LITIGATING AGAINST DIRECTORS AND OFFICERS OF BANKRUPT DOT-COM ENTITIES: A POTENTIAL ASSET FOR THE DEBTOR'S ESTATE

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ABSTRACT

Creditors' committees under Chapter 11 of the United States Bankruptcy Code have the statutory duty to perform essential functions to maximize recovery for the bankrupt estate. One potential supply of funds for the bankrupt estate consists of recovery from directors and officers whose breach of their fiduciary duties contributed to the company's insolvency. Due to the many complexities and untraditional characteristics of dot-com entities, creditors typically experience difficulties in recovering losses if the dot-com entity becomes insolvent. Creditors' committees, however, can often obtain funds for the bankrupt estate from personal assets of errant directors and officers of the insolvent dot-com entity, or from director and officer (D&O) insurance policies.

The purpose of this article is to analyze the potential liability of the debtor's directors and officers resulting from those directors' or officers' mismanagement of the of the bankrupt dot-com company. Specifically, the multiple facets of the responsibilities of directors and creditors' committee litigation will be addressed.

I. INTRODUCTION

In cases filed under Chapter 11 of the United States Bankruptcy Code (Bankruptcy Code),[1] when a debtor-in-possession is responsible for the management of the estate, committees composed of unsecured creditors are formed.[2] These committees perform crucial functions, fulfilling

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[1]The Bankruptcy Reform Act of 1978, 11 U.S.C. §§ 101-1330 (2000).

[2]"While the role of creditors' committees is far less important in cases under Chapters 7 and 9 of the Bankruptcy Code, or in Chapter 11 cases in which a trustee has been appointed, such committees nonetheless can be effective advocates for the interests of their unsecured creditor constituencies." Kenneth N. Klee & K. John Shaffer, *Symposium on Bankruptcy: Chapter 11 Issues: Creditors' Committees Under Chapter 11 of the Bankruptcy Code*, 44 S.C. L. REV. 995, 997 (1993).

statutorily-mandated duties to investigate the extent of the debtor's assets and liabilities, thus maximizing recovery for the estate.[3] One area that a creditors' committee should not overlook during its investigation is whether any wrongdoing on the part of the debtor's directors and officers may have contributed to the company's insolvency. If a creditors' committee is able to uncover financial mismanagement that is the result of a breach of the directors' and officers' fiduciary duties, the committee may be able to recover those assets for the bankrupt estate. The committee may recover such assets by litigating against the errant directors and officers and by making claims against the insurance policies that may cover such misconduct.

Investigating the potential misconduct of directors and officers of failed dot-com entities may be particularly important for several reasons. First, the nature of the "new economy" means that many dot-com entities may be managed by young, inexperienced boards of directors that may not have the necessary sophistication to monitor officers' activities. Second, although most e-commerce ventures have proven to be notoriously unprofitable to date, directors and officers of dot-com entities may tend to make irrational spending decisions, choosing to leverage their company's perceived future profitability for certain perks they believe are required in the present. Third, the digital economy prompts dot-com entities to make impossible promises by the very nature of the rushed competitive environment. Finally, dot-com entities do not hold assets typical to traditional "bricks-and-mortar" companies. To further complicate the scenario, dot-com entities often exist on extreme amounts of credit from all-too-willing backers. As such, creditors will likely face an uphill struggle to recoup losses if the company becomes insolvent. Accordingly, recovering from an entities' director and officers for wrongdoing can infuse the estate with much-needed cash.

A. *Creditors' Committee Has an Obligation Under Statute to Investigate*

Under the Bankruptcy Code, the creditors' committee is the principle entity charged with the responsibility to monitor the Chapter 11 bankrupt estate.[4] Under section 1102 of the Bankruptcy Code, the United States Trustee must appoint a creditors' committee in all Chapter 11 cases, except for those cases that involve small businesses.[5] A committee of unsecured

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[3] *Id.*

[4] *See id.* at 1000.

[5] 11 U.S.C. § 1102(a)(1) (2000).

creditors ordinarily will consist of creditors that hold the seven largest claims against the debtor.[6] Ideally, the committee will represent "an appropriate constituent body of parties-in-interest for the benefit of the reorganization process as it proceeds within the mechanisms of the bankruptcy court."[7]

The Bankruptcy Code grants substantial investigative powers and duties to Chapter 11 creditors' committees.[8] Under section 1103(c)(2) of the Bankruptcy Code, a creditors' committee is permitted to "investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business . . . and any other matter relevant to the case or to the formulation of a plan."[9] The Bankruptcy Code further directs the creditors' committee to confer with the bankruptcy trustee and the debtor-in-possession to transact business.[10] To assist in fulfilling these duties, creditors' committees may employ certain professionals upon application to the court.[11] Attorneys and accountants employed by the committee can investigate the financial business practices of the debtor to determine whether there has been any wrongdoing by the debtor's directors and officers.[12] In carrying out its investigative duties, a creditors' committee does not act on behalf of the debtors' estate, but rather must

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[6]*See id.* § 1102(b)(1).

[7]*In re* Eastern Maine Elec. Co-op., Inc., 121 B.R. 917, 933 (Bankr. D. Me. 1990); *see also* H.R. REP. NO. 95-595, at 235 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6194 ("These committees are designed to deal with the debtor in a more manageable way than the entire body of creditors could. They are representative bodies that must speak for groups of creditors with similar interests.").

[8]*See* 7 LAWRENCE P. KING, COLLIER ON BANKRUPTCY ¶ 1103.05[2] (15th ed. rev. 1997) (discussing the nature of the fiduciary duties owed by the committee members to the class of creditors, which the committee represents).

[9]11 U.S.C. § 1103(c)(2) (2000).

[10]*See id.* § 1103(d); *see also In re* Cumberland Farms, Inc., 154 B.R. 9, 12 (Bankr. D. Mass. 1993) (establishing that one important function of creditors' committee is to closely monitor debtor's operation); *In re* Structurlite Plastics Corp., 91 B.R. 813, 818 (Bankr. S.D. Ohio 1988) (holding that the Bankrutpcy Code "imposes a duty upon a debtor-in-possession to meet with the [creditors'] Committee as soon as practicable after its appointment to 'transact such business as may be necessary and proper'") (citations omitted).

[11]*See* 11 U.S.C. § 1103(a) (stating that creditors' committees may employ "attorneys, accountants, or other agents" with court approval); *id.* § 328 (professionals may be employed on reasonable terms and conditions); *see also In re* Arkansas Co., 798 F.2d 645, 647 (3d Cir. 1986) (holding that creditors' committees may employ attorneys).

[12]*See* 11 U.S.C. § 1103(c)(2); *see also In re* Wire Cloth Prods., 130 B.R. 798, 812 (Bankr. N.D. Ill. 1991) (reasoning that attorneys employed on behalf of the creditors' committee must further economic interests of unsecured creditors). Professionals employed by the committee are entitled to reasonable compensation for services provided; the compensation is an administrative cost paid from the bankruptcy estate. *See* 11 U.S.C. §§ 328, 503(b)(1)(A).

pursue a course that is in the best interest of the class of creditors it represents.[13]

The committee and its hired professionals provide the creditors with valuable information about the events that led to the financial condition of the debtor through the use of informal interviews of the debtor's directors and officers and by taking advantage of certain pre-litigation discovery procedures.[14] For example, under Bankruptcy Rule 7027, the creditors' committee may conduct formal depositions prior to filing an adversary action.[15]

Further, because the committee is charged with a duty to investigate, the statute has been interpreted as requiring the debtor to provide the committee with its financial records.[16] Examination of these records by accountants who have been hired by the creditors' committee provides valuable insight into how the officers managed the debtor company and whether the directors were informed timely about and acted appropriately with respect to financial decisions.[17]

B. *Potential Source of Recovery for Debtor's Estate And/or Creditors' Committee if it Can Demonstrate That Directors and Officers Breached Fiduciary Duties to Company*

As discussed, a creditors' committee must attempt to maximize recovery of the debtor's estate.[18] A potential source of recovery, which should not be overlooked, is personal funds from directors and officers or insurance coverage under a directors' and officers' liability policy (D&O

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[13]*See* Official Unsecured Creditors' Comm. v. Stern (*In re* SPM Mfg. Corp.), 984 F.2d 1305, 1315-16 (1st Cir. 1993) (citing *In re* Seaescape Cruises, Ltd., 131 B.R. 241, 243 (Bankr. S.D. Fla. 1991)).

[14]*See, e.g.*, FED. R. BANKR. P. 7027 (providing for the taking of depositions prior to commencement of adversary proceeding).

[15]*See id.*

[16]*See, e.g.*, *In re* International Horizons, Inc. 689 F.2d 996, 1003 (11th Cir. 1982) (providing that to keep debtors' financial records from creditors' committees would deny creditors and bankruptcy courts access to the source of information and records most relevant and necessary to their investigation of "the acts, conducts, assets, liabilities and financial condition of the debtor"); *In re* Kaiser Steel Corp., 84 B.R. 202, 206 (Bankr. D. Colo. 1988) (providing that committee must have access to financial records to perform investigatory duties).

[17]*See, e.g.*, *In re* Evans Prods. Co., 58 B.R. 572, 576 (S.D. Fla. 1985) (providing that financial records shed light on allegations of misconduct, mismanagement, and irregularity in the management of debtor's affairs).

