

Litigating Breach of Fiduciary Duty Claims Regarding Closely Held Entities

THURSDAY, JUNE 13, 2019

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

Christopher D. Sullivan, Partner, **Diamond McCarthy**, San Francisco

Eric Jon Taylor, Partner, **Hunton Andrews Kurth**, Atlanta

William T. Webb, Founding Partner, **Webb Legal Group**, San Francisco

The audio portion of the conference may be accessed via the telephone or by using your computer's speakers. Please refer to the instructions emailed to registrants for additional information. If you have any questions, please contact **Customer Service at 1-800-926-7926 ext. 1.**

Tips for Optimal Quality

FOR LIVE EVENT ONLY

Sound Quality

If you are listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.

If the sound quality is not satisfactory, you may listen via the phone: dial **1-866-869-6667** and enter your PIN when prompted. Otherwise, please **send us a chat** or e-mail sound@straffordpub.com immediately so we can address the problem.

If you dialed in and have any difficulties during the call, press *0 for assistance.

Viewing Quality

To maximize your screen, press the F11 key on your keyboard. To exit full screen, press the F11 key again.

Continuing Education Credits

FOR LIVE EVENT ONLY

In order for us to process your continuing education credit, you must confirm your participation in this webinar by completing and submitting the Attendance Affirmation/Evaluation after the webinar.

A link to the Attendance Affirmation/Evaluation will be in the thank you email that you will receive immediately following the program.

For additional information about continuing education, call us at 1-800-926-7926 ext. 2.

If you have not printed the conference materials for this program, please complete the following steps:

- Click on the ^ symbol next to “Conference Materials” in the middle of the left-hand column on your screen.
- Click on the tab labeled “Handouts” that appears, and there you will see a PDF of the slides for today's program.
- Double click on the PDF and a separate page will open.
- Print the slides by clicking on the printer icon.

Litigating Breach of Fiduciary Duty Claims

Eric Jon Taylor

Telephone: 404.888.4109

Email: etaylor@huntonak.com

**Hunton Andrews Kurth LLP
Bank of America Plaza, St. 4100
600 Peachtree Street, N.E.
Atlanta, GA 30308**

Elements of Breach of Fiduciary Duty Claim

- Defendant owed a fiduciary duty to Plaintiff
- Defendant breached its fiduciary duty
- Plaintiff was damaged by Defendants breach of fiduciary duty
- Punitive damages (sometimes fees)
- Similar to, but different from fraud
- No need to prove intent
- Fact intensive analysis

- Very high standard
- Utmost good faith
- Duty to act in the best (or sole) interest of others
- Complete candor
- Total transparency
- Loyalty
- But reasonable care and diligence
- Common sense ideas

How Jurors Treat Fiduciary Duties

- Some measure of control/power
- No self dealing/mixed motives
- No shading of truth
- No withholding of information
- No conflict of interest

Examples of Fiduciary Duty

- Attorney or Accountant/Client
- Partner/Partnership
- Trustee/Beneficiary
- Guardian/Ward
- Principal/Agent
- Controlling Stockholder/Minority Shareholder
- Officer and Directors/Shareholders
- Employer to Employee (Employee to Employer?)
- Statutory/Common Law/Contract

- Scope/Breadth of fiduciary duty
- Timeframe: when fiduciary relationship arises
- Specific action/inaction by Defendant
- Reasonableness
- Prudence
- Disclosures

Unique Characteristics of Fiduciary Duty Litigation

- Frequently close relationships/nature of claim is very serious
- Frequently ongoing business activities
- Third party involvement
- Can be hard to settle

- Defendant was unfair to Plaintiff
- Defendant put his interest ahead of Plaintiff's
- Plaintiff did not know all the facts (and would have done something different)
- Plaintiff had no meaningful recourse
- Defendant knew and understood trust and reliance of Plaintiff

- There was no special duty to Plaintiff
- Defendant disclosed all important information to Plaintiff
- Defendant did not profit (to Plaintiff's detriment)
- Third parties are responsible (or the Market)
- Subjective trust v. objective facts

Thank You

Eric Jon Taylor

Telephone: 404.888.4109
Email: etaylor@huntonak.com
Hunton Andrews Kurth LLP
Bank of America Plaza, St. 4100
600 Peachtree Street, N.E.
Atlanta, GA 30308



DIAMOND McCARTHY LLP

Christopher D. Sullivan, Esq.

