BUSINESS LAW TODAY

Of Spoiled Milk—Warnings That Should and Should Not Have Been Issued: Another Take on the Potential for Management and Controlling Shareholder Liability Related to an Insolvent Company's WARN Act Violations

By Gregory W. Werkheiser

Introduction

For the better part of three decades, an apocryphal tale has circulated on the Internet about a man who leaps from a terminal height off a building only to be mortally wounded by a shotgun blast as he hurtles past an open window on the way down. This dark fable then asks whether the medical examiner should conclude that the death of this man, who was imminently going to perish by his own hand, was a suicide or was murder.

The Delaware bankruptcy court's brief opinion in *Stanziale v. MILK072011, LLC (In re Golden Guernsey Dairy, LLC),* 548 B.R. 410 (Bankr. D. Del. 2015), addressed the insolvency analogue to this hypothetical. Otherwise stated, if management and a controlling member of a Delaware limited liability company that is already hopelessly insolvent, without any apparent justification fail to take action that could have prevented the company from incurring a substantial liability, is their failure to act wrongful as to the company, and does equity provide a remedy for that wrong? According to the *Golden Guernsey* decision, the answer is plainly "yes." This, it is submitted, is the real import of this six-page opinion issued in a lawsuit filed in connection with the chapter 7 bankruptcy liquidation of a failed private-equity-backed dairy operation.

If the name "Golden Guernsey" sounds familiar, it is because the opinion was the subject of an article by Bret Amron that appeared in the July 2017 issue of this publication. Amron provides readers with a thorough and helpful review of state and federal WARN Act obligations. At issue in *Golden Guernsey* was the company's violations of the Wisconsin Wage Payment Act (WWPA). The WWPA is one example of many "baby" WARN Acts various states have enacted, modeled to one extent or another on the federal Worker Adjustment and Retraining Notification Act (federal WARN Act). Given that the differences between the federal WARN Act and the WWPA are immaterial for purposes of this article, both are generically referred to herein as the WARN Act.

Perhaps less helpfully, the article then sounds the alarm that "[p]rior to [*Golden Guernsey*], directors and officers generally have not been held individually liable for a company's failure to provide timely notice under the WARN Act . . . ." It further cautions that "[i]n light of [*Golden Guernsey*], there is at least a colorable argument for trustees and plaintiffs to assert a claim for breach of fiduciary duty against corporate officials. . . ."

Why, you may ask, has this author bothered to write a second article about a semi-obscure bankruptcy court opinion that is now approximately two years old and almost certainly has a total word count less than this installment, let alone both articles? The Amron article implied that the Delaware bankruptcy court had somehow blurred the line between statutory WARN Act liability, which is generally confined to the specific business enterprise that employed the affected individuals, and fiduciary liability of such a business enterprise's directors, officers, managers, shareholders, and members.

There are court decisions that arguably do that; however, *Golden Guernsey* is not one of them. Compare, for example, *D'Amico v. Tweeter Opco, LLC (In re Tweeter Opco, LLC),* 453 B.R. 534 (Bankr. D. Del. 2011) (holding second LLC that was indirect upstream owner of debtor LLC could be held liable as "employer" under federal WARN Act because of factors demonstrating indirect parent's *de facto* control over relevant matters).

Golden Guernsey's WARN-Act-Related *Caremark* Claim

Nothing about the *Golden Guernsey* case suggests that corporate actors now have any more reason to fear being sued on breach of fiduciary duty claims "based on [such] individuals' failure to provide the requisite 60-day notice under the WARN Act," as the Amron article put it, than they did prior to the issuance of this opinion. Although the failure of management and the controlling member to fulfill clear statutory obligations under the WARN Act indisputably served as the backdrop for this dispute, the bankruptcy trustee's claim against the defendants had a well-established basis in Delaware fiduciary law. As such, the bankruptcy court properly focused on whether the complaint adequately pled a claim under Delaware law for a breach of fiduciary duty, based on the fiduciary-defendants' failure to act in good faith. In the parlance of Delaware corporate law, at issue in *Golden Guernsey* was whether the trustee had alleged sufficient facts to state a so-called *Caremark* claim against the fiduciary defendants.

