UNITED STATES DISTRICT COURT

DISTRICT OF MAINE

GARY M. GROWE, as Trustee of Great Northern Paper, Inc.,	)	
Plaintiff,	)	
v.	)	Civil No. 03-198-B-S
LAMBERT BEDARD, et al.,	)	
Defendants.	)	

ORDER DENYING MOTION TO STRIKE AND RECOMMENDED DECISION ON MOTION FOR SUMMARY JUDGMENT

Defendants Harold Gordon, John Kelsall and Benoit Michel, all former outside directors of Great Northern Paper, Inc. (GNP), have moved for summary judgment against all of the claims asserted against them by Gary M. Growe, Chapter 7 Trustee of bankruptcy debtor GNP. In his First Amended Complaint, the Trustee alleges that these individual defendants wasted corporate assets (count V), breached their duties to the corporation (negligence counts VI, X and XIII), and violated section 174 of the Delaware General Corporation Code (count IX) in connection with certain corporate transactions that transpired during the Outside Directors' tenure at GNP. The Outside Directors maintain, among other things, that they are entitled to summary judgment because GNP's articles included a director exculpation clause and the Trustee's complaint fails to include any claims or counts that the Outside Directors breached their duties of loyalty and good faith (Docket No. 87 at 8-11), because the Trustee cannot present evidence capable of meeting the strict standard for waste (Id. at 11-17), and because the Trustee is misapplying section 174 of the Delaware General Corporation Code (Id. at 17-19). I recommend that the court **DENY** the Outside Directors' motion for summary judgment in its entirety. I also **DENY** herein an ancillary motion to strike filed by the Trustee (Docket No. 95).

Statement of Facts

The acquisition and insolvency of GNP

GNP, a Delaware corporation, owned and operated two paper mills in Millinocket and East Millinocket, Maine. (Pl. Statement Mat. Facts, Docket No. 97, ¶ 23; Def. Reply Statement, Docket No. 105, ¶¶ 23, 112; Pl. Reply Statement of Mat. Facts, Docket No. 105, ¶ 112.)[1] On August 17, 1999, Inexcon Maine, Inc. ("IMI"), a Maine corporation owned indirectly and controlled by defendants Lambert Bedard and Joe Kass, purchased the stock of GNP from Bowater, Inc., in a kind of "leveraged" buyout. (¶ 24.) IMI did not put any money or equity into the acquisition; instead the acquisition was funded entirely through the proceeds of term loans to GNP totaling $122,250,000, which were transferred by GNP to IMI as a dividend, and used to fund the purchase from Bowater. (¶ 25; see also Lambert Bedard Depo. Trans. I, Docket No. 97, Elec. Attach. 2, at 50-51.) Although not every dollar of these loan proceeds was paid to Bowater, there was no material amount left over from the financing to provide GNP with working capital. (¶ 27.)[2]

After the buyout, GNP began to pursue a modernization plan that would permit the company to produce higher-margin paper products, but which required a $130 million investment to rebuild or upgrade one of the company's paper machines.[3] (¶ 28.) GNP did not have funding for the proposed modernization project at the time of the buyout, nor when it

[1] Because the Trustee's statement of additional material facts is incorporated within and runs sequentially to the outside directors' statement of material facts, all subsequent citations are to the relevant paragraph of the several statements.

[2] The Outside Directors deny the Trustee's statements of fact with respect to the form of the transaction. However, they do not provide any record citation in support of their denials. Instead, they simply maintain that the facts are immaterial.

[3] The record reflects that the terms of the purchase from Bowater required that GNP exit the standard newsprint business within two years. (See record citations for additional statement ¶ 32.)

entered into contracts for the project in mid-2000. (¶ 31.) In the eight months prior to IMI's August 1999 acquisition of GNP, GNP had lost $18.2 million in connection with its mill operation. (¶ 32.) In the four months remaining in 1999 after the buyout, GNP experienced a further net operating loss of $3,616,000. (¶ 33.) Net operating losses continued over the next three years, up until GNP filed a Chapter 11 petition on January 9, 2003. (¶¶ 33-34.) Losses in 2000 totaled $2,051,000; in 2001, $11,757,000; and in 2002, approximately $74 million. (¶ 34.) GNP was insolvent, in both the equitable and balance sheet meanings of the term, as of December 2, 1999, and continuously thereafter until its bankruptcy filing. (¶ 35.)

GNP's service fee agreement with IMI

On September 10, 1999, Kass directed Timothy Morgan, GNP's chief financial officer, to commence making monthly payments of $175,000 to IMI for "management fees." (¶ 43.) From that date until its bankruptcy petition, GNP paid to IMI in said fees: $638,000 in 1999; $1,474.000 in 2000; $475,000 in 2001 and $565,000 in 2002, for a total of $3,152,000. (¶¶ 5, 44.) This arrangement was not reflected in an executed contract or written agreement until August 4, 2000, although the agreement, when finally reduced to writing and executed, was executed "as of" September 1, 1999. (¶¶ 6, 45-46.) According to the language of the written contract, IMI provided the following consideration for GNP's monthly payments:

> IMI hereby covenants and agrees to retains [sic] the services of IPI and GNP hereby covenants and agrees to retains [sic] the services of IMI for the purpose of advising in Management, Financing and Operations as well as providing Head Office's functions including, but not restricted to, Legal, Economic and Credit services to IMI and GNP during the term of this Agreement as provided for in Section 3 hereof.