Typical Bases for Claims Against Directors and Officers

- Breach of Fiduciary Duty
- Derivative Claims by Shareholders
- Wasting of Corporate Assets
- Overdistributions or Excess Dividends
- Securities Law Claims – 10b-5, Section 11 and State Blue Sky
- Common Law Fraud and Negligent Misrepresentation
- ERISA
- Environmental and Product Liability
- Employment Related Litigation

Duties

- **Duty of Care**
 - Business Judgment Rule – director is not liable for a mistake in business judgment that is made in good faith and in what he/she believes to be in the best interests of the corporation, when no conflict of interests exist.
 - For the most part, all of the cases where the courts talk about holding a director liable for negligence (although in virtually none of them has this actually been done) involved situations where a director failed to diligently perform duties or abdicated responsibility. In all of these cases, some other corporate official was guilty of dishonesty, fraud, and the complaint against the other directors was that they had failed to prevent this and supervise the business.
 - An honest business decision, no matter how stupid, will not subject the director to liability **WHEN** there is **NO** conflict of interests, and the director has ruined himself along with the other shareholders.
- **Duty of Loyalty**
 - Directors – while not trustees – are fiduciaries. They owe a duty to all stockholders, including minority stockholders, and must administer their duties for the common benefit.
 - Duty of highest good faith. The same duty of good faith and fair dealing is demanded of officers.

Conflicts of Interests

- Conflicts of Interest
 - Transactions with Interested Directors
 - Material Financial Interests
 - Approval by a Disinterested Board
 - Approval by Shareholders

- Corporate Opportunities
 - Manner in which the opportunity is presented
 - Similarity of the opportunity offered and the business of the corporation
 - Ability of the company to take advantage of the opportunity
 - Desire of the company to expand its business

Breach of Fiduciary Duty Scenarios

- Investors sued a company alleging that the company's officers had personal connections to a third party contractor and that they hired that contractor to **further their personal interests**, not the interests of the company. Other officers and directors were alleged to have either knowingly colluded with one another, or at least breached their duty of care in undertaking the project **without properly investigating the qualifications** of the contractor.
- When a privately held family business experienced an upswing of profits, the majority shareholders **voted to approve a large compensation package to the CEO**, the family patriarch and founder of the company. A 20% shareholder was upset that the majority shareholders, three children of the CEO were siphoning of corporate earnings leaving him with no reward. He sued for breach of fiduciary duty and minority shareholder oppression.
- Creditors of a company that was having financial trouble and in need of capital, sued its directors and officers for **failure to identify, evaluate, negotiate, and secure** the sale of company assets in a timely manner, which resulted in the company defaulting on its outstanding loans.

Breach of Fiduciary Duty Scenarios

- Chapter 11 liquidating trustee sued directors and officers for breaches of fiduciary duty and avoidance of fraudulent transfers for **directing the company to engage in risky transactions with entities that they or their family members owned and controlled**, including transferring millions of dollars to a start-up in return for unsecured notes, transferring software rights critical to the company's business for no consideration, and entering into a real estate transaction in which some of the directors and officers received millions of dollars from the company to invest in a property with potential upside to them while the company bore all the risk
- Bankruptcy trustee brought charges against directors and officers, claiming they devised a strategy to **disguise the company's financial position**. The company allegedly participated in a transaction causing overstatement of stockholder's equity
- Various creditors filed suit against the President and VP of a company that **facilitated the purchase** of smaller businesses, which was **mishandled** and ended up not being profitable and led to the company's bankruptcy.

Breach of Fiduciary Duty Examples in Various Contexts

- Raising Capital
 - Self-Dealing
 - Failure to Investigate/Lack of Due Diligence
 - Lack of Disclosure
- Merger & Acquisition
 - Lack of Due Diligence
 - Self Dealing/Related Entities
- Shareholder Disputes
 - Misrepresentation/Omissions
 - Fraud
 - Conflicts of interest – personal interests v. interests of shareholders

Breach of Fiduciary Duty Examples in Various Contexts

- Bankruptcy/Insolvency
 - Corporate waste/mismanagement
 - Failure to exercise adequate oversight and control; failure to maintain adequate records
 - Failure to exercise reasonable and independent business judgment with respect to offers by outside investors to purchase or invest
 - Failure to consider the interests of shareholders and creditors in light of financial distress
 - Attempts by D&Os to negotiate unreasonable personal benefits at expense of company, shareholders, and creditors
 - Over distributions or excess dividends
 - Disguising the company's precarious financial condition
 - Fraudulent transfer claims against D&Os.
 - Who can and should bring these claims?