[18]*See supra* Part I.

coverage or D&O policy) if an investigation by the creditors' committee can uncover chargeable wrongdoing.[19]

1. Recovery from Individual Directors and Officers

If an investigation into the financial affairs of the debtor uncovers wrongdoing on the part of a debtor's directors and officers, the creditors' committee may make claims directly against the target individuals.[20] Directors and officers may be held personally liable for breaches of duties to the corporation and its shareholders.[21] This approach will be affected by whether individual directors or officers have the financial resources to pay a judgment. Personal liability may exist even when directors and officers did not personally benefit from any wrongdoing.[22]

2. Recovery from Insurance Policies

Another possible avenue for recovering losses because of director or officer mismanagement is from D&O coverage under the corporate insurance policy.[23]

> There are three basic types of D&O coverage: first, liability coverage paid to, or on behalf of, the individual D&O when the corporation does not, or is not allowed to, provide reimbursement protection; second, corporate indemnification coverage which reimburses the corporation for losses, judgments, or other related expenses it may incur as a result of indemnifying its D&O from liability for covered wrongful acts; and third, entity coverage, which provides direct liability

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[19]*See* A.H. Robins Co. v. Piccinin, 788 F.2d 994, 1006 (4th Cir. 1986) (citing *In re* Johns-Manville Corp., 33 B.R. 254, 261 (S.D.N.Y. 1983) (recognizing that insurers may be called upon to indemnify officers and directors under policy provisions)).

[20]*See, e.g.*, *In re* First Capital Holdings Corp., 146 B.R. 7, 11-12 (Bankr. C.D. Cal. 1992) (recognizing that creditors' committees have standing to assert a claim on behalf of the debtor, to protect their interest in the estate when they have found that members of the board of directors have permitted or participated in alleged wrongdoing).

[21]*See* 1 DAVID A. DREXLER ET AL., DELAWARE CORPORATION LAW AND PRACTICE § 15.06[1], at 15-36 (2001) (chronicling bankruptcy cases where Delaware courts began to hold directors personally liable for negligence).

[22]1 WILLIAM E. KNEPPER & DAN A. BAILEY, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS 203 (6th ed. 1998).

[23]*See generally* George Ong, Note & Comment, *Directors and Officers Insurance Proceeds in Bankruptcy: The Impact on an Estate and Its Claimants*, 13 BANKR. DEV. J. 235 (1996).

> protection against claims (not otherwise covered by the corporation) brought against the corporation due to D&O misconduct.[24]

Therefore, the funding of a D&O insurance policy is generally separated into two parts: one providing direct coverage to the director or officer, and the other reimbursing the corporation for any indemnification payments made to its directors or officers.[25] The total coverage on an insurance policy with these elements generally is fixed as an aggregate limit provided to the corporation, the director or officer, or both.[26]

D&O policies typically provide coverage for each "wrongful act" committed by a director or officer, a term defined in the policy.[27] A general definition of "wrongful act" would include "an error, misstatement, misleading statement, act, omission, neglect, or breach of duty committed, attempted, or allegedly committed or attempted, by an Insured Person" in his insured capacity.[28] Therefore, if a creditors' committee can reach funds under a D&O policy through negotiation or litigation, those assets may bolster the estate.[29]

II. OVERVIEW OF THE RESPONSIBILITIES OF DIRECTORS

To effectively understand the potential civil liability of a debtor's directors and officers, this section will discuss and analyze the following issues: (1) the characteristics and structure of the board of directors; (2) the various fiduciary responsibilities of the board; (3) the typical breaches of fiduciary responsibilities; and (4) the doctrines that limit the liability of directors and officers and that serve as defenses to civil litigation.

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[24] *Id.* at 239 (citing KAREN P. GORDON, DIRECTORS' AND OFFICERS' LIABILITY CLAIMS: THE BROKER'S PERSPECTIVE, IN DIRECTORS' AND OFFICERS' LIABILITY INSURANCE 1994, at 34 (PLI Commercial Law and Practice course, Handbook Series No. A-692, 1994)).

[25] *See id.*

[26] *See id.* (citing GORDON, *supra* note 24, at 35).

[27] *See* Ong, *supra* note 23, at 239.

[28] *See id.* (quoting JOHN F. OLSON & JOSIAH O. HATCH III, DIRECTOR AND OFFICER LIABILITY: INDEMNIFICATION AND INSURANCE app. 10-2-7 (1994) (providing Chubb & Son, Inc.'s Executive Protection Policy form)).

[29] *See In re* Minoco Group of Cos., Ltd. 799 F.2d 517, 519 (9th Cir. 1986) (holding that corporate insurance policies, including D&O coverage, are property of the bankrupt estate).

A. *Structure of the Board*

Boards are typically composed of "inside" and "outside" directors that the shareholders elect.[30] An "inside" or management director generally serves the corporation both as a director and as an officer or employee.[31] In his or her capacity as an officer, the inside director participates in the day-to-day management of the corporation and usually is compensated for his or her full-time attention to the corporation's affairs.[32] An "outside" or non-management director is usually not a full-time employee of the corporation and has no significant relationship with the corporation or its management, except in his or her position as director.[33] Outside directors generally spend far less time on corporate work than inside directors, often lack detailed information, and are not generally expected to focus on "noncritical matters" or be involved in the "hands-on management of corporate affairs."[34]

The outside director, nevertheless, is not insulated from liability merely because he or she does not participate in the day-to-day operations of the corporation.[35] Rather, all directors and officers of corporations must act diligently under applicable statutes and regulations or they risk being held responsible for their acts as well as their failure to act.[36] Board members are accountable for knowing about and assessing important corporate actions; moreover, board members are further responsible for ensuring that adequate and appropriate disclosures are made on a timely basis.[37] Because a typical Board is unable to manage all of the day-to-day business of a large company, it is essential for the Board to institute procedures to ensure that all directors are kept apprised of company affairs. Importantly, lack of knowledge is not a valid defense when the director or officer should have known about the company's improper actions.[38]

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[30]*See* EDWARD BRODSKY & M. PATRICIA ADAMSKI, LAW OF CORPORATE OFFICERS AND DIRECTORS: RIGHTS, DUTIES AND LIABILITIES § 2:02 (1999).

[31]*See id.* § 2.03, at 7.

[32]*See id.*

[33]*See id.* § 2.02, at 3.

[34]*See* BRODSKY & ADAMSKI, *supra* note 30, § 2.02, at 3.

[35]*See id.*

[36]*See id.* § 1.02, at 2-3 (citing Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1341 (Del. 1987)).

[37]*See id.* § 1.02, at 2-3.

[38]*See* BRODSKY & ADAMSKI, *supra* note 30, § 1.02, at 2-3.

B. *Fiduciary Responsibilities of the Board*

In general, board members are expected to manage the business of the corporation, set corporate policy, and select officers who will implement the policies formulated by the Board on a day-to-day basis.[39] The Board's responsibilities include five general areas:

(1) Authorizing important corporate actions;
(2) Providing advice to corporate management;
(3) Instituting and implementing effective auditing procedures to keep the board adequately informed of the corporation's financial status;
(4) Regularly reviewing the corporation's investments to ensure compliance with laws and regulations; and
(5) Monitoring the performance of management, setting goals, and measuring management's performance against these goals.[40]

Directors have an obligation to be aware of corporate developments, to address any substantive adverse developments which are brought to their attention, and to investigate when their experience alerts them to events or circumstances that require further inquiry.[41] Directors are expected to spend a meaningful amount of time taking care of the company's business and must comply with the fiduciary duties that they owe to the corporation.[42] These duties fall into two broad categories—a "duty of loyalty" and a "duty of care."[43] More importantly, these duties are still owed to creditors once a corporation becomes insolvent.[44]

1. Duty of Loyalty

Upon accepting the position of director or officer of a corporation, an individual assumes a duty of loyalty to the company and to its

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[39]*See id.*

[40]*See id.*; *see also* GREGORY V. VARALLO & DANIEL A. DREISBACH, FUNDAMENTALS OF CORPORATE GOVERNANCE: A GUIDE FOR DIRECTORS AND CORPORATE COUNSEL 1-3 (1996) (reasoning that "the board's agenda [should] be structured around an annual monitoring schedule that regularly includes a review of issues such as strategic planning and goal formation, capital and manpower allocation and planning, and performance appraisals") (citations omitted).

[41]*See* BRODSKY & ADAMSKI, *supra* note 30, § 1.02, at 2.

[42]*See id.*

[43]*See id.*

[44]*See* VARALLO & DREISBACH, *supra* note 40, at 4.

shareholders.[45] The duty of loyalty "precludes a director or officer from appropriating for himself a business opportunity that 'belongs' to the corporation."[46] The duty of loyalty requires the director or officer to show allegiance to the corporate mission and personal disinterest when considering the business affairs of the corporation.[47]

2. Duty of Care

The duty of care requires a director to perform his or her duties in good faith, on the basis of adequate information, in what he or she reasonably believes to be in the best interests of the corporation.[48] A director is expected to use the care that a reasonably prudent person would use in a similar position and circumstance.[49] The duty of care requires a board member to attend meetings, make informed decisions, and supervise activities that are delegated to officers of the corporation.[50]

Many states have codified the duty of care based, in general, on the definition provided by the Revised Model Business Corporation Act.[51] In states without a statutorily defined duty of care, such as Delaware, directors generally "are bound to use that amount of care which 'ordinarily careful and prudent men would use under similar circumstances.'"[52]

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[45]*See* WLR Foods, Inc. v. Tyson Foods, Inc., 869 F. Supp. 419, 421 (W.D. Va. 1994) (citing Glass v. Glass, 321 S.E.2d 69, 74 (Va. 1984); Adelman v. Conotti Corp., 213 S.E.2d 774, 779 (Va. 1975)).

[46]BRODSKY & ADAMSKI, *supra* note 30, § 4:01, at 1 (citing Rowen v. LeMars Mut. Ins. Co., 282 N.W.2d 639, 660 (Iowa 1979)).

[47]*See* Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. Ch. 1939).

[48]*See* BRODSKY & ADAMSKI, *supra* note 30, § 2.04, at 11-12 (citing REV. MODEL BUS. CORP. ACT § 8.30(a) (1998)).

