2006), provides that "[u]nless otherwise agreed, an agent has a duty to the principal to act with the care, competence and diligence normally exercised by agents in similar circumstances."

negligence standard.²³ Delaware law has been silent on the extension of this agency-based duty, and the *Gantler* court did not address this care standard since the allegations revolved around the duty of loyalty, not care.²⁴

The duty of loyalty under traditional common law agency principles is similar to that of a corporate duty of loyalty and is described as requiring the agent to act solely for the corporate principal's benefit. While there are many aspects to the agent's duty of loyalty, the most commonly recognized include not acting adversely to the principal without consent, not acting on behalf of one with interests adverse to the principal without consent, not competing with the principal, not wrongly appropriating a corporate opportunity, providing an accounting to the principal for profits and not using or wrongly communicating confidential information.²⁵

In addition to the heightened duty of care and the duty of loyalty, an agent also owes its principal the duty of obedience,²⁶ which, according to the *Restatement (Third) of the Law of Agency*, requires the agent "to comply with all lawful instructions received from the principal and persons designated by the principal concerning the agent's actions on behalf of the principal."²⁷ This basic tenet of fiduciary law—obedience—is lost in courts' discussions of fiduciary duties. This absence makes sense when one considers that fiduciary duty law has developed to govern non-agent corporate directors rather than officers.²⁸ Obedience is, however, expressly recognized by the Model Business Corporation Act. The comment to § 8.42 states that "[c]onsistent with the principles of agency, which generally govern the conduct of corporate employees, an officer is expected to observe the duties of obedience and loyalty and to act with the care that a person in a like position would reasonably exercise under similar circumstances." This recognition in the Model Act supports the application of the duty of obedience and agency principles to officer conduct. Moreover, Delaware and other courts have also in passing referred to officers as agents of the company.²⁹ Thus, this concept is not foreign to practice, but

only to written opinions holding officers to such standards.

This expanded standard for officer conduct is also consistent with the distinctions made for protections for directors and officers. For instance, directors are provided with protection from monetary liability for breaches of the duty of care in certain scenarios pursuant to § 102(b)(7) of the Delaware General Corporation Law (DGCL). Officers, however, are not provided such protection in Delaware.³⁰ Additionally, in certain circumstances, directors may rely on the advice of professionals and corporate officers in making decisions under DGCL § 141(e). Officers are excluded from the statute's protection.

Conclusion

Adopting a theory of liability of corporate officers based on agency law fully appreciates both the role of officers within a typical business organization as well as the recent demand for increased accountability of such officers, especially of failed corporations. While the *Gantler* court accurately stated that "officers of Delaware corporations, like directors, owe fiduciary duties of care and loyalty," it did not go further to define the type and scope of fiduciary duties owed by corporate officers to recognize the distinct roles officers and directors play in corporations. In doing so, a missing piece from the puzzle of officer accountability remains and courts should fill that void by applying all agency law fiduciary duties to corporate officers, including in those cases that will necessarily result from the continuing fallout of the Great Recession. ■

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²³ See *Van Gorkom*, 488 A.2d at 873.

²⁴ *Gantler*, 965 A.2d at 708; see also *Shaner*, *supra*, n. 3, at 43.

²⁵ *Johnson and Millon*, *supra*, n. 23, at 1629.

²⁶ *Restatement (Third) of Agency* § 8.09(2); see also *Shaner*, *supra*, n. 3, at 43-44.

²⁷ *Restatement (Third) of Agency* § 8.09(2).

²⁸ Directors are not agents of a company, see *Arnold v. Soc'y for Sav. Bancorp Inc.*, 678 A.2d 533, 539-40 (Del. 1996), and therefore the duty of obedience does not apply to director duties.

²⁹ *Triton Constr. Co. v. Eastern Shore Elec. Servs. Inc.*, No. 3290-VCP, 2009 Del. Ch. LEXIS 88, *27 (Del. Ch. May 18, 2009) (stating that "hallmark principles of agency law apply to traditional corporate fiduciaries" including officers, but finding that defendant was not corporate fiduciary); *Sci. Access. Corp. v. Summagraphics Corp.*, 425 A.2d 957, 962 (Del. 1980) (discussing agency principles); *In re Walt Disney Co. Derivative Litig.*, No. 15452, 2004 WL 2050138, at *4 n. 39 (Del. Ch. Sept. 10, 2004) ("Under Delaware law, an agent, such as a CEO, can bind the principal if the third person with whom that agent is dealing reasonably concludes that the agent is acting on behalf of the principal.").

³⁰ See *McPadden v. Sidhu*, 964 A.2d 1262, 1275 (Del. Ch. 2008).