A *Caremark* claim—so named for the seminal case involving the directors of Caremark International (*In re Caremark Int'l Inc. Deriv. Litig*., 698 A.2d 959 (Del. Ch. 1996)), *rev'd on other grounds,* 74 A.3d 612 (Del. 2013))—is a special species of a breach-of-fiduciary-duty claim under Delaware law that "seeks to hold directors accountable for the consequences of a corporate trauma." *La. Mun. Police Empls. Ret. Sys. v. Pyott,* 46 A.3d 313, 340 (Del. Ch. 2012). "In a typical *Caremark* case, plaintiffs argue that the defendants are liable for damages that arise from a failure to properly monitor or oversee employee misconduct or violations of law." *In re Citigroup Inc. S'holder Deriv. Litig.,* 964 A.2d 106, 123 (Del. Ch. 2009). In a case decided after *Caremark,* the Delaware Supreme Court articulated how fiduciaries may be found liable under the *Caremark* standard as follows:

> We hold that *Caremark* articulates the necessary conditions predicate for director oversight liability: (a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention. In either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations. *Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith.*

Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006) (footnotes omitted) (emphasis added). It is well accepted in Delaware jurisprudence that a *Caremark* claim "is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment. . . ." *Citigroup,* 964 A.2d at 967.

The *Golden Guernsey* opinion leaves little doubt that the bankruptcy court viewed the breach of fiduciary duty claim before it as in the nature of a *Caremark* claim. Citing *Stone v. Ritter,* Bankruptcy Judge Gross wrote: "A breach of the duty of loyalty may be found when the fiduciary has failed to act in good faith." The court then continued by reciting the *Stone v. Ritter* restatement of the standard for a *Caremark* claim as it appeared in an earlier decision of the bankruptcy court. *Golden Guernsey,* 548 B.R. at 413 (quoting *Bridgeport Hold. Inc. Liquid. Trust v. Boyer (In re Bridgeport Hold., Inc.),* 388 B.R. 548, 564 (Bankr. D. Del. 2008) (quoting *Stone v. Ritter,* 911 A.2d at 370) (internal quotations omitted)).

Unfortunately, instead of detailing the complaint's specific allegations that supported the *Caremark* claim, after identifying the standard to be applied, the *Golden Guernsey* opinion abruptly concluded that "[t]he Complaint alleges facts that support a finding that the Defendants breached their fiduciary duties to Debtor." Although the court's brevity on this issue is perhaps regrettable in light of the resulting confusion the opinion has spawned, it is certainly understandable that the bankruptcy court did not feel compelled to delve into the specific supporting allegations, considering the context in which this opinion issued.

Review of the parties' briefing reveals that the defendants did not attempt to dispute the sufficiency of the complaint's allegations under the *Caremark* standard. Otherwise stated, the defendants essentially conceded for purposes of the motion to dismiss that by not providing the WARN Act notices, they had failed to act in the face of a known duty to act in a manner that demonstrated conscious disregard for their responsibilities as fiduciaries for the company. Instead (and somewhat puzzlingly), the defendants challenged the sufficiency of the complaint on two grounds unrelated to *Caremark*: (1) that the trustee-plaintiff lacked standing to bring a claim on behalf of the debtor's estate for what was argued to be an injury only to the debtor's creditors; and (2) that the plaintiff's claim was really a disguised "deepening insolvency" claim, a theory of liability that Delaware courts have squarely rejected. Accordingly, in view of how the parties had framed the issues in dispute, the bankruptcy court did not need to closely examine the complaint's *Caremark*-claim-related allegations to dispose of the defendants' motion to dismiss.

Had the bankruptcy court expounded in greater detail about the complaint's allegations, it had plenty of support—especially at this preliminary stage of the litigation—for the conclusion that the complaint adequately alleged a *Caremark* breach of duty of loyalty claim under applicable federal pleading standards. As Delaware courts have recognized, "[i]n practice, plaintiffs often attempt to satisfy the elements of a *Caremark* claim by pleading that the board had knowledge of certain 'red flags' indicating corporate misconduct and acted in bad faith by consciously disregarding its duty to address that misconduct." *Melbourne Mun. Firefighters' Pension Trust Fund v. Jacobs,* 2016 WL 4076369, at *8 (Del. Ch. Aug. 1, 2016) (collecting cases). The *Golden Guernsey* complaint included numerous "red flag" allegations.