[49]*See id.*

[50]*See id.*

[51]The Revised Model Business Corporation Act defines the duty of care as follows:

(a) A director shall discharge his duties as a director, including his duties as a member of a committee:

(1) in good faith;

(2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and

(3) in a manner he reasonably believes to be in the best interests of the corporation.

REV. MODEL BUS. CORP. ACT § 8:30(a) (1985).

[52]*See* BRODSKY & ADAMSKI, *supra* note 30, § 2:04, at 12 (quoting Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963)).

3. Duty to Creditors

As discussed above, directors and officers owe fiduciary duties to the corporation and its shareholders, and generally not to creditors.[53] Such duties to creditors, however, may arise when the corporation is approaching bankruptcy.[54] Several courts have held that directors and officers of an insolvent company have a fiduciary duty to creditors to protect the assets of the company.[55] Many courts have recognized this fiduciary duty under a trust-fund doctrine, under which the directors are considered trustees of the corporate assets held for the benefit of the insolvent corporation's creditors.[56]

This fiduciary duty arises when the corporation becomes insolvent.[57] "Insolvent" is defined in section 101(32)(A) of the Bankruptcy Code as a "financial condition such that the sum of each entity's debts is greater than all of such entity's property, at a fair valuation."[58] Some courts provide a broader definition of insolvency that also includes a condition wherein a debtor has insufficient "presently salable assets to pay existing debts as

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[53]*See* 1 KNEPPER & BAILEY, *supra* note 22, at 201; *compare* Revlon, Inc. v. Mac Andrews & Forbes Holdings Inc., 506 A.2d 173, 179 (Del. 1986) (holding that a solvent corporation owes a duty of care and loyalty to the corporation and its shareholders) *with* Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504, 1519 (S.D.N.Y. 1989) (holding that directors of solvent corporations do *not* owe fiduciary duties to creditors because creditors' rights are defined by their contracts).

[54]*See* 1 KNEPPER & BAILEY, *supra* note 22, at 203.

[55]*See, e.g.*, Bank Leumi-Le-Israel, B.M., Philadelphia Branch v. Sunbelt Indus., Inc., 485 F. Supp. 556 (S.D. Ga. 1980); Cargill, Inc. v. American Pork Producers, Inc., 426 F. Supp. 499 (D.S.D. 1977); *In re* Healthco Int'l, Inc., 208 B.R. 288 (Bankr. D. Mass. 1997); *In re* Xonics, Inc., 99 B.R. 870 (Bankr. N.D. Ill. 1989); Wieboldt Stores, Inc. v. Schottenstein, 94 B.R. 488 (N.D. Ill. 1988).

[56]*See* Upton v. Tribilcock, 91 U.S. 45, 47-48 (1875); Automatic Canteen Co. of Am. v. Wharton, 358 F.2d 587, 590 (2d Cir. 1966); Mussetter v. Lyke, 10 F. Supp. 2d 944, 964 (N.D. Ill. 1998) (citing Geyer v. Ingersoll Publications Co., 621 A.2d 784, 787 (Del. Ch. 1992)); Malloy v. Korf, 352 F. Supp. 569, 571-72 (E.D. Wis. 1972); Hinz v. Van Dusen, 70 N.W. 657, 659 (Wis. 1897) (citing Beach v. Miller, 22 N.E. 464 (Ill. 1889)).

[57]*See* 1 KNEPPER & BAILEY, *supra* note 22, at 203.

[58]11 U.S.C. § 101(32)(A). In applying this test, "[t]he debtor's assets and liabilities are tallied at fair valuation to determine whether the corporation's debts exceed its assets." Mellon Bank, N.A. v. Metro Communications, Inc., 945 F.2d 635, 648 (3d Cir. 1991), *cert. denied*, Committee of Unsecured Creditors v. Mellon Bank, N.A., 503 U.S. 932 (1992); *In re* Joshua Slocum, Ltd., 103 B.R. 610, 621 (Bankr. E.D. Pa.), *aff'd*, 121 B.R. 442 (E.D. Pa. 1989). Alternatively, in determining whether a company is insolvent, the "assets must be valued at fair market value in the context of a 'going concern' and . . . [the] liabilities should be measured at face value." *In re* Trans World Airlines, Inc., 134 F.3d 188, 190 (3d. Cir.), *cert. denied*, Travelers Int'l AG v. Trans World Airlines, Inc., 523 U.S. 1138 (1998).

they mature."[59] In such a case, the debtor will be deemed insolvent. In addition, another test that is used to determine insolvency is the "unreasonably small capital" test which denotes a financial condition short of "equitable insolvency," but a financial condition that "is likely to lead to insolvency" in the future.[60]

Once a company files for bankruptcy, however, the fiduciary duty owed to creditors by the directors and officers is clear.[61] The Supreme Court in *Commodity Futures Trading Commission v. Weintraub*[62] noted that "the fiduciary duty of the trustee runs to shareholders as well as to creditors."[63] The court further explained, "[I]f a debtor remains in possession—that is, if a trustee is not appointed—the debtor's directors bear essentially the same fiduciary obligation to creditors and shareholders as would the trustee for a debtor out of possession."[64] Thus, directors of a

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[59]Moody v. Security Pac. Bus. Credit, Inc., 971 F.2d 1056, 1066 (3d Cir. 1992) (citing Larrimer v. Feeney, 192 A.2d 351, 353 (Pa. 1963). The court in *Larrimer* established that insolvency has two components under Pennsylvania law: insolvency in the "bankruptcy sense" and insolvency in the "equity sense." *See Larrimer*, 192 A.2d at 353.

[60]Moody v. Security Pac. Bus. Credit, Inc., 971 F.2d 1056, 1070 (3d Cir. 1992) (citing *In re* Vadnais Lumber Supply, Inc., 100 B.R. 127, 137 (Bankr. D. Mass. 1984)). The court reasoned that "[u]nreasonably small capitalization . . . encompasses difficulties which are short of insolvency in any sense but are likely to lead to insolvency at some point in the future." *See id.*

[61]*See* Geyer v. Ingersoll Publications Co., 621 A.2d 784, 787 (Del. Ch. 1992). The court determined that "insolvency in fact" as opposed to "insolvency due to a statutory filing" creates a fiduciary duty to creditors. *See id. accord* Value Property Trust v. Zim Co. (*In re* Mortgage & Realty Trust), 195 B.R. 740, 757 (Bankr. C.D. Cal. 1996) ("It is the time of insolvency, not the time of filing of a bankruptcy case, that determines the ripening of these additional fiduciary duties.").

[62]471 U.S. 343 (1985).

[63]*Id.* at 355.

[64]*Id.* (citing Wolf v. Weinstein, 372 U.S. 633, 649-52 (1963)) ; *see also* Fulton State Bank v. Schipper (*In re* Schipper), 933 F.2d 513 (7th Cir. 1991) (holding that a debtor in possession owes a fiduciary duty to the unsecured creditors); LaSalle Nat'l Bank v. Perelman, 82 F. Supp. 2d 279, 292 (D. Del. 2000) ("The debtor in a Chapter 11 bankruptcy has a fiduciary duty to act in the best interest of the estate as a whole, including its creditors, equity interest holders, and other parties in interest."); *In re* Baldwin-United Corp., 43 B.R. 443, 459 n.22 (Bankr. S.D. Ohio 1984) (citing 11 U.S.C. § 1107(a) (2000)) ("[T]he directors of a Chapter 11 debtor are not fiduciaries of the corporation; rather, they are fiduciaries of the estate, which the debtor-in-possession holds as trustee for the creditors."). Directors of such a debtor are held to the same duties of loyalty and care that directors of insolvent corporations have outside of bankruptcy proceedings. *See also* Bowers v. Atlanta Motor Speedway, Inc. (*In re* Southeast Hotel Properties L.P.), 99 F.3d 151, 152 n.1 (4th Cir. 1996) (quoting Kremen v. Hartford Mut. Ins. Co., 958 F.2d 602, 605 (4th Cir. 1992)) (a "debtor-in-possession" is a fiduciary and owes the same duties as a trustee"); *In re* Federal Roofing Co., Inc., 205 B.R. 638, 642 (Bankr. N.D. Ala. 1996) ("If a debtor remains in possession . . . the debtor's directors bear essentially the same fiduciary obligation to creditors and shareholders as would the trustee for a debtor out of possession").

debtor-in-possession must be mindful not only of the best interests of the creditors, but the estate, as well.[65]

C. *The Most Common Breaches of Fiduciary Duties*

Two types of situations typify a breach of the duty of care: (1) cases in which a board decision is subject to attack, and (2) cases where the board is accused of failing to adequately supervise corporate officers and employees.[66] Each type of situation is described below.

1. Lack of Care in Authorizing or Making Decisions

The duty of care requires that directors and officers perform their duties and make business decisions with good faith and on an informed basis.[67] Thus, directors and officers must inform themselves "of all material information reasonably available to them."[68] "[A] director's decision [must] be made on the basis of 'reasonable diligence' in gathering and considering material information."[69] Courts, for the most part, will assess whether a director made an informed business decision based upon a standard of gross negligence, recklessness, or intentional misconduct.[70] If a director failed to act with the appropriate level of care in making a business decision, the "business judgment rule" would not insulate a director from liability.[71]

The duty to act with care in decision-making requires directors "to proceed with a 'critical eye' by acting in an informed and deliberate manner respecting the corporate merits of an issue before the board."[72] The level of diligence or depth of inquiry necessary to make an informed decision is dependent upon the particular circumstances surrounding the decision.[73] In assessing the sufficiency of the directors' inquiry and analysis, certain

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[65]*Commodity Futures Trading Comm'n*, 471 U.S. at 356.

[66]*See* BRODSKY & ADAMSKI, *supra* note 30, § 2:07, at 39.

[67]*See* Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).

[68]*See id.*

[69]Hanson Trust PLC v. ML SCM Acquisition, Inc., 781 F.2d 264, 274 (2d Cir. 1986).