(¶¶ 7, 48.) The contract further provided that "this Agreement shall not be [sic] less than a five (5) year period, beginning on September 1st, 1999 until August 31st, 2004." (¶ 8.) In the event that the agreement should be terminated before August 31, 2004, the contract provided that IMI would be entitled to receive the full payment of its fees up to the ending term date of August 31, 2004. (¶ 9.)

Although the agreement obligated GNP to compensate IMI, the agreement did not require IMI to pay Inexcon Paper, Inc. ("IPI"), for "Head Office" services rendered to IMI under the agreement. (¶ 49.) Nevertheless, IMI paid a portion of the management fee to its parent, IPI, which in turn made payments to Inexcon, Inc. ("Inexcon"), a Canadian corporation controlled by Lambert Bedard, and to Archer Consultants, Inc. (“Archer”), a Canadian corporation controlled by Kass. (¶ 52.) The actual services provided under the agreement were to be provided by Lambert Bedard and Joseph Kass, through Inexcon and Archer. (¶¶ 53, 56.)

Bedard served as GNP's Chief Operating Officer from the buyout through June 1, 2001, and as GNP's Chief Executive Officer from June 1, 2001, until January 9, 2003. Bedard was also a director and Vice Chairman of GNP's board. (¶ 15.) Bedard received compensation for his services to GNP through IMI, IPI and ultimately Inexcon, at the annual rate of $240,000 from the buyout until the fall of 2000, when his salary was increased to the annual rate of $300,000. (¶ 57.)

Joseph Kass served as the Chief Executive Officer ("CEO") and Chair of GNP's board of directors from the buyout through June 1, 2001. (¶ 14, 58.) After June 1, 2001, Kass continued as a director of GNP until January 9, 2003. (¶ 14.) Like Bedard, Kass received compensation through IMI and IPI (and ultimately Archer) until June 1, 2001, when he was removed as CEO. (¶ 58.) Neither Joseph Kass nor Lambert Bedard received a salary directly from GNP for their work as executives of GNP. (¶ 16.) However, the source of funds for their executive compensation came from GNP's payments to IMI under the service fees agreement. (¶ 17.)

In relation to the IMI service agreement, Kass was "supposed to look after everything that had to do with finance, accounting and CFO function." (¶ 59.) There is a genuine issue of material fact whether Kass performed any of these functions. (¶¶ 19-20, 60-72.) For purposes of summary judgment, the court may assume he did not. As for Bedard, the Trustee admits that Bedard worked diligently on behalf of GNP as an executive officer and that Bedard worked hard to obtain financing for GNP, update GNP's paper making machinery, and provide management oversight for GNP. (¶ 22.) According to the sworn testimony of Bedard, the only material services GNP received from or on behalf of IMI were the services of Bedard and a credit analyst in Montreal (¶ 75), whose combined salaries totaled between roughly $300,000 and $350,000. (¶¶ 57, 76.) The record reflects that IPI hired the analyst and that IPI also maintained a secretary/accountant who it compensated at the rate of $30,000 Canadian. (¶ 21.)[4]

The outside directors and GNP's financial condition

On November 15, 1999, IMI elected the Outside Directors (Harold Gordon, John Kelsall and Benoit Michel) to serve on GNP's board of directors. Each of them was an acquaintance of either Kass or Bedard at the time. (¶¶ 1, 79.) At no time did Gordon, Kelsall or Michel ever own any stock of GNP. (¶ 2.) The first board meeting attended by the Outside Directors was held on December 2-3, 1999, and they met once every three months thereafter, on average.[5] (¶¶ 3, 80.) Each of the Outside Directors reviewed all of the financial statements provided to them

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[4] **Motion to strike.** In support of their motion for summary judgment, the Outside Directors offer that the compensation received by Bedard and Kass was substantially less than the industry average for paper company executives. (¶ 18.) The Trustee has moved to strike this assertion on the ground that it is supported only by citation to Kass's answers to interrogatories, in which the basis for his personal knowledge of industry compensation rates is not asserted. (Docket No. 95.) I agree with the Trustee that the answers to interrogatories document does not provide as clean a record cite for this proposition as would an affidavit in which the factual basis for the testimony is also presented, but I find nothing inherently inadmissible in the testimony itself. In any event, I do not consider this testimony to be material to the instant motion, which raises as a material issue the amount and nature of the so-called "service fees" paid by GNP to IMI, not the amount of salary IMI or the other Inexcon corporations paid to Bedard and Kass. The motion to strike (Docket No. 95) is **DENIED**.

[5] GNP's board of directors generally met once every three months. (¶ 3.)

before and during meetings of the GNP Board of Directors. (¶ 81.) The written service fees agreement was never submitted to the GNP board for approval. (¶ 50.) Thus, Gordon, Kelsall, and Michel never voted to ratify or approve the execution of the Services Agreement. (¶ 10.) Nor were they ever asked to. (¶ 11.) However, all of the directors were aware of the execution of the written agreement. (Id.)[6]

For the December 1999 board meeting, financial statements distributed to the directors included projected loss figures for full year 1999 of over $14 million and projected losses of roughly $3.6 million for the five-month period beginning with August and ending in December 1999 (the post buyout period in 1999). (¶¶ 82-83.) The statements also reflected that GNP would expend $797,000 on corporate administration during the same five-month, post-closing period.[7] (¶ 85.) The projected 1999 year-end balance sheet showed negative equity of $3,641,000. (¶ 84.)