The complaint contained several detailed allegations that demonstrated that the debtor had been operating under dire financial circumstances for an extended period of time and that defendants were well aware that, among other things, the company was and had been for some time hopelessly insolvent and destined to run out of funds to operate. These allegations included the following:

- Each of the defendants during the relevant period was directly involved in the management of the debtor.
- The debtor had never operated profitably, either before or after being acquired by the indirect parent entity on September 9, 2011, and lost nearly $2 million in the initial three months after the acquisition.
- Management had prepared financial statements for the 12-month period ending September 30, 2012—over three months before the debtor ceased operations—showing a net loss from operations of $4.5 million and a net loss of approximately $6.5 million.
- The debtor's insolvency was predictable and inevitable no later than September 2011, given its steady and consistent operating losses, capital structure, the onerous provisions contained in its milk supply agreement, its high labor costs, and interest payments.
- The parent made no net investment of its own capital in the debtor.
- The debtor had negative working capital of negative $113,190 as of December 31, 2011—a full year before operations were discontinued.
- The debtor's management and sole member were aware of the WARN Act requirements, as evidenced by certain postings made in areas of the debtor's computer servers accessible by its employees.
- By November 14, 2012—52 days prior to the closing of the debtor's facilities—the debtor's controller had provided senior individuals at the debtor's parent with copies of a 16-week cash-flow forecast that showed the debtor would have overdrawn its line of credit by November 23, 2012, and would become even more deeply overdrawn over the next two months.
- By December 22, 2012, the debtor's president had notified its parent's managing partner that the company was entirely out of funds to operate.
- The debtor's books and records for the relevant period contained no indication that the debtor had access to or was seeking alternate sources of funding.

The cumulative import of these allegations, if true, was to establish (1) the inevitability that the debtor's business would have to be shut down for lack of funding; (2) the defendants' awareness for months prior to the date that the debtor discontinued operations that the debtor would run out of money to operate; (3) the absence of any efforts to address the debtor's financial distress; (4) the defendants' failure to provide 60-days advance notice of the shutdown as mandated by the WARN Act; and (5) the inapplicability of any exceptions or exemptions to the WARN Act notice requirement.

To be certain, the complaint's allegations concerning the defendants' knowledge of the WARN Act obligations and their mental state in failing to fulfill those obligations were weak. As an element of a *Caremark* claim, "[c]onscious disregard involves an intentional dereliction of duty which is more culpable than simple inattention or failure to be informed of all facts material to the decision." *In re Goldman Sachs Gp., Inc. S'holder Litig.,* 2011 WL 4826104, at *13 (Del. Ch. Oct. 12, 2011) (quoting *In re Walt Disney Co. Deriv. Litig.,* 906 A.2d 27, 66 (Del. 2006)). See also *Lyondell Chem. Co. v. Ryan,* 970 A.2d 235, 243–44 (Del. 2009) ("Only if they knowingly and completely failed to undertake their responsibilities would they breach their duty of loyalty.").

Had this action been filed in the Court of Chancery of Delaware, it is doubtful whether the complaint would have survived a motion to dismiss that targeted the sufficiency of these allegations under *Caremark.* Under the Chancery Court's established pleading standards, the plaintiff would have been required to "plead particularized facts from which it [was] reasonably inferable that the [defendants] consciously disregarded [their] duties by 'intentionally fail[ing] to act in the face of a known duty to act.'" *Melbourne,* 2016 WL 4076369, at *9 (quoting *Disney,* 906 A.2d at 67).