[70]*See id.* at 274-75; Smith v. Van Gorkom, 488 A.2d 858, 874-78 & n.19 (Del. 1985).

[71]*See Hanson Trust*, 781 F.2d at 275.

[72]Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334, 1345 (Del. 1987) (citing *Van Gorkom*, 488 A.2d at 872-73 (en banc)); *see also Aronson*, 473 A.2d at 812, 816 (discussing the importance of sound business judgment).

[73]*See, e.g.*, *Ivanhoe Partners*, 535 A.2d at 1344-45.

states, such as Delaware, apply a standard of gross negligence, considering whether the directors acted with "'unintelligent and unadvised judgment.'"[74]

Many state statutes provide that a director may rely on information, opinions, reports, or statements prepared by officers or employees of the corporation if the director reasonably believes the officer or employee is reliable and competent in the matters presented.[75] Such reliance, however, is not an absolute defense to a claim alleging a breach of duty of care, as the director still must act with good faith and due care.[76] If the director had knowledge that would have caused his reliance on the representations of others to be unwarranted, good faith may be negated.[77]

2. Failure to Adequately Supervise

Directors and officers may violate the duty of care by failing to adequately supervise officers or employees through lack of attention or some other neglect of duty.[78] A claim based upon a failure to supervise generally alleges that the directors failed to address a particular matter, or failed to detect or prevent misconduct by corporate officers or employees.[79] Although directors may delegate day-to-day corporate affairs, such delegation must be consistent with the directors' exercise of due care.[80] Thus, a decision to delegate will be protected by the exercise of prudent business judgment, so long as the delegation is made with due care.[81] Likewise, a decision by directors concerning whether to address a certain matter, or adopt a policy for dealing with certain issues, will also be protected if the decision is the product of sound business judgment.[82] This protection fails, however, "where directors have either abdicated their functions, or absent a conscious decision, failed to act."[83] The standard of liability for breach of duty of care with respect to a failure to act or neglect

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[74]Gimbel v. Signal Cos., Inc., 316 A.2d 599, 615 (Del. Ch. 1974) (quoting Mitchell v. Highland-Western Glass Co., 167 A. 831, 833 (Del. Ch. 1933)).

[75]*See, e.g.*, DEL. CODE ANN. tit. 8, § 141(e) (2001).

[76]*See* BRODSKY & ADAMSKI, *supra* note 30, § 2:10, at 57.

[77]*See id.*

[78]*See* 1 KNEPPER & BAILEY, *supra* note 22, at 99.

[79]*See id.* at 100 (citing Allied Freightways, Inc. v. Cholfin, 91 N.E.2d 765 (Mass. 1950)) ("A director cannot escape liability for acts of subordinates by abandoning his duties as a director.").

[80]*See* Rosenblatt v. Getty Oil co., 493 A.2d 929, 943 (Del. 1985).

[81]*See* 1 KNEPPER & BAILEY, *supra* note 22, at 100.

[82]*See In re* Caremark Int'l Inc. Derivative Litig., 698 A.2d 959, 967-68 (Del. Ch. 1996) ("Where a director *in fact exercises a good faith effort to be informed and to exercise appropriate judgment*, he or she should be deemed to satisfy fully the duty of attention.").

[83]*Aronson*, 473 A.2d at 813.

was described by the Delaware Court of Chancery in *Rabkin v. Philip A. Hunt Chemical Corp.*[84] as "ordinary negligence."[85]

Directors cannot be held "personally liable for the wrongful acts or omissions of corporate officers or employees merely by virtue of their position as directors."[86] To establish liability, the plaintiff must demonstrate either that the director had knowledge of the wrongful act or that the director, upon exercising due care, should have been aware that the situation required curative action.[87] Lack of knowledge of the wrongdoing is not an absolute defense; directors cannot avoid liability for failing to act by ignoring what is taking place around them regarding the business of the corporation.[88] Directors are imputed with knowledge of facts which they reasonably should have known or uncovered in carrying out their duties.[89] By attending board meetings, a director is expected to acquire a general knowledge about the financial status of the company, as well its managerial structure.[90] "The existence of red flags which would arouse the suspicion of the ordinarily prudent director may trigger a duty to make reasonable inquiries and act with due care regarding the suspicions."[91] Absent cause for suspicion, directors have no duty "to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists."[92] The complete failure of directors to establish procedures to monitor employee compliance, however, could subject directors to liability for failing to exercise due care.[93]

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[84]No. 7547, 1987 Del. Ch. LEXIS 522, at *3, *10 (Del. Ch. Dec. 17, 1987).

[85]*See id.* at *10.

[86]*See* BRODSKY & ADAMSKI, *supra* note 30, § 2:12, at 67-68.

[87]*See id.* at 68 (citing Harman v. Willbern, 374 F. Supp. 1149, 1163 (D. Kan. 1974), *aff'd*, 520 F.2d 1333 (10th Cir. 1975)).

[88]*See id.* (citing Nat'l Automobile & Cas. Ins. Co. v. Payne, 67 Cal. Rptr. 784, 790 (Cal App. 1968)).

[89]*See id.* (citing *Harman*, 374 F. Supp. at 1161, *aff'd*, 520 F.2d 1333 (10th Cir. 1975); Platt Corp. v. Platt, 249 N.Y.S.2d 1, 6 (N.Y. Sup. Ct. 1964), *aff'd*, 258 N.Y.S.2d 629 (N.Y. App. Div. 1965), *rev'd on other grounds*, 21 N.E.2d 134 (N.Y. 1966)).

[90]*See* BRODSKY & ADAMSKI, *supra* note 30, § 2:12, at 68 (citing *Nat'l Automobile & Cas. Ins. Co.*, 67 Cal. Rptr. at 790; Trembert v. Mott, 261 N.W. 109, 114 (Mich. 1935)).

[91]*See id.* (citing Preston-Thomas Constr., Inc. v. Central Leasing Corp., 518 P.2d 1125, 1127 (Okla. Ct. App. 1973); Percy v. Millaudon, 8 Mart. (n.s.) (La. 1829)).

[92]*See* Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963).

[93]*See* ABA Committee on Corp. Law, Section of Corp., Banking and Bus. Law, *Corporate Director's Guidebook*, 33 BUS. LAW. 1591, 1612 (1978); E. Norman Veasey & William E. Manning, *Codified Standard—Safe Harbor or Uncharted Reef? An Analysis of the Model Act Standard of Care Compared with Delaware Law*, 35 BUS. LAW. 919, 929-30 (1980).

III. CREDITORS' COMMITTEE LITIGATION

A. *Standing*

Sections 1103 and 1109 of the Bankruptcy Code grant creditors' committees broad authority to represent the interests of the pool of unsecured creditors. Section 1109 further provides that creditors' committees "may appear and be heard on any issue in a case."[94] As the Bankruptcy Code does not grant express authority for suits commenced by a creditors' committee, it is unclear, therefore, whether a creditors' committee has standing to sue a third party.[95] Courts have been reluctant to allow creditors' committees to commence adversary proceedings on behalf of the estate, particularly when the debtor is willing and able to do so.[96] At least one court, however, has held that a creditors' committee has a "duty" to sue on behalf of the estate in cases whereby the debtor unjustifiably fails to do so.[97] Thus, to file suit on behalf of the estate, the creditors' committee may have to demonstrate the following: "(1) a colorable claim exists that the debtor has not pursued, (2) the committee made a demand upon the debtor to bring the action, and (3) the debtor unjustifiably refused to pursue the action following the demand."[98] While these are not "rigid requirements," it would be prudent for a creditors' committee to make a demand upon the debtor,[99] prior to petitioning the court for standing to sue.

In permitting a suit to go forward, the court in *In re Monsour Medical Center*[100] held that a creditors' committee had an implied authority to sue when the debtor-in-possession failed to take appropriate action.[101]

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[94]*See* 11 U.S.C. §§ 1103(c)(5), 1109(b) (2000).

[95]*See, e.g.*, Official Unsecured Creditors Comm. of Suffola, Inc. v. U.S. Nat'l Bank of Oregon (*In re* Suffola, Inc.), 2 F.3d 977, 979 n.1 (9th Cir. 1993) (recognizing "qualified implied authorization" to commence adversary proceedings in limited circumstances).

[96]*See, e.g.*, Louisiana World Exposition, Inc. v. Federal Ins. Co., 858 F.2d 233, 247 (5th Cir. 1988).

> While the circumstances under which a creditors' committee may sue are not explicitly spelled out in the Code, the bankruptcy courts have generally required that the claim be colorable, that the debtor-in-possession have refused unjustifiably to pursue the claim, and that the committee first receive leave to sue from the bankruptcy court.

[97]*See In re* First Capital Holdings Corp., 146 B.R. 7, 11 (Bankr. C.D. Cal. 1992).

[98]*See* Klee & Shaffer, *supra* note 2, at 1044.

[99]*See id.* at 1045; *see also* Richard N. Chassin, Comment, *Judicial Misinterpretations of Creditors' Committees*, 1 BANKR. DEV. J. 107, 132 (1984).

[100]5 B.R. 715 (Bankr. W.D. Pa. 1980).