Forecasts distributed to the directors projected future costs for corporate administration at $177,000 monthly. (¶ 102.) GNP's audited 1999 year-end financial statements disclosed that the "Company has a management fees agreement with its parent company under which it pays $175[,000] per month for management services," and disclosed the amount of such fees paid and accrued in that year. Its financial statements for 2000 contained the same statement and updated amounts. (¶ 103.) The clerk of GNP (Martin I. Eisenstein, Esq.) received and retained copies of each of GNP's audited financial statements for the years 1999 through 2000. (¶ 106.) The outside directors contend that they neither received nor reviewed the audited financial

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[6] The outside directors deny that they were aware of the agreement at the time it was executed and assert that they only became aware of it subsequently. (Docket No. 105, ¶ 50.) However, this denial is not supported by any record citation and the testimony cited by the Trustee supports an inference that all of GNP's directors were contemporaneously aware of the execution of the agreement. (Docket No. 97, ¶ 50, citing Lambert Bedard Depo. Trans. I, Docket No. 97, Elec. Attach. 2 at 67.)

[7] The Outside Directors point out that, in comparison, annual figures for GNP's corporate administration expenses under Bowater's ownership were roughly 9.6 million dollars for 1996, 10.8 million for 1997 and 7.9 million for 1998, considerably higher than the amount expended after IMI's acquisition of the company. (¶ 82.)

statements. The Trustee contends that the outside directors received the financial statements but perhaps did not review them. Neither assertion is necessarily supported by the requests for admissions that the parties cite in support of their statements. (¶¶ 104, 106.) What can be said is that the outside directors reviewed all financial statements that were provided to the board of directors in connection with board meetings. (¶ 107, citing Answers to Interrogatories propounded on Gordon, Kelsall and Michel, see Docket No. 97, Elec. Attach. ## 50, 51, 52.) I infer from this fact that the outside directors were aware of the contents of GNP's financial statements, audited or otherwise, which include figures pertaining to the monthly fee GNP paid to IMI under the service agreement.

In an opinion accompanying financial statements for the year ending December 31, 2000, GNP's auditors included a going concern qualification. That qualification stated in part as follows:

> As a result of the modernization program expenditures in 2000, a working capital deficiency of approximately $16,600[,000] existed at December 31, 2000. . . . The completion of the modernization program is dependent on obtaining the required financing and on generating sufficient cash flow from operations . . . . The inability to obtain the required financing and to generate the required cash flow from operations could result in the Company being unable to complete the modernization program, which would also call into question. . . the Company's ability to continue to operate as a going concern.

(¶ 105.) The minutes from GNP's April 22-23, 2001, board meeting reflect the following vote:

> Upon motion of Director Michel, seconded by Director Leathers, the Board unanimously voted to accept the budget set forth in the notebook, except with regard to the income statement and cash requirement budgets of MTC.

(¶ 108.) The budget accepted at the meeting was for 2001 and included under the heading "Items not Affecting Op Income," "Corporate G&A" in the amount of $175,000 per month for a total for 2001 of $2.1 million. (¶ 109.)

Gordon first became aware of GNP's payment of management fees to IMI, and of the Services Agreement or some other agreement between or among IPI, IMI and GNP relating to payment of management fees, early in his tenure as director. (¶ 95.) Kelsall does not recall any discussion of the IMI Fees by GNP's Board of Directors. (¶ 98.) According to Michel, he asked Kass about the payments and Kass informed him that at least some of the money would be put back into GNP if the need arose. (¶ 99.) The date of this conversation is not indicated in the cited portion of the record.

The transfer of GNP assets to IMI

No later than the summer of 2000, GNP was incurring cash flow difficulties and was not paying its debts as they came due. (¶ 114.) On May 24, 2001, Katahdin Federal Credit Union ("KFCU") loaned $1,350,000 to L. Bedard (the "First Loan"). (¶ 117.) In conjunction with the loan, Eldon Doody, GNP's president, signed a deed transferring a "guest house" property from GNP to IMI. IMI guaranteed the First Loan and granted KFCU a mortgage on the guest house to secure it. (Id.) Before KFCU made the loan, its Board was informed that the guest house was worth $1.4 million, although it was assessed for tax purposes at $155,000. (¶¶ 118-119.) The proceeds of the loan were wired to IMI, which then advanced $1,304,180 of those loan proceeds to or for the benefit of GNP. (¶ 121.) On June 1, 2001, GNP held a board meeting at which the directors unanimously ratified the guest house transfer. The directors also unanimously approved a further transfer of real estate by GNP to IMI, as well as GNP's guaranty of a proposed additional loan from KFCU to IMI in the amount of $700,000 with a term of 30 days. On June 4, 2001, GNP transferred various real properties to IMI, including a landfill, log scales, airport hanger, a golf course and approximately 3,800 acres. (¶ 127.) The landfill, known as the Dolby Landfill, was a fully licensed landfill that took all the waste material from both GNP mills and all the sludge from its recycled fiber plant. (¶ 129.) The Dolby landfill was an important part of GNP's operations, and its assessed value in the 1990s was somewhere between $10 and $20 million. (¶ 130.) IMI granted KFCU a mortgage on these properties to secure a $700,000 loan from KFCU to IMI (the "Second Loan"), which was guaranteed by GNP and Bedard. (¶ 131.) IMI advanced $620,000 from the Second Loan proceeds to or for the benefit of GNP. (¶ 133.) The funds advanced by IMI to GNP from the First Loan and Second Loans were booked by GNP and IMI as a loan from IMI to GNP. (¶ 134.) There was no entry on the books of GNP or IMI reflecting the transfers, and those assets remained on the books of GNP. (¶ 136.) By September 18, 2001, both loans were paid off in full with funds transferred by GNP to IMI. (¶ 139-141.) IMI retained title to the transferred property notwithstanding the repayment. (¶ 142.)