The bankruptcy court is an arm of the federal district court, however, and as such federal rules of pleading applied. See, for example*, Andresen v. Diorio,* 349 F.3d 8 (1st Cir. 2003) ("[U]under standard *Erie* doctrine, state pleading requirements, so far as they are concerned with the degree of detail to be alleged, are irrelevant in federal court even as to claims arising under state law.") (collecting cases). No applicable analogue to the Chancery Court's heightened pleading requirement for *Caremark* claims exists in either the Federal Rules of Civil Procedure or the Federal Rules of Bankruptcy Procedure. Accordingly, with the benefit of the less rigorous notice pleading standards under the federal rules, it is likely that the plaintiff's claim would have survived a Rule 12(b)(6) motion to dismiss even if the defendants directly challenged the sufficiency of its allegations under *Caremark* and its progeny.

Golden Guernsey, Bankruptcy Trustee Standing, and Deepening Insolvency

The principal arguments the defendants presented in support of dismissal of the complaint should have been (and were) quickly disposed of by the bankruptcy court. The defendants argued that because the debtor was alleged to have been indisputably insolvent during the entire period when the WARN Act notice might have been provided, the trustee lacked standing. The defendants asserted that "the only conceivable injury that could result from Defendants' alleged wrongdoing is to the general unsecured creditor body, who allegedly stand to receive less than what they might have received absent the WARN Act Claim." Motion to Dismiss Adv. Compl. of Defs. MILK072011, LLC and Andrew Nikou, ¶ 29, *Stanziale v. MILK072011, LLC (In re Golden Guernsey Dairy, LLC,* Adv. Pro. No. 14-50953 (KG) (Bankr. D. Del. Dec. 22, 2014), ECF No. 10. In further support of this position, the defendants sought to persuade the bankruptcy court that the trustee's claim was really in the nature of a deepening insolvency theory of liability, which Delaware law has eschewed. The defendants argued at ¶ 28 that "an already insolvent company, with no prospects of reorganization and headed immediately towards a chapter 7 liquidation with no hope of satisfying its current liabilities, cannot be damaged by the existence of an additional claim subsequently lodged against the estate."

Relying on a well-developed body of bankruptcy law in the Third Circuit and elsewhere, the bankruptcy court rejected this position, noting that "[t]he Trustee is charged with pursuing the estate's interests . . . whether the claims are direct or derivative in nature." Addressing the defendants' attempts to characterize the trustee's allegations as a deepening insolvency claim, the court observed:

> The present case, as the Trustee alleges in the Complaint, is not one in which the Defendants made strategic errors. . . . The situation is not, as in *Trenwick America Litig. Trust v. Ernst & Young, L.L.P.,* 906 A.2d 168 (Del. Ch. 206), *aff'd sub nom. Trenwick America Litig. Trust v. Billett,* 931 A.2d 438 (Del. 2007), one in which the defendants made imprudent investments.

The court later concluded (albeit in somewhat summary fashion) that this case was one in which the trustee adequately alleged the defendants' conscious disregard for their duties by their knowing failure, without justification, to provide the WARN Act notice to affected employees.

Although the understanding of the *Golden Guernsey* opinion once again could have benefitted from some further explanation of why the court reached the result it did, the answer to that question becomes clear upon examination of this decision in the context of the Delaware bankruptcy court's other decisions addressing what remains of the deepening insolvency theory post-*Trenwick.* Initially, in *Miller v. McCown De Leeuw & Co., Inc. (In re The Brown Schools),* 386 B.R. 37 (Bankr. D. Del. 2008), a decision that issued soon after the Delaware Supreme Court affirmed *Trenwick,* the court explored the boundaries of what was and was not an impermissible deepening insolvency claim under Delaware law. The trustee's complaint included claims that both asserted deepening insolvency as an independent cause of action (which, following *Trenwick's* affirmance, the trustee agreed to dismiss) and claims for the breach of the duty of loyalty, aiding and abetting breach of fiduciary duty, corporate waste, and civil conspiracy. All of these claims revolved around allegations that the debtors' majority shareholders had used its control position to wrongfully prolong the debtors' existence while the debtors were insolvent so that certain transactions could be consummated through which the majority shareholder preferred itself over the interest of the debtors and their creditors.