[101]*See id.*

The court identified three forms of relief that creditors' committees could seek when a debtor-in-possession breached its statutory duty to sue: (1) petition the court to compel the debtor-in-possession to act, (2) petition for removal of a trustee and the appointment of a trustee in place of the debtor-in-possession, and (3) petition to convert the Chapter 11 bankruptcy to a Chapter 7 case.[102] The court in *In re Wesco Products*[103] recognized the implied right to sue under section 1103(c)(5) of the Bankruptcy Code, which provides that the creditors' committee may "perform such other services as are in the interest of those represented," in the event that the debtor-in-possession has failed to act.[104] The court in *In re Segarra*,[105] however, came to a contrary conclusion, denying a creditors' committee the right to sue even when the debtor-in-possession unjustifiably failed to pursue a legitimate claim.[106]

B. *Doctrines Limiting Directors' and Officers' Liability*

Creditors' committees must be mindful of two potential limitations on directors' and officers' liability: (1) the business judgment rule, and (2) statutory limitations on liability.[107] Under the business judgment rule, directors and officers may be protected if they acted in good faith and with the requisite due care. Many states have added enacted legislation granting further protection to directors and officers by limiting personal liability and placing certain monetary limitations on liability.[108]

1. Overcoming Business Judgment Rule

Directors and officers charged with breaching a fiduciary duty may raise the "business judgment rule," as a defense which can limit their exposure to liability.[109] Under the rule, so long as a director acts in good faith and with due care, he or she cannot be held liable for business decisions.[110] As such, "courts will not second-guess business decisions by

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[102]*See id.* at 718.

[103]22 B.R. 107 (Bankr. N.D. Ill. 1982).

[104]*See id.* at 109 (citing *In re Monsour Med. Ctr.*, 5 B.R. at 715).

[105]14 B.R. 870 (Bankr. D.P.R. 1981).

[106]*See id.* at 878.

[107]*See infra* Part III.B.2.

[108]*See id.*

[109]*See, e.g.*, *LaSalle Nat'l Bank*, 82 F. Supp.2d at 292; *cf. In re* Revco D.S., Inc., 118 B.R. 468, 476 (N.D. Ohio 1990); Peoples Banking Co. v. Derryberry (*In re* Hartley), 50 B.R. 852, 863-64 (N.D. Ohio 1985) (discussing the effects of personal bias on sound business judgment).

[110]*See* Treco, Inc. v. Land of Lincoln Sav. & Loan, 749 F.2d 374, 377 (7th Cir. 1984).

directors if the directors follow appropriate procedures in making the decision."[111] The rule thereby recognizes that "directors are, in most cases, more qualified to make business decisions than are judges."[112] That is, "the responsibility for business judgments must rest with the corporate directors; their individual capabilities and experience peculiarly qualify them for the discharge of that responsibility."[113]

The Delaware Supreme Court explained in *Aronson v. Lewis*[114] that 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."[115] "The business judgment rule, thus, prevents a substantive review of the merits of a business decision made by directors acting, without self-dealing, and in good faith and with due care."[116] A plaintiff who challenges a business decision not involving self-dealing has the burden of rebutting the application of the business judgment rule.[117]

Because of its presumption, the business judgment rule gives directors and officers great latitude when making complex business decisions and operates to avoid overly conservative management that likely would result if directors and officers were exposed to excessive liability.[118] As such, it provides an incentive for individuals to serve as directors, particularly as outside directors.[119]

The business judgment rule is not absolute, however, and contains a number of exceptions. For example, the presumption that the judgment of directors or officers is proper applies only when a judgment has, in fact,

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[111] 1 KNEPPER & BAILEY, *supra* note 22, at 47. "Courts recognize that after-the-fact litigation is a most imperfect device to valuate corporate business decisions." *Id.* at 52; *see also* Panter v. Marshall Field & Co., 646 F.2d 271, 297 (7th Cir. 1981) (reasoning that the business judgment rule is designed to prevent "Monday morning-quarterbacking").

[112] International Ins. Co. v. Johns, 874 F.2d 1447, 1458 n.20 (11th Cir. 1989).

[113] Auerbach v. Bennett, 393 N.E.2d 994, 1000 (N.Y. 1979).

[114] 473 A.2d 805 (Del. 1984).

[115] *Id.* at 812.

[116] BRODSKY & ADAMSKI, *supra* note 30, § 2:06, at 32; *see also In re* J.P. Stevens & Co. Shareholders Litig., 542 A.2d 770, 780 (Del. Ch. 1988) (stating the proposition that business judgments made in good faith are not subject to review).

[117] *See Aronson*, 473 A.2d at 812 (citations omitted).

[118] *See* Dynamics Corp. of Am. v. CTS Corp., 794 F.2d 250, 256 (7th Cir. 1986), *rev'd on other grounds*, CTS Corp. v. Dynamics Corp. of Am., 481 U.S. 69 (1987); Joy v. North, 692 F.2d 880, 886 (2d Cir. 1982); Cramer v. General Tel. & Elecs. Corp., 582 F.2d 259, 274 (3d Cir. 1978); Granada Invs., Inc. v. DWG Corp., 823 F. Supp. 448, 454-55 (N.D. Ohio 1993).

[119] *See, e.g.*, Weiss v. Temporary Inv. Fund, Inc., 692 F.2d 928, 941 (3d Cir. 1982), *vacated and remanded on other grounds*, 465 U.S. 1001 (1984).

been made.[120] Accordingly, "[w]hen courts say that they will not interfere in matters of business judgment, it is presupposed that judgment —reasonable diligence—has in fact been exercised."[121] Thus, although a conscious decision not to take action may be protected by the business judgment rule, the rule does not apply to cases in which "directors have either abdicated their functions, or absent a conscious decision, failed to act."[122] Moreover, although directors are given wide discretion to act under the business judgment rule without fear of liability or judcial second-guessing, the rule will not shelter a director who failed to act in good faith, or whose decision was a "gross abuse of discretion."[123]

2. Circumventing Statutes Limiting Liability

Most states have enacted statutes that allow corporations to limit the exposure of directors to personal liability, or that otherwise limit or eliminate monetary liability.[124] The law of the state of incorporation will generally govern substantive issues relating to director and officer liability.[125] States generally have taken two approaches to limiting liability: (1) providing relief from civil liability to directors and sometimes officers, and (2) expanding the scope of financial protection for directors and officers.[126] States that provide relief from civil liability have adopted one or more of the following concepts: (1) authorizing corporate charter provisions to eliminate or restrict personal liability for money damages; (2) statutory "self-executing elimination or restriction" of personal liability; (3) heightening the level of proof required to impose personal liability; (4) expanding the scope of "criteria and constituencies" directors may consider in making decisions; and (5) enacting or modifying statutes setting forth standards of conduct.[127] Specific criteria must be met, however, to take advantage of state statutes limiting liability; therefore, it is important for

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[120]*See, e.g.*, Casey v. Woodruff, 49 N.Y.S.2d 625, 643 (N.Y. Sup. Ct. 1944).

[121]*Id.*

[122]*Aronson*, 473 A.2d at 813; *see also* Rales v. Blasband, 634 A.2d 927 (Del. 1993) (reasoning that a director's failure to act precludes the application of the business judgment rule); *In re* Prudential Ins. Co. Derivative Litig., 659 A.2d 961, 968 (N.J. Super. Ct. Ch. Div. 1995) (holding that demand is excused where the complaint evidences the inability of the board to exercise its power).

[123]*See* BRODSKY & ADAMSKI, *supra* note 30, § 2:06, at 34. It is important to note that the business judgment rule does not apply if the directors have breached their duty of care.

[124]*See, e.g.*, 1 KNEPPER & BAILEY, *supra* note 22, at 3.

[125]*See id.*

[126]*See id.*

[127]*See id.*

attorneys representing the creditors' committee to carefully determine whether these statutory limitations may be raised.[128]

For example, relatively recent sections of the Delaware Code permit a corporation to adopt provisions in its certificate of incorporation to eliminate or limit personal liability of directors.[129] The Delaware law allows corporations to limit the liability of directors *only* in shareholders' actions or in actions by or in the right of the corporation.[130] Additionally, the Delaware law does not limit liability for breach of duty of loyalty for acts or omissions not in good faith.[131] As such, the distinction between a breach of duty of loyalty versus a breach of duty of care is clearly important. The Delaware law allows corporations to eliminate personal liability for breaches of the duty of care, unless the breach can be characterized as a breach of duty of loyalty, a breach of duty involving intentional misconduct, or an action or omission not taken in good faith.[132] The Delaware Supreme Court, in *Emerald Partners v. Berlin*,[133] characterized the Delaware law as an affirmative defense for directors, therefore, in a well-pleaded case plaintiffs may be able to prevent directors from attempting to limit liability.[134]

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[128]*See, e.g.*, 1 KNEPPER & BAILEY, *supra* note 22, at 3.

[129]*See* DEL. CODE. ANN. tit. 8, § 102(b)(7) (Supp. 1998). The Delaware law protects only directors. *See id.* A majority of states have enacted statutes following the model found in the Delaware law. *See, e.g.*, ALA. CODE § 10-2B-2.02(b)(3) (1999); ALASKA STAT. § 10.06.210(N) (Michie 2000); ARIZ. REV. STAT. ANN. § 10-202(B)(1) (1995); ARK. CODE ANN. § 4-27-202(b)(3) (Michie 2001); CAL. CORP. CODE §§ 204(a)(10), 204.5 (West 1990); COLO. REV. STAT. ANN. § 7-108-402 (1999); IDAHO CODE ANN. § 30-1-202(2)(d) (Michie 1999); 805 ILL. COMP. STAT. ANN. 5/2.10(b)(3) (1993); IND. CODE ANN. § 23-1-35-1(e)(1), (2) (1999); IOWA CODE ANN. § 490.832 (1999); KAN. STAT. ANN. § 17-6002(b)(8) (1995); LA. REV. STAT. ANN. § 12:24C(4) (West 1994); MASS. GEN. LAWS ch. 156B, § 13(b)(1½) (1992); MINN. STAT. ANN. §§ 302A.251(4), 302A.111(4)(u) (West 1985); MONT. CODE ANN. § 35-1-216(2)(d) (2001); NEB. REV. STAT. ANN. § 21-2018(2)(d) (1999); N.J. STAT. ANN. §§ 14A:2-7(3), 14A:6-14(3) (Supp. 2002); N.D. CENT. CODE § 10-19.1-10(5)(u), 10-19.1-50(5) (2001); OKLA. STAT. ANN. tit. 18, § 1006(B)(7) (Supp. 2002); R.I. GEN. LAWS 7 1.1 48(a)(6) (1999); S.C. CODE ANN. § 33-2-102(e) (Law Co-op. 1990); S.D. CODIFIED LAWS § 47-2-58.8 (Michie 2000); TENN. CODE ANN. § 48-12-102(b)(3) (2001); *cf.* TEX. REV. CIV. STAT. ANN. art. 1302, § 7.06 (Vernon 1997); UTAH CODE ANN. § 16-10a-202(2)(iv) (2001); VT. STAT. ANN. tit. 11A, § 2.02(f)(4) (1997); WYO. STAT. ANN. tit. 17, § 17-16-202(b)(iv) (Michie 2001). A broad variety of statutes limiting liability exist in the remaining states.