The director exculpation provision

> GNP's articles of incorporation include the following provision:
>
> EIGHTH: No Director of the Corporation shall have any personal liability to the Corporation or its shareholders for any monetary damages for breach of fiduciary duty as a director, except that this Article EIGHTH shall not eliminate or limit the liability of a director (i) for any breach of such director's duty of loyalty to the Corporation or its shareholders, (ii) for acts or omissions not in good faith or which involves intentional misconduct or a knowing violation of the law, (iii) under Section 174 of the General Corporation Law of the State of Delaware [re: improper dividends], or (iv) for any transaction from which such director derived an improper personal benefit.

(¶¶ 4, 113.)

Statement of the Claims and Issues Presented

Stated as succinctly as possible, the claims alleged against the Outside Directors in the Trustee's complaint are as follows:

(Count V) That GNP's payment of $175,000 per month to IMI for management services constituted waste of corporate assets (Docket No. 58, ¶ 161);

(Count VI) That the Outside Directors' failure to take action to stop GNP from continuing to make such wasteful payments constituted "negligence" (id., ¶ 166);

(Count IX) That the payments under the service fees agreement were, in substance, illegal dividends recoverable pursuant to 8 Del. Code § 174 (id., ¶¶ 181-82);

(Count X) That payment of illegal dividends in violation of the Code constituted a separate instance of actionable "negligence" (id., ¶ 187); and

(Count XIII) That the Outside Directors' authorization of the property transfers from GNP to IMI in connection with the KFCU loan facility constituted "negligence."[8]

The outside directors contend that they are entitled to summary judgment on all claims related to the IMI services agreement (Counts V, VI, IX and X) because they "did not participate in the payment of fees to IMI." (Docket No. 87 at 4.) As they see it, they cannot be held liable on any theory in connection with the services agreement because that agreement was already in place when they became directors and they did not cause, authorize or ratify the making of payments under the agreement and did not vote to ratify the execution of the agreement. (Id. at 4-5, 6-7.) In addition, the outside directors argue, among other things, that they are entitled to summary judgment against the waste of corporate assets claim (Count V) and the three negligence claims (Counts VI, X and XIII) pursuant to GNP's exculpatory clause. (Id. at 8-11.) In response (and in a nut shell), the Trustee argues that the Outside Directors owed a special duty to GNP's creditors, by virtue of GNP's insolvency, to prevent GNP from making payments to IMI under the services agreement and to prevent GNP from transferring assets to IMI for insignificant consideration, which duty they breached, and that their breaches are actionable despite the exculpation clause because the exculpation clause does not apply to claims by

[8] I have placed italics around the term negligence because the breaches described by the Trustee actually involve fiduciary duties, not just garden-variety negligence.

creditors, whose interests the Trustee is advancing. (Docket No. 96 at 1-2.) Alternatively, the Trustee argues that the director exculpation provision does not automatically support entry of summary judgment under Delaware law where, as here, the underlying transactions involved self-dealing on the part of corporate directors, unless the Outside Directors first satisfy Delaware's "entire fairness" doctrine. (Id. at 17-19.) In reply, the Outside Directors argue, among other things, that the creditor claims discussed by the Trustee in his memorandum of law are simply not asserted in the amended complaint and that the director exculpation provision is dispositive of the claims because only the duty of care is implicated in the claims against them. (Docket No. 106 at 2-3.)

Applicable Law

The court must apply the law of Delaware to the substantive component of the instant motion because GNP is a Delaware corporation and the Trustee's claims concern the liability of the Outside Directors to GNP and its creditors. See Young v. Lepone, 305 F.3d 1, 13 (1st Cir. 2002). According to the authors of the Restatement (Second) of Conflict of Laws:

> The local law of the state of incorporation will be applied to determine the existence and extent of a director's or officer's liability to the corporation, its creditors and shareholders, except where, with respect to the particular issue, some other state has a more significant relationship under the principles stated in § 6 to the parties and the transaction, in which event the local law of the other state will be applied.

Restatement (Second) of Conflict of Laws § 309 (1971). Although the Outside Directors casually assert that Maine law governs this matter in, of all places, the closing paragraph of their reply memorandum (Docket No. 106 at 12), they do not attempt to explain why.