DIAMOND McCARTHY LLP

Christopher D. Sullivan, Esq.
csullivan@diamondmccarthy.com

The Business Judgment Rule and Other Defenses

William T. Webb
Webb Legal Group
San Francisco

www.webblegalgroup.com

Business Judgment Rule

- Delaware:

Delaware:

The business judgment rule is a **presumption** that “in making a business decision the directors of a corporation acted on an **informed** basis, **in good faith** and **in the honest belief that the action taken was in the best interests of the company** [and its shareholders].”²⁸ The business judgment rule operates as a **procedural guide** for litigants and as a **substantive rule of law**.²⁹ “As a procedural guide, the business judgment presumption is a rule of evidence that places the initial burden of proof on the plaintiff.”³⁰

To rebut the presumptive applicability of the business judgment rule, a shareholder plaintiff has the burden of proving that the board of directors, in reaching its challenged decision, **violated any one of its triad of fiduciary duties: due care, loyalty, or good faith**.³¹ If a shareholder plaintiff fails to meet this evidentiary burden, the business judgment rule operates to provide substantive protection for the directors and for the decisions that they have made.³² If the presumption of the business judgment rule is rebutted, however, the burden shifts to the director defendants to prove to the *trier of fact* that the challenged transaction was “**entirely fair**” to the shareholder plaintiff.³³

Emerald Partners v. Berlin, 787 A.2d 85, 90–91 (Del. 2001)

Business Judgment Rule

- **California:**

The business judgment rule is premised on the notion that management of the corporation is best left to those to whom it has been entrusted, not to the courts. (*Gaillard v. Natomas Co.* (1989) 208 Cal.App.3d 1250, 1263, 256 Cal.Rptr. 702.) The rule requires **judicial deference** to the business judgment of corporate directors **so long as there is no fraud or breach of trust**, and **no conflict of interest** exists. (1 Marsh, Cal. Corporation Law (4th Ed.2000) § 11.03, p. 11–15; see *Gaillard v. Natomas Co.*, *supra*, 208 Cal.App.3d at p. 1263, 256 Cal.Rptr. 702.) The rule has been codified in Corporations Code section 309,³ which requires a director to perform “in good faith, in a manner such director believes to be in the best interests of the corporation and its shareholders and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.” (§ 309, subd. (a).)⁴

Desaigoudar v. Meyercord, 108 Cal. App. 4th 173, 183, 133 Cal. Rptr. 2d 408, 415 (2003), as modified on denial of reh’g (May 28, 2003)

Business Judgment Rule

- **Illinois:**

The business judgment rule acts to shield directors who have been diligent and careful in performing their duties from liability for honest errors or mistakes of judgment. (*Lower v. Lanark Mutual Fire Insurance*; see generally 3A W. Fletcher, *Cyclopedia of the Law of Private Corporations*, sec. 1039 (perm. ed. rev. 1986).)

Under this rule, the “judgment of the directors of corporations enjoys the benefit of a **presumption** that it was formed **in good faith** and was **designed to promote the best interests of the corporation** they serve.” (*Shlensky v. Wrigley*, 95 Ill.App.2d at 178, 237 N.E.2d 776, quoting *Davis v. Louisville Gas & Electric Co.* (1928), 16 Del.Ch. 157, 142 A. 654, 659.) Consequently, absent allegations of “**bad faith, fraud, illegality or gross overreaching**, courts are not at liberty to interfere with the exercise of business judgment by corporate directors.” *Fields v. Sax*, 123 Ill.App.3d at 467, 70 Ill.Dec. 864, 462 N.E.2d 983; see also *Shlensky v. Wrigley*, 95 Ill.App.2d at 181, 237 N.E.2d 776 (“unless the conduct of the defendants at least borders on one of the elements [**fraud, illegality or conflict of interest**], the courts should not interfere”).