[130]*See, e.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7) (Supp. 1998).

[131]*See id.*

[132]*See id.* §102(b)(7)(i)-(iii).

[133]726 A.2d 1215 (Del. 1999).

[134]*See id.* at 1223.

C. *Statute of Limitation Issues*

Applicable statutes of limitation may bar the recovery of damages that occurred prior to the limitations period. Several exceptions, however, may be applicable to allow for the recovery of damages as a result of actions taken prior to the limitations period.

1. Applicable Statutes of Limitation

Statutes of limitation applicable to creditors' committee litigation may include statutes in the debtor's state of incorporation, as well as statutes in states in which the debtor conducts business depending on the choice of jurisdiction. Many statutes provide for a three-year limitations period from the date the cause of action accrues.[135] Thus, it is important for creditors' committees to promptly file claims against directors and officers before the expiration of the applicable limitations periods.

2. Tolling of Statutes of Limitation

The Bankruptcy Code may provide some relief from state statutes of limitation. When a trustee steps into the shoes of the debtor, the trustee is given an extension of time to file an action, assuming the limitations period for commencing the action did not expire prior to filing the bankruptcy.[136] Section 108 of the Bankruptcy Code provides:

> (a) If applicable nonbankruptcy law . . . fixes a period within which the debtor may commence an action, and such period has not expired before the date of the filing of the petition, the trustee may commence such action only before the later of—
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> (1) the end of such period, including any suspension of such period occurring on or after the commencement of the case; or
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> (2) two years after the order for relief.[137]

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[135] *See, e.g.*, DEL. CODE ANN. tit. 10, § 8106 (1999) ("[N]o action to recover damages caused by an injury unaccompanied with force or resulting indirectly from the act of the defendant shall be brought after the expiration of 3 years from the accruing of the cause of such action . . . ."); MD. CODE ANN. CTS. & JUD. PROC. § 5-101 (1998) ("A civil action at law shall be filed within three years from the date it accrues unless another provision of the Code provides a different period of time within which an action shall be commenced.").

[136] *See, e.g.*, 11 U.S.C. § 108(9) (2000).

[137] *Id.*

Accordingly, it is apparent that the extension of time for filing suit provided in the Bankruptcy Code may permit claims to be asserted against acts that would otherwise be precluded by state statutes of limitation.

3. The Doctrine of Adverse Domination

The doctrine of adverse domination, another exception to certain states' statutes of limitation, may be applicable as well. "The adverse domination doctrine provides that while culpable individuals continue to have superior power over a corporation, limitations are tolled until a majority of disinterested directors discover or are put on notice of a cause of action."[138] In discussing this doctrine, the court in *RTC v. Gardener*[139] establishes:

> a cause of action will be tolled during the period that a plaintiff corporation is controlled by wrongdoers. Tolling is considered appropriate because where culpable directors and officers control a corporation, they are unlikely to initiate actions or investigations for fear that such actions will reveal their own wrongdoing.[140]

Under the reasoning in *Gardner*, statutes of limitations for claims made against directors would be tolled by showing through a D&O investigation that targeted directors and officers were in control of the debtor until their resignation from the Board. The doctrine of adverse domination, therefore, could be used to permit assertion of claims against directors and officers during the entire period of wrongdoing even when state statutes would otherwise limit such actions.[141]

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[138]Askanase v. Fatjo, 828 F. Supp. 465, 471 (S.D. Tex. 1993) (citations omiited).

[139]798 F. Supp. 790 (D.D.C. 1992).

[140]*Id.* at 795.

[141]However, the doctrine of adverse domination is not accepted in all states. No cases have been found in Delaware that adopt this exception to its statute of limitation. Other states have explicitly recognized the doctrine of adverse domination. *See, e.g.*, Hecht v. RTC, 635 A.2d 394, 406 (Md. 1994) (concluding that fairness required application of doctrine of adverse domination "in the context of corporate claims against directors and officers"); *see also* Lease Resolution Corp. v. Larney, 719 N.E. 2d 165, 170 (Ill. App. Ct. 1999) (reasoning that adverse domination operates to toll the statute of limitations period for claims by a corporation against its officers and directors for the period during which the corporation was controlled by the particular 'wrongdoing" directors); RTC. v. Scaletty, 891 P.2d 1110, 1116 (Kan. 1995)(holding that "[t]he doctrine of adverse domination is recognized in Kansas as the appropriate method for determining . . . when injury to the corporation by its directors is readily ascertainable by the corporation); RTC. v. Greer, 911 P.2d 257, 264 (Okla. 1995)(establishing that the adverse domiantion doctrine

D. *The Automatic Stay of Non-Bankruptcy Litigation*

Section 362(a) of the Bankruptcy Code automatically stays all non-bankruptcy litigation against the debtor.[142] The automatic stay becomes effective upon the filing of the bankruptcy petition and remains in effect until the proceeding is closed or dismissed or until the debtor's property is no longer property of the bankrupt estate.[143] Two types of actions stayed by section 362(a) may arguably be relevant to director and officer suits:

> (1) the commencement . . . of a judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the commencement of the case under [the Bankruptcy Code], or to recover a claim against the debtor that arose before the commencement of the case under [the Bankruptcy Code]; [or]
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> . . . .
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> (3) any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate . . . .[144]

Actions against a debtor's directors and officers are not generally stayed in Chapter 11 or Chapter 7 cases under section 362(a).[145] In fact, absent "unusual circumstances," the plain language of section 362(a) generally applies only to debtors.[146] An "unusual situation" may arise, however, "when there is such identity between the debtor and the third-party defendant that the debtor may be said to be the real party defendant and that a judgment against the third-party defendant will in effect be a

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is only available to corporations); RTC v. Grant, 901 P.2d 807, 809 (Okla. 1995) (finding that the doctrine of adverse domination is applicable to cases involving fraudulent conduct on behalf of a corporation's directors and officers during that period of time the corporation is controlled by such directors and officers); FDIC v. Smith, 980 P.2d 141, 145 (Or. 1999) (acknowledging that the doctrine of adverse domination presupposes that it is impossible for a corporation to initiate a suit while it is controlled by guilty officers and directors); Clark v. Milam, 452 S.E.2d 714, 719 (W. Va. 1994) (reaffirming that the equitable nature of the doctrine of adverse domination provides for the tolling of the applicable statute of limitations period).

[142]*See* 11 U.S.C. § 362(a) (2000).

[143]*See* 1 KNEPPER & BAILEY, *supra* note 22, at 69.

[144]11 U.S.C. § 362(a) (2000).

[145]*See, e.g.*, Bedel v. Thompson, 103 F.R.D. 78, 81-83 (S.D. Ohio 1984) (action against former directors for violations of securities laws not stayed).

[146]Credit Alliance Corp. v. Williams, 851 F.2d 119, 121-22 (4th Cir. 1988); *see also In re* First Cent. Fin. Corp., 238 B.R. 9, 18-19 (Bankr. E.D.N.Y. 1999) (explaining that automatic stay is meant to apply when actions would threaten debtor's reorganization).

judgment or finding against the debtor."[147] Some courts have found that this relationship exists in an action against a director or officer who is fully indemnified by the debtor.[148] Other courts, however, have rejected this argument.[149]

In any event, a bankruptcy court may, after notice and hearing, grant relief from an automatic stay, thereby allowing creditors' committee litigation to proceed.[150]

E. *Insurance Issues*

A thorough analysis of the existing D&O Policies will give creditors' committees a clear view of whether there are funds to be recovered from this source. Further, attorneys for the creditors' committee will want to establish the parameters under which the committee may bring suit and be prepared to fight over the insured versus insured exclusion.

1. Determining the Policy Scope and Limits

In evaluating an individual's claim under a D&O Policy, a creditors' committee must show that the alleged misconduct falls within the scope of coverage under the policy. That is, the creditors' committee must show that the corporation had a D&O Policy that was effective during the time of the

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[147]A.H. Robins Co. v. Piccinin, 788 F.2d 994, 999 (4th Cir. 1986).

[148]*See, e.g.*, Eastern Air Lines, Inc. v. Rolleston, 111 B.R. 423, 435 (Bankr. S.D.N.Y. 1990) (finding that if indemnification rights of a party are so intimately intertwined with those of debtor that debtor may be said to be a real party in interest, and an extension of automatic stay under § 105 would be justified), *aff'd in part sub nom, In re* Ionosphere Clubs, Inc., 124 B.R. 635 (S.D.N.Y. 1991).

See also In re Family Health Servs. Inc., 105 B.R. 937 (Bankr. C.D. Cal. 1989).

> [A] third party who is entitled to absolute indemnity by the debtor on any judgment rendered against that third party is the proper subject for application or extension of the statutory stay. This 'identity of interests' provides the special or 'unusual circumstances' which justify an order that stays proceedings against non-debtor parties.

Id. at 942 (citations omitted).