Discussion

Summary judgment is warranted only if “the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law." Fed. R. Civ. P. 56(c). The Court must view the summary judgment facts in the light most favorable to the nonmoving party and credit all favorable inferences that might reasonably be drawn from the facts without resort to speculation. Merchants Ins. Co. v. United States Fid. & Guar. Co., 143 F.3d 5, 7 (1st Cir. 1998). If such facts and inferences could support a favorable verdict for the nonmoving party, then there is a trial-worthy controversy and summary judgment must be denied. ATC Realty, LLC v. Town of Kingston, 303 F.3d 91, 94 (1st Cir. 2002).

A The Trustee's claims against the Outside Directors are implicitly in the nature of "creditor claims."

A review of the Trustee's amended complaint reflects that none of the counts targeted at the Outside Directors (Counts V, VI, IX, X and XIII) includes an express allegation that the Outside Directors defrauded GNP's creditors or otherwise breached any fiduciary duty owed to creditors on account of GNP's financial condition. This omission is curious because such claims and duties have been expressly asserted against Bedard, Kass, Timothy Morgan, Martin Bedard, Mendel Schwimmer, and Eldon Doody. (See First Amended Complaint, Docket No. 58, Count I, ¶¶ 128-130, 133 and plea for relief, Count VII, ¶¶ 169-171 and plea, Count XI, ¶¶ 193-194, and XII, ¶¶ 196, 201, 208-213, 215 and plea.) In comparison, the claims against the Outside Directors do not expressly recite that creditor claims are being advanced. Moreover, all three of the negligence claims advanced against the Outside Directors specifically allege breach of the duty of care owed to GNP (Id., Count XIII, ¶ 217) or injury to GNP, without mention of a corresponding duty or injury to creditors generally. (Id., Counts VI, ¶ 167, Count X, ¶ 188, Count XIII ¶ 218.) Despite this curious aspect of the complaint, I conclude that the Trustee's claims on behalf of the estate are inherently "creditor claims" because the Trustee is appearing on behalf of the bankruptcy estate and because the general allegations present matters of corporate mismanagement while GNP was insolvent or in the zone of insolvency, which generates fiduciary duties running toward creditors. Lasalle Nat'l Bank v. Perelman, 82 F. Supp. 2d 279, 290 (Del. 2000); Geyer v. Ingersoll Publications Co., 621 A.2d 784, 790 (Del. Ch. 1992). See also Bovay v. H. M. Byllesby & Co., 38 A.2d 808, 813 (Del. 1944) ("An insolvent corporation is civilly dead in the sense that its property may be administered in equity as a trust fund for the benefit of creditors. The fact which creates the trust is the insolvency, and when that fact is established, the trust arises, and the legality of the acts thereafter performed will be decided by very different principles than in the case of solvency."). Furthermore, the Trustee's counts against the Outside Directors all incorporate allegation 61, which generally alleges that all of the directors owed a fiduciary duty to GNP's creditors on account of GNP's insolvency. (Id., ¶¶ 61, 151, 165, 179, 186, 216.)[9]

B. Despite labeling three of his claims against the Outside Directors as "negligence" claims, the Outside Directors' "negligence" claims implicate both the fiduciary duty of due care and the fiduciary duty of loyalty.

Counts VI, X and XIII are all captioned as "negligence" claims. None of these claims mention "fiduciary duties." This is in marked distinction from several of the claims the Trustee alleges against Bedard, Kass and Schwimmer, such as Counts VII and XII, which depend on the same transactions, but are captioned as claims for "breach of fiduciary duties." I raise this issue because the nature of the claims being pressed against the Outside Directors is important to the application of the director exculpation provision raised by the Outside Directors in support of their motion and discussed below. The directors of a Delaware corporation owe fiduciary duties

[9] The relevant section of the Delaware General Corporations Code on which Count IX is premised clearly suggests that the Trustee is implicitly proceeding on behalf of both GNP and its creditors with respect at least to that claim. See 8 Del. Code § 174(a) (providing that directors' liability for unlawful dividend payments extends to creditors in the event of the corporation's insolvency).

to the corporation and its shareholders. Summit Metals, Inc. v. Gray (In re Summit Metals), 2004 U.S. Dist LEXIS 15819, *46, 2004 WL 1812700, *12 (D. Del. Aug. 6, 2004). "To state a claim for breach of fiduciary duty, a complaint must allege facts from which one could reasonably conclude 'that directors, in reaching their challenged decision, breached any one of the triads of their fiduciary duty-good faith, loyalty or due care.'" Official Comm. of Unsecured Creditors of Teu Holdings v. Kemeny (In re Teu Holdings, Inc.), 287 B.R. 26, 32 (Bankr. D. Del. 2002) (quoting Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993)).