Stamp v. Touche Ross & Co., 263 Ill. App. 3d 1010, 1015–16, 636 N.E.2d 616, 621 (1993)

Business Judgment Rule

- New York Court of Appeals (i.e. its highest court):

We begin with the general principle that courts should strive to avoid interfering with the internal management of business corporations. To that end, we have long adhered to the business judgment rule, which provides that, where corporate officers or directors exercise **unbiased judgment** in determining that certain actions will promote the corporation's interests, courts will defer to those determinations if they were made **in good faith** (see *40 W. 67th St. v. Pullman*, 100 N.Y.2d 147, 153, 760 N.Y.S.2d 745, 790 N.E.2d 1174 [2003]; *Chelrob, Inc. v. Barrett*, 293 N.Y. 442, 459–460, 57 N.E.2d 825 [1944]). The doctrine is based, at least in part, on a recognition that: courts are ill equipped to evaluate what are essentially business judgments; there is no objective standard by which to measure the correctness of many corporate decisions (which involve the weighing of various considerations); and corporate directors are charged with the authority to make those decisions (see *Auerbach v. Bennett*, 47 N.Y.2d 619, 630–631, 419 N.Y.S.2d 920, 393 N.E.2d 994 [1979]). Hence, **absent fraud or bad faith**, courts should respect those business determinations and refrain from any further judicial inquiry (see *id.* at 631, 419 N.Y.S.2d 920, 393 N.E.2d 994). We have, therefore, held that the substantive determination of a committee of disinterested directors is beyond judicial inquiry under the business judgment rule, but that “**the court may inquire as to the disinterested independence of the members of that committee and as to the appropriateness and sufficiency of the investigative procedures chosen and pursued by the committee**” (*id.* at 623–624, 419 N.Y.S.2d 920, 393 N.E.2d 994).

In re Kenneth Cole Prods., Inc., 27 N.Y.3d 268, 274–75, 52 N.E.3d 214, 218 (2016)

Business Judgment Rule

- Typically applies to all entities:
 - Partnerships
 - Corporations (Cal. Corp. Code § 309)
 - LLC's
 - etc.

Other defenses

- Actions among partners and the partnership often include contract and tort causes of action
- These causes of action can be attacked by:
 - demonstrating an absence of an element
 - asserting contract and tort affirmative defenses

Other defenses

- Both legal and equitable defenses can apply (note Revised Uniform Partnership Act (RUPA) expressly states that equitable defenses apply)
- Common defenses include:
 - Ratification
 - Acquiescence
 - Estoppel
 - Statutes of limitation
 - Laches

Resources

- *Litigating the Business Divorce* (Bloomberg, 2016)
- Shameless plug: *Litigating and Adjudicating Business Entity Governance Disputes in California* (LexisNexis, July 2019)
- William T. Webb, wwebb@webblegalgroup.com

Derivative Action Procedures

William T. Webb
Webb Legal Group
San Francisco

www.webblegalgroup.com

Direct v. Derivative Claims

- Direct claims
- Derivative claims

Procedural Requirements for Derivative Claims

- Standing requirements
 - Stock ownership
 - Adequacy of representation

Procedural Requirements for Derivative Claims, con't

- Demand Requirement/Futility
- Procedural issues:
 - Demand Accepted
 - Demand refused

Procedural Requirements for Derivative Claims, con't

- Special Litigation Committee
 - Independence
 - Judicial discretion

Procedural Requirements for Derivative Claims, con't

- Bond required in some jurisdictions

Procedural Requirements for Derivative Claims, con't

- Proper Plaintiff
- Proper Defendant

Procedural Requirements for Derivative Claims, con't

- Right to a jury trial
 - State actions
 - Federal actions

Procedural Requirements for Derivative Claims, con't

- Remedies
 - Damages
 - Injunctive relief
 - Preliminary/non-dissipation injunctions
 - Permanent injunctions
 - Receivership
 - Declaratory relief

Procedural Requirements for Derivative Claims, con't

- Remedies, con't
 - Constructive trust
 - Accounting
 - Breach of contract
 - Specific performance
 - Punitive damages
 - Attorney's fees and costs

Common Defenses

- Business Judgment Rule
- Ratification
- Acquiescence
- Estoppel
- Statute of Limitations
- Laches

Ethical issues

- Dual representation
- Class and derivative plaintiffs

Settlement issues

- Settlement concerns
- Court approval
- Remedial measures
- Objections

Resources

- *Litigating the Business Divorce* (Bloomberg, 2016)
- Shameless plug: *Litigating and Adjudicating Business Entity Governance Disputes in California* (LexisNexis, July 2019)
- William T. Webb, wwebb@webblegalgroup.com

Thank You

William T. Webb
Webb Legal Group
San Francisco

www.webblegalgroup.com