[149]*See, e.g.*, United States v. Huckabee Auto Co., 783 F.2d 1546, 1547-48 (11th Cir. 1986) (holding that because officer's liability is separate and distinct from any liability of the corporation, a bankruptcy court does not have jurisdiction to stay action against officer); *see also* Reliance Acceptance Group, Inc. v. Levin (*In re* Reliance Acceptance Group, Inc.), 235 B.R. 548, 556-62 (D. Del. 1999) (refusing to abrogate right of shareholders to sue directors and officers based on debtor's argument that such litigation might diminish funds available under D&O insurance policy, increase amount of claims for indemnification by directors and officers, and allow directors and officers to set off amounts paid to shareholders in a subsequent claim by a debtor).

[150]*See* 11 U.S.C. § 362(d) (2000).

alleged wrongdoing. Further, the creditors' committee must determine if the alleged action or inaction on the part of target directors and officers falls under the policy's definition of "wrongdoing."[151] Lastly, a creditors' committee should be aware of the policy limit for each claim.

2. Timeliness of Demand: Claims-Made Policies

Most D&O Policies are "claims-made" policies under which a claim must be asserted against a director or officer during the policy period to obtain coverage under the policy.[152] Therefore, a creditors' committee may obtain D&O coverage under a policy for alleged wrongdoing that occurred prior to the policy period, if the claim is made during the policy period. To reach this coverage, notice of any alleged claims under the D&O policy must be made under the requirements of the policy and prior to the expiration of the policy. Attorneys for the creditors' committee should carefully give notice under the relevant policy directives and follow-up any notice given. By giving timely notice, the committee will be able to preserve any claims it may not be prepared to make prior to the policy's expiration. This enables the committee, with its professionals, to make an adequate investigation before beginning negotiations with the insurance company or before bringing suit against directors and officers.

3. Exclusion: The Insured versus Insured Quagmire

One hurdle to recovering from the insurance policy is the "insured versus insured" exclusion in the policy.[153] An insured versus insured exclusion typically prevents one insured, such as a corporation, from suing another insured, such as a director or officer of the corporation. Therefore, the issue in the present context is whether a creditors' committee is an "insured" for purposes of the policy exclusion—that is, whether the creditors' committee is suing on behalf of the creditors or on behalf of the

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[151] *See supra* text accompanying notes 27-28.

[152] *See* OLSON & HATCH III, *supra* note 29, § 10.061, at 10-15.

[153] An insured versus insured exclusion may set forth language similar to the following:

> The Insurer shall not be liable to make any payment for Loss in connection with a Claim made against an Insured which is brought by or on behalf of the Company against any individual insured; provided however, this exclusion shall not apply to any derivative Claim made on behalf of the Organization by a member, an attorney general, or any other such representative party if such action is brought and maintained independently of and without solicitation of or assistance of, or active participation of or intervention of any Individual Insured or the Organization or any Affiliate thereof.

debtor-in-possession. A few courts have addressed this question tangentially, but the issue remains unsettled.

The court in *In re Pintlar Corp.*[154] found that the exclusion would not bar litigation trustees from seeking recovery where all D&O claims had been assigned to trustees appointed after confirmation of a reorganization plan. The court held that the insured versus insured exclusion did not bar the trustees from recovering under the policy because "the litigation Trustees are not acting for the benefit of the corporation, but for the benefit of the corporation's creditors, including the shareholders."[155] In reaching this conclusion, the court explained that the claims against the officers and directors essentially belonged to the creditors acting through the litigation trustees because "[t]he primary purpose of the plan is to marshal the remaining assets of [the corporations] for payment of creditors."[156] The court then analogized the claims to those that could have been brought by the corporations' shareholders prior to the bankruptcy filing in a shareholders' derivative action:[157] "These are the same claims a shareholder could have pursued prior to the filing of the Chapter 11 petitions. After the filing of the Chapter 11 petitions, these claims were barred by the section 362 automatic stay. The defendants' coverage would have extended to these shareholders' derivative actions."[158] Accordingly, the court concluded that "to the extent that such action is analogous to a shareholders' derivative action coverage may be provided."[159]

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[154]205 B.R. 945 (Bankr. D. Idaho 1997).

[155]*Id.* at 948.

[156]*Id.* at 947-48.

[157]*Id.* at 948. The shareholder is permitted "to step into the corporation's shoes and to seek in its right the restitution he could not demand in his own." *Id.* Injury to the corporation is a prerequisite to bringing a shareholder derivative action, and any recovery in the suit will be made to the corporation. *See* Kauffman v. Dreyfus Fund, Inc., 434 F.2d 727, 732 (3d Cir. 1970) (holding that the purpose of a derivative suit is redressing injury to the corporation rather than to the individual stockholder). Among other requirements, a shareholder must allege that he or she made efforts to obtain the action requested from the directors and/or the reasons for failing to make the effort or to obtain the action desired. *See* Fed. R. Civ. P. 23.1 (shareholder must make demand on Board unless such demand is excused). Demand will be excused when the shareholder asserts particularized facts sufficient to show the "futility" of demand. The futility exception applies to limited circumstances when a shareholder may bypass the board's business judgment in deciding not to take over the litigation. *See* Kamen v. Kemper Fin. Servs., Inc., 500 U.S. 90, 92 (1991). Standards for determining whether shareholders have demonstrated futility are codified in state law and differ from jurisdiction to jurisdiction. Thus, shareholders in a derivative suit stand in a similar position to a creditors' committee in this respect.

[158]*Pintlar*, 205 B.R. at 948.

[159]*Id.*; *see also* Hurley v. Columbia Gas Co., 976 F. Supp. 268 (D. Del. 1997) (implicitly adopting principles underlying *Pintlar* decision); *In re* Buckeye Countrymark, Inc., 251 B.R. 835, 841 (Bankr. S.D. Ohio 2000) (bankruptcy trustee is neither the same entity or the alter ego of the debtor nor brings claims on behalf of the debtor; rather the trustee brings claims on behalf of the

The same reasoning has been adopted in several FDIC cases where the FDIC, as receiver for a failed bank, sought insurance coverage that otherwise would be barred by the insured versus insured exclusion.[160] This reasoning is sound because the intent behind the insured versus insured exclusion "is to protect insurance companies against collusive suits between the insured corporation and its insured officers and directors."[161] When the plaintiff in a D&O action is a trustee suing on behalf of creditors or, more specifically, a creditors' committee suing directly, the party is genuinely adverse to the defendant directors and officers and there can be no threat of collusion.[162]

Several courts, however, have reached an opposite conclusion when considering whether a debtor-in-possession may recover under an insurance policy. These courts have found that if the debtor-in-possession stands in the shoes of the bankrupt corporation that could not have recovered on the policy, the debtor-in-possession would therefore be barred as well.[163] In *Reliance Insurance Co. of Illinois v. Weis*,[164] for example, the court found that the insured versus insured provision barred the D&O coverage sought by the distribution and liquidation agent for a corporation that had filed for bankruptcy protection. The court reasoned that although the benefits of

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creditors making exclusionary language inapplicable).

[160]*See, e.g.*, American Cas. Co. v. Sentry Fed. Sav. Bank., 867 F. Supp. 50, 60 (D. Mass. 1994) (holding that insured versus insured exclusion did not bar insurance coverage for claims asserted against directors and officers by RTC because intent behind exclusion is to protect insurer from collusion, a concern not implicated when party is adverse); Slaughter v. American Cas. Co., 842 F. Supp. 371, 374 (E.D. Ark. 1993) (finding that an insured versus insured exclusion did not bar coverage for RTC claims against directors and officers because RTC was genuinely adverse party and RTC is authorized to bring suit as creditor on behalf of creditors and shareholders and as subrogee to rights of depositors), *rev'd on other grounds*, 37 F.3d 385 (1994).

[161]*In re Buckeye Countrymark, Inc.*, 251 B.R. at 841; *see also American Cas. Co.*, 867 F. Supp. at 60; Conklin Co. v. National Union Fire Ins. Co., No. 4-86-860, 1987 U.S. Dist. LEXIS 12337 (D. Minn. Jan. 28, 1987).

[162]*See In re Buckeye Countrymark, Inc.*, 251 B.R. at 841. Another approach under a claims made insurance policy would be to show that the relevant time for determining whether someone was an "insured" would be at the time the suit was filed. *See* Township of Center, Butler Cty., Pa. v. First Mercury Syndicate, Inc., 117 F.3d 115, 118 (3d Cir. 1997). Thus, a creditors' committee might not be considered an insured.

[163]*See, e.g.*, Fidelity & Deposit Co. of Md. v. Conner, 973 F.2d 1236 (5th Cir. 1992) (rejecting FDIC's arguments that it was entitled to coverage under the D&O policy issued to the failed bank reasoning that FDIC had no greater rights than the insured); Mt. Hawley Ins. Co. v. Fed. Sav. & Loan Ins. Corp., 695 F. Supp. 469 (C.D. Cal. 1987) (holding that claims brought by the FSLIC as receiver for insolvent bank against bank's directors and officers were excluded under the insured versus insured endorsement to D&O policy); Reliance Ins. Co. of Ill. v. Weis, 148 B.R. 575 (E.D. Mo. 1992) (denying coverage under insured versus insured exclusion in insurance policy).

[164]148 B.R. 575 (E.D. Mo. 1992).

claims against former officers might inure to the benefit of the creditors, the claims were filed "on behalf of" the corporation and its estate.[165] The court rejected the argument that the claims were being asserted derivatively on behalf of the corporation's shareholders.[166]

Insurance companies may not wish to test the scope of the insured versus insured exclusion again because they risk getting a definite unfavorable answer that would allow recovery by creditors' committees. Attorneys for creditors' committees, however, must be prepared to fight this potential obstacle to recovery.