"[T]he duty of loyalty is transgressed when a corporate fiduciary, whether director, officer or controlling shareholder, uses his or her corporate office or, in the case of a controlling shareholder, control over corporate machinery, to promote, advance or effectuate a transaction between the corporation and such person (or an entity in which the fiduciary has a substantial economic interest, directly or indirectly) and that transaction is not substantively fair to the corporation." Solash v. Telex Corp., 1988 Del. Ch. LEXIS 7, *19, 1988 WL 3587, *7-8 (Del. Ch. Jan. 19, 1988)). "Essentially, the duty of loyalty mandates that the best interest of the corporation and its shareholders takes precedence over any interest possessed by a director, officer or controlling shareholder . . . ." Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 361 (Del. 1993).[10]

To establish a breach of the duty of due care, a plaintiff must ordinarily establish gross negligence on the part of directors. Emerald Partners v. Berlin, 787 A.2d 85, 90 (Del. 2001); Smith v. Van Gorkom, 488 A.2d 858, 872-73 (Del. 1985). It has been said that "Delaware courts tolerate ordinary negligence from corporate fiduciaries." In re United Artists Theatre Co., 315

[10] The duty of good faith appears to be part of the duty of loyalty under Delaware law. See In re Gaylord Container Corp. Shareholders Litig., 753 A.2d 462, 476 (Del. Ch. 2000) (discussing this curious fact about the "triad" and citing commentators). See also Guttman v. Hen-Hsun Huang, 823 A.2d 492, 506 (Del. Ch. 2003). I have been unable to identify a case applying Delaware law in which the duty of good faith is articulated in a manner that sets it apart from the duty of loyalty.

F.3d 217, 231 (3d Cir. 2003). However, the Trustee argues that under Delaware law claims for simple negligence are appropriate when they are premised on director inaction, situations in which directors abdicate their duty to lead or manage a corporation, such as by letting corporate officers control important transactions that the directors should control, see, e.g., Kaplan v. Centex Corp., 284 A.2d 119, 124-25 (Del. Ch. 1971), or by dropping the ball so that an important transaction or business opportunity is lost, see, e.g., Rabkin v. Philip A. Hunt Chem. Corp., 1987 Del. Ch. LEXIS 522, *3, 1987 WL 28436, *1-*2 (Del. Ch. Dec. 17, 1987). (Docket No. 96 at 14-19.) Inaction of this nature, in effect, constitutes a breach of the directors' "legal responsibility to manage the business of a corporation for the benefit of its shareholder owners," a responsibility also owed to the corporation itself, and one that is inherently fiduciary in nature. Malone v. Brincat, 722 A.2d 5, 9-10 (Del. 1998). The Trustee maintains that the Outside Directors fall into this category of director negligence with respect to the IMI service fees transaction, because they never did anything to prevent GNP from paying the fees called for by the agreement. (Docket No. 96 at 14-19.)

When directors are subjected to litigation for breach of the duties owed a corporation or, by virtue of insolvency, its creditors, "generally one of three standards of judicial review is applied: the traditional business judgment rule, an intermediate standard of enhanced judicial scrutiny, or the entire fairness analysis." Emerald Partners, 787 A.2d at 89 (observing that the determination of the standard "often controls the outcome of the litigation on the merits"). The default standard is set by the business judgment rule. "The [business judgment] rule posits a powerful presumption in favor of actions taken by the directors in that a decision made by a loyal and informed board will not be overturned by the courts unless it cannot be attributed to any rational business purpose." Cede & Co., 634 A.2d at 361 (internal quotation marks omitted). To rebut the rule, a plaintiff must provide evidence that the directors, in reaching a challenged decision, breached their fiduciary duties to the corporation or its shareholders. Id. Among the kind of evidence that may suffice to rebut the business judgment rule is evidence that the defendant directors abdicated their duties. Id. at 363 (citing Lutz v. Boas, 171 A.2d 381, 395-96 (Del. Ch. 1961)). Unless the rule is rebutted, it is inappropriate for the court to second-guess the directors' decision. Id. at 361. However, "[i]f the rule is rebutted, the burden shifts to the defendant directors, the proponents of the challenged transaction, to prove [by a preponderance of the evidence] to the trier of fact the 'entire fairness' of the transaction." Id.; see also Emerald Partners, 787 A.2d at 91; Kahn v. Lynch Communications Sys., Inc., 638 A.2d 1110, 1115 (Del. 1994).

According to the Trustee, the summary judgment record generates a genuine issue of material fact whether the Outside Directors abdicated their fiduciary duty to GNP to manage or take control of self-dealing transactions between GNP and IMI, which were essentially left to the control of Bedard and Kass, members of GNP's board of directors and the indirect owners of IMI, GNP's sole shareholder. (Docket No. 96 at 9-10.) Although this self-dealing might not have presented a problem outside of insolvency, because IMI was GNP's sole shareholder, in the context of insolvency it became the fiduciary duty of the Outside Directors to guard GNP's assets in trust for GNP's creditors, Bovay, 38 A.2d at 813; Geyer, 621 A.2d at 787, regardless of whether the Outside Directors individually profited from the subject transactions. Given this context, I conclude that the Trustee has succeeded in rebutting the business judgment rule based on directorial abdication of duty.