The *Brown School* defendants made the now-familiar argument that the trustee's claims, despite not being expressly denominated as deepening insolvency claims, were just that. The bankruptcy court was unpersuaded, noting that *Trenwick* itself implied that other causes of action were not impacted by its holding that a claim for deepening insolvency could not be maintained as an independent cause of action. See *Trenwick,* 906 A.2d at 205 ("If a plaintiff cannot state a claim that the directors of an insolvent corporation acted disloyally or without due care in implementing a business strategy, it may not cure that deficiency simply by alleging that the corporation became more insolvent as a result of the failed strategy."). Additionally, citing the Third Circuit's decision in *Seitz v. Detweiler, Hershey & Assoc., P.C. (In re CitX Corp.),* 448 F.3d 672, 677–78 (3d Cir. 2006), the defendants argued that, as a matter of law, damages for deepening insolvency were unavailable. Rejecting this proposition, the bankruptcy court declined to extend *CitX*'s holding that deepening insolvency was not a viable measure of damages for a professional malpractice claim to the distinct claims in the action before it.

More recently, in *Stanziale v. Versa Cap. Mgm't, LLC (In re Simplexity, LLC),* 2017 WL 65069 (Bankr. D. Del. Jan. 5, 2017), the Delaware bankruptcy court was again asked by the defendants seeking to escape liability on breach-of-fiduciary-duty claims to read *Trenwick's* holding expansively to reach other types of claims connected with the debtor's insolvency. Specifically, in *Simplexity,* the trustee alleged that the director- and shareholder-defendants had engaged in self-dealing and acted in bad faith and with gross negligence by, among other things, not causing the debtor to file bankruptcy sooner and not providing WARN Act notices to employees, despite having actual knowledge that the lender had terminated any forbearance and was about to sweep all of the debtor's cash. The *Simplexity* court reasoned that the trustee's complaint did not implicate deepening insolvency because, instead of charging the defendants with causing the debtor's insolvency, it sought redress for "the Defendants' failure to act in the face of insolvency itself. . . ."

Golden Guernsey likewise appears not to implicate deepening insolvency as an independent tort of the type Delaware courts have rejected. As reviewed above, the *Golden Guernsey* complaint appears to allege with some specificity that the defendants consciously and in bad faith ignored a known duty to provide the WARN Act notice. The trustee alleged, in substance, that by failing to act, the defendants proximately caused the debtor to incur a substantial liability for which it would not otherwise have been exposed (and for which it received nothing of value). These allegations, taken as true, do appear to state a *Caremark*-type claim (at least under federal pleading standards) and cannot legitimately be labeled a disguised deepening insolvency cause of action.

The Lessons *Golden Guernsey* Does and Does Not Teach

The *Golden Guernsey* opinion provides important lessons for directors, officers, managers, shareholders, members, and other control persons for distressed entities. Even in situations where a company is irretrievably insolvent and beyond rehabilitation, these parties cannot—with impunity—ignore their responsibilities to the entity. Although their respective fiduciary obligations may run only to the entity itself, Delaware law is clear that creditors of such an insolvent entity are the ultimate beneficiaries. Under such circumstances, Delaware fiduciary law does not demand self-sacrifice, nor does it allow responsible persons to cut and run, however, ignoring in the process all potential consequences to the company and its other stakeholders.

Golden Guernsey does not represent any paradigm shift or even signal a developing trend away from established standards governing the conduct of business fiduciaries, however, as suggested by the Amron article. In particular, *Golden Guernsey* does not mean going forward that management and controlling members or shareholders of distressed enterprises will routinely face statutory WARN Act liability. The opinion merely illustrates one scenario in which a viable *Caremark* claim could be pled based upon the alleged exceptional and extreme lapses of the debtor's management and controlling member.

Gregory W. Werkheiser is a partner with the Business Reorganization and Restructuring Group of Morris, Nichols, Arsht & Tunnell LLP in Wilmington, Delaware, where for over 20 years he has represented distressed companies, fiduciaries, secured and unsecured lenders, trade creditors, and acquirers in financial restructurings, bankruptcy proceedings, loan workouts, commercial disputes, cross-border cases, and bankruptcy- and insolvency-related litigation, with a particular emphasis on bankruptcy appellate litigation and bankruptcy-IP law matters. *The author wishes to thank his colleagues Andrew M. Johnston and Daniel B. Butz for giving generously of their time and attention to help vastly improve this article.*