F. *The Investigation*

Attorneys and professionals retained by the creditors' committee will perform a thorough investigation for the purpose of determining whether directors and officers of the debtor committed any wrongdoing in their oversight of the debtor. The investigation may encompass the review and analysis of key financial documents, board minutes, corporate documents, and insurance policies obtained informally from the debtor. If the debtor fails to cooperate, the creditors' committee may issue subpoenas for these relevant documents.[167] Attorneys and professionals will then research and assess whether the committee and/or the estate may have claims against directors and officers for mismanagement, breach of duty, or any other harm, and if so, determine the approximate damage claims and potential recovery from individual officers and directors or under relevant D&O policies. The attorneys and professionals also will analyze any potential defenses and challenges to a suit. The attorneys and professionals will update the committee periodically and may provide interim and final reports. The committee will retain control over the investigation, directing the attorneys and professionals to take action in the best interests of the creditors and the estate.

Attorneys and professionals can be retained under agreements where the investigation may be performed in logical steps, thereby limiting costs to the estate and clearly delineating when and if further investigation may be appropriate.

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[165] *See id.* at 583.

[166] *See id.*

[167] *See, e.g.*, FED. R. BANKR. P. 7027 (providing that witnesses can be interviewed informally or deposed under Bankruptcy Rule 7027).

G. *Issues Unique to Dot-Com Bankruptcies*

Dot-com entities, by the very nature of the fast-paced e-commerce environment, can be fertile targets of director and officer investigations. Proper business judgment may not have been followed in many areas of decision-making, including undertaking expansion programs and making acquisitions. Directors and officers are not insulated from liability when the dot-com entity fails because of business decisions made without proper analysis and prudent due diligence, nor are they insulated when the dot-com entity fails because directors and officers put their own interests ahead of the entity's. Directors may give management "free reign" to run the day-to-day business of the entity, thereby failing to properly supervise officers. Dot-com entities that have various related corporate entities may have engaged in related entity transactions that are improper and preferential. Financial expenditures may have been inappropriate and imprudent and, as such, caused a rapid depletion of capital. When spending is grossly disproportionate to the dot-com entity's revenue and profits, those expenses often are "red flags" that indicate the directors and officers have violated their duties of care and loyalty.

In many cases, all of a dot-com entity's assets will be pledged to secured lenders, and the unsecured creditors face the potential of a complete loss of their investment. The following sections provide insight into the most common mistakes made by directors and officers that might give rise to liability, using examples from recent dot-com failures.

1. Too Much, Too Soon: Boo.com

The dreams of two young Swedish entrepreneurs to "raise enormous sums of cash, spend lavishly on advertising, lose money on every sale, take the company public and make every employee a billionaire"[168] were dashed when Ernst Malmsten and Kajsa Leander were forced to call liquidators six months after the debut of their company Boo.com. The website, which would provide global online fashion service in seven languages and multiple currencies using advanced technology allowing shoppers to view products in three dimensions from 360 degrees, may have been an overly ambitious effort. Investors provided a quick $125 million to Malmsten and Leander who had previously started an online bookstore, and the founders of Boo.com spent large sums of money promoting their website in trade journals and glossy fashion magazines. The pair established headquarters

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[168] Andrew Ross Sorkin, *Boo-com, Online Fashion Retailer, Goes Out of Business*, N.Y. TIMES, May 19, 2000, at C4.

on upscale Carnaby Street in London and opened satellite offices in New York, Paris, Stockholm, Amsterdam, and Munich. It ultimately operated in eighteen countries, and, as such, opening in multiple countries was considered to be part of the downfall of the company. A staff that expanded quickly from forty to four hundred routinely flew first class and stayed at the finest international hotels. One analyst noted that the dot-com had "very little spending restraint."[169] At the same time, the website fell upon technical problems and delays, and development fell behind. Its advanced technology prevented many average Internet users from using the website, blocking a huge market share.[170]

2. Internet Still Is Wildly Unprofitable

"Typically, startups haven't yet turned a profit, thus making it virtually impossible to reorganize."[171] Palo Alto software firm TOC Holding Co, for example, which provided service for PCS over the Internet, filed for bankruptcy protection in 1997 after accumulating $3.5 million in debt.[172] The company, which sold subscription to a computer-maintenance website known as Tuneup.com, also sold software packages and provided advice to computer users. Although approximately 5,000 customers bought software and subscribed to the website, it was not enough to sustain the business.[173]

Many dot-com entities that are related to, or have financial backing from bricks-and-mortar companies, have been unable to turn a profit. For example, IdeaForest.com, an online arts and crafts store with backing from Jo-Ann Fabric Stores, Inc., laid off staff shortly after launching the website.[174]

3. Nature of the Board: Young and Inexperienced

Directors and officers of dot-com entities may make poor business decisions that will impact the profitability of the company. For example, "Toysmart.com's downfall can be traced to several factors, including

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[169] *Id.*

[170] *See id.*

[171] *Mouse Trap*, 17:40 BUS. J., June 30, 2000, at 1.

[172] Pete Barlas, *TOC Holding Latest Internet Company to File Bankruptcy*, 15:4 BUS. J.—SAN JOSE, May 26, 1997, at 6.

[173] *See id.*

[174] Lucas Mearian, *Three More Dot-Coms Hit by Financial Problems*, COMPUTERWORLD, Jan. 10, 2001.

problems with management and the company's business model, as well as poor timing."[175] The company launched a "substantial advertising campaign that, according to *Adweek* magazine, cost the company $21 million."[176]

Woodtech Information Systems, an Internet service provider (ISP) that attempted to avoid filing for bankruptcy in February 1997, had only one officer and may have suffered from a lack of management oversight. For example, two employees were charged with computer tampering against another local ISP.[177]

4. Unique Assets Must Be Preserved

"The Internet is not a typical bricks-and-mortar business where people can get a recovery through liquidation."[178] The real assets of a dot-com entity are "in the minds of the company employees. If they walk out the door, the assets walk out the door with them."[179] Most dot-com entities are "built on ideas, concepts, patents and intellectual property."[180] Other "cyberassets" are "intangible in nature and consist of software licenses, patents, trademarks and other intellectual property," such as domain names and a web presence.[181] Thus, dot-com entities generally have no conventional assets: no real estate, no inventory, no warehouse. The value of intangible assets "is far more difficult to pin down, and bankers, lawyers and consultants have little to go on."[182] Intangible assets, therefore, may be valued by "whatever a bidder is willing to pay for them."[183] Thus, it is

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[175] *Mouse Trap*, *supra* note 171, at 1.

[176] *Id.*

[177] Paul Flemming, *Woodtech Offers 10 Percent to Its Creditors*, 17:40 SPRINGFIELD BUS. J., April 7, 1997, at 1.

[178] Frank Alvarado, *Faltering Net Firms Will Find Bankruptcy Lawyers Reluctant*, BROWARD DAILY BUS. REV., Mar. 13, 2000, at A1 (quoting Thomas Lauria, a Miami bankruptcy attorney).

[179] *Id.*

[180] *Failing Dot-Coms Usher in a New Legal Era*, 20:17 BOSTON BUS. J., June 2, 2000, at 1.

[181] *Can an Internet Company Be Reorganized?*, 36:1 BCD NEWS & COMMENT, May 31, 2000 (quoting Robert P. Simons, an attorney for MCI Worldcom, the largest creditor in the AGIS bankruptcy); *see also* John F. Manser, *Dot-com Bankruptcy Filing a Sign?*, NAT'L L.J., June 26, 2000, at B1 (dot-com assets may include proprietary information, such as "highly sophisticated demographic lists"); *Mouse Trap*, *supra* note 171, at 1 ("[M]ost Internet companies mainly possess less tangible assets, such as their Web sites, software, company names, customer lists, intellectual property, patents and copyrights.").

[182] *Failing Dot-Coms User in a New Legal Era*, *supra* note 180, at 1.

[183] *Id.*

important for creditors' committees to recognize these unique assets and marshal them for the estate.[184]

IV. CONCLUSION: NEED FOR QUICK ACTION IN INVESTIGATING DIRECTORS AND OFFICERS AFTER FILING OF BANKRUPTCY

If a creditors' committee suspects that actions such as those outlined above may have occurred and may have caused the insolvency of the debtor corporation, it must move swiftly to secure its entitlement to any funds under D&O Insurance Policies or from directors and officers directly. Employing attorneys and accountants early in the process will ensure that these valuable assets are not overlooked, particularly where it appears that there are few funds to be located elsewhere.

A. *Preservation of Evidence*

Because a bankruptcy filing often occurs in the midst of chaos, it is wise to retain attorneys and accountants who can gather vital documents such as financial records and board minutes before they are misplaced. Attorneys can also move quickly to interview principles of the debtor and to identify and locate background witnesses who can help uncover important information about the business habits of directors and officers. These items will form the basis for negotiating with directors, officers, and insurance companies, and for bringing suit if necessary. It is often easier to obtain these documents and conduct informational interviews at this stage instead of getting involved in costly and time-consuming discovery, if the case proceeds to litigation, because of the provisions set forth in the Bankruptcy Code.

B. *Timeliness of Insurance Notification*

As noted above, all insurance policies will have a notice period for the making of claims. It is important, therefore, for creditors' committees to retain counsel before such notice periods expire, thereby foreclosing recovery under any otherwise eligible policy. Recovery may be available in many instances even for earlier wrongdoing, so long as a claim is made

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[184]Compaq Computer, which owns the AltaVista Internet search engine, paid more than $3 million to Alta Vista Technology for the altavista.com domain name. *Can an Internet Company Be Reorganized?*, *supra* note 181.

during the existence of the policy. Thus, preserving this right under the policy should be of paramount importance to creditors' committees.

Dot-com bankruptcies provide unique circumstances for unsecured creditors. Recovery for director and officer wrongdoing, however, follows traditional principles of law that oftentimes will provide the bulk of funds available to unsecured creditors. Creditors' committees of bankrupt dot-com entities would be wise, therefore, to investigate this area of recovery to obtain funds lost to dot-com entities with few other assets.