Under Delaware law, "[d]irector liability for a breach of the duty to exercise appropriate attention may, in theory, arise . . . from an *unconsidered failure of the board to act* in circumstances in which due attention would, arguably, have prevented the loss." In re Caremark, Int'l, Inc., 698 A.2d 959, 967 (Del. 1996). A failure to act that leads to harm does not, however, automatically rise to the level of director negligence, or a breach of due care, because "[m]ost of the decisions that a corporation, acting through its human agents, makes are . . . not the subject of director attention. Legally, the board itself will be required only to authorize the most significant corporate acts or transactions: mergers, changes in capital structure, fundamental changes in business, appointment and compensation of the CEO, etc." Id. at 968. Here, the Outside Directors have themselves described the IMI service fees agreement as an executive compensation agreement. Additionally, the summary judgment record is sufficient to support a finding that Kass was not performing the executive functions he was supposed to deliver, such that, in the words of the Caremark court, the board "arguably" could have renegotiated the agreement to prevent any further "loss,"[11] id. Finally, the Outside Directors themselves repeatedly profess their own failure to act or apply any business judgment with respect to the same. (Docket No. 96, 15-19.) Accordingly, the Trustee's showing is sufficient to rebut the business judgment rule based on the Outside Directors' abdication of their duty to oversee an important corporate transaction or contract pertaining to executive compensation for self-dealing insiders.

[11] I raise this point because the Outside Directors would argue that there was no action they could have taken in relation to the service fees agreement since the agreement was entered into before they joined the board and was subject to a five year term with a liquidated damages provision. I do not find this argument very compelling because it would seem that if Kass was not providing the executive services he was meant to provide, then IMI may have been in material breach of the agreement, which would have provided an adequate reason for the board to act. Compare, cf. In re Maine Poly, Inc., ___ B.R. ___, 2004 Bankr. LEXIS 1695, *20-*22, 2004 WL 2495143, *6-*7 (Bankr. D. Me. Nov. 4, 2004) (describing the kind of action taken by one corporate executive under somewhat analogous circumstances). Furthermore, the record establishes that the amount GNP paid to IMI in a given year did not actually reflect the terms of the agreement, but fluctuated from year to year, which has some tendency to show a discretionary component in the payment of fees under the agreement, likely tied to the ongoing business judgment of IMI's principals, who were the self-dealing insiders on GNP's board of directors.

C. Now is not the time to give effect to the director exculpation provision.

According to the Trustee, because his summary judgment papers are sufficient to rebut the business judgment rule and generate a genuine issue concerning breach of the duty of loyalty, the Outside Directors, as a matter of Delaware procedural law, must demonstrate the entire fairness of the challenged transactions to the trier-of-fact before the court may consider whether the exculpation provision in GNP's articles shields the Outside Directors from liability for money damages. (Docket No. 96 at 10, 19.) For their part, the Outside Directors maintain that the exculpatory provision in GNP's articles entitles them to a summary disposition on the negligence claims as a matter of law. (Outside Directors' Reply, Docket No. 106, at 1-3.) I agree with the Trustee that summary judgment may not enter before there is a finding on the issue of entire fairness with respect to the challenged transactions.

The entire fairness doctrine is a procedural rule that Delaware courts apply to place the initial burden of proof on defendant directors at trial when a case raises legitimate issues regarding the director defendants' breach of the fiduciary duties of good faith and loyalty to the corporation and its shareholders.

Pursuant to Section 102(b)(7):

> (b) In addition to the matters required to be set forth in the certificate of incorporation by subsection (a) of this section, the certificate of incorporation may also contain any or all of the following matters:
> . . . .
> (7) A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit. No such provision shall eliminate or limit the liability of a director for any act or omission occurring prior to the date when such provision becomes effective. All references in this paragraph to a director shall

> also be deemed to refer (x) to a member of the governing body of a corporation which is not authorized to issue capital stock, and (y) to such other person or persons, if any, who, pursuant to a provision of the certificate of incorporation in accordance with § 141(a) of this title, exercise or perform any of the powers or duties otherwise conferred or imposed upon the board of directors by this title.

8 Del. Code § 102(b)(7). By its terms, Section 102(b)(7) insulates individual corporate directors from personal liability for money damages unless they have breached the duty of good faith and loyalty, violated Section 174, or authorized a transaction in which they derive "improper personal benefit." Id.

In Emerald Partners, the Supreme Court of Delaware, discussing its own precedent, Malpiede v. Townson, observed:

> Although a Section 102(b)(7) provision does not operate to defeat the validity of a plaintiff's claim on the merits, it can operate to defeat the plaintiff's ability to recover monetary damages. Accordingly, if the shareholder complaint only alleges a duty of care violation, the entry of a monetary judgment following a finding of unfairness would be uncollectable. Consequently, a trial pursuant to the entire fairness standard of review would serve no useful purpose. Thus, under those specific circumstances, when the presumption of the business judgment rule has been rebutted in the shareholder complaint solely by successfully alleging a duty of care violation, the director defendants do not have to prove entire fairness to the trier of fact, because of the exculpation afforded to the directors by the Section 102(b)(7) provision inserted by the shareholders into the corporation's charter.

Emerald Partners, 787 A.2d at 92 (discussing Malpiede v. Townson, 780 A.2d 1075 (2001)). In effect, Emerald Partners establishes that unless a breach of good faith or loyalty is made out on the part of a director, an exculpatory provision in the articles will prevent a plaintiff from recovering money damages from that director and, by extension, obviates the need for said director to prove entire fairness to the trier of fact, even if a breach of the duty of care is made out. Id. at 91 ("Since its enactment, Delaware courts have consistently held that the adoption of a charter provision, in accordance with Section 102(b)(7), bars the recovery of monetary damages from directors for a successful shareholder claim that is based exclusively upon establishing a violation of the duty of care."); see also Malpiede v. Townson, 780 A.2d 1075, 1094 (Del. 2001) (affirming judgment on a motion to dismiss where the pleadings raised only a potential breach of the duty of care and observing that "if there is only an unambiguous, residual due care claim and nothing else—as a matter of law—then Section 102(b)(7) would bar the claim."). However, where a question is raised with regard to loyalty, an exculpatory provision will not justify a summary disposition. As observed in Emerald Partners:

> "[W]hen entire fairness is the applicable standard of judicial review, . . . injury or damages becomes a proper focus only *after* a transaction is determined *not* to be entirely fair. *A fortiori*, the exculpatory effect of a Section 102(b)(7) provision only becomes a proper focus of judicial scrutiny after the directors' potential personal liability for the payment of monetary damages has been established. Accordingly, although a Section 102(b)(7) charter provision may provide exculpation for directors against the payment of monetary damages that is attributed exclusively to violating the duty of care, even in a transaction that requires the entire fairness review standard *ab initio*, it cannot eliminate an entire fairness analysis by the Court of Chancery.

787 A.2d at 93. Furthermore, under Delaware law, directorial abdication of duty is sufficiently serious to implicate the Outside Directors' duty of loyalty, not merely their duty of care. See Cede, 634 A.2d at 363 (characterizing abdication of directorial duty as evidence of disloyalty); Pereira v. Cogan, 294 B.R. 449, 529 (S.D.N.Y. 2003) ("In sum, Cogan's self-interest, the close relationships of the Board members to Cogan, and the complete lack of any exercise of diligence in the performance of the Board's duties [with respect to Cogan's executive compensation package] further suggest that a breach of the duty of loyalty exists. As a result, it is the Defendants' burden to prove that both disputed transactions were entirely fair to [the corporation].").

Because the Trustee's summary judgment presentation generates a genuine issue of material fact whether the Outside Directors violated their duty of care and their duty of loyalty to GNP by abdicating their directorial duty to oversee executive compensation that had been prearranged by self-dealing directors, and because the Outside Directors do not endeavor with their summary judgment papers to establish the entire fairness of the challenged transactions, the Outside Directors' motion for summary judgment should be denied with respect to Counts VI and XIII of the Trustee's amended complaint.[12]

D. The court should not summarily dispose of the claims for illegal dividends and waste (Counts IX and X) prior to considering the defendants' entire fairness presentation.

1. Illegal dividends

Counts IX and X are premised on Section 174 of the Delaware General Corporations Code. The director exculpation clause has no applicability with respect to violations of Section 174. 8 Del. Code § 102(b)(7)(iii). Pursuant to Section 174, directors of Delaware corporations are liable for unlawful payment of dividends for the amount paid as a dividend, plus interest. 8 Del. Code § 174(a). "The purpose of section 174 . . . is to provide a cause of action to creditors who have extended credit to a corporation based on that corporation's stated capital. And when the corporation impairs that capital . . . it depletes the creditors' 'trust fund' and seriously jeopardizes their means to recover their debts." Johnston v. Wolfe, 487 A.2d 1132, 1134-35 (Del. 1985). See also In re Buckhead Am. Corp., 178 B.R. 956, 972 (D. Del. 1994). Liability under Section 174 is premised on a finding of "any willful or negligent violation of § 160 or 173 of [the] title." Id. Section 160 concerns a corporation's "powers" in relation to its own stock and has no apparent relation to the claims against the Outside Directors. Section 173 addresses the declaration and payment of dividends. Id., § 173. According to that provision, "[d]ividends may

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12 Because there is a genuine issue of fact whether the Outside Directors breached their directorial duty of loyalty to GNP when it came to overseeing executive compensation for the inside, self-dealing or self-interested directors, I believe there also exists, by implication, a genuine issue whether the Outside Directors were loyal to GNP when it came to the matter of the asset transfers from GNP to IMI, an entity ultimately controlled by the inside directors. Accordingly, I recommend that the Outside Directors are not entitled to summary judgment on Count XIII any more than they are entitled to judgment on Count VI. The third negligence count, Count X, which alleges negligence based on the alleged violation of a statutory provision pertaining to the payment of dividends, is addressed below, in the discussion of the statutory claim.

be paid in cash, in property, or in shares of the corporation's capital stock." Id. Section 173 further provides, "No corporation shall pay dividends except in accordance with this chapter." Standing alone, these statutory provisions provide little guidance as to the viability of the Trustee's claims. However, the Trustee points to Section 170 of the subject chapter, which provides that directors may only declare and pay dividends out of capital surplus or, if there is no surplus, out of net profits for the year in which a dividend is to be paid. Id., § 170.

Because GNP had neither a capital surplus nor net profits in any of the years IMI owned GNP's stock, and because the IMI service fees agreement had the effect of "pull[ing] large sums of money out of GNP while it was insolvent," the Trustee maintains that the difference between the value of the payments to IMI and the value of any services received "should be characterized as an illegal dividend . . . under Section 174." (Docket No. 96 at 24.) For their part, the Outside Directors maintain that no dividend was paid to IMI because the payments were made pursuant to an executive services agreement. (Docket No. 87 at 18.) Thus, they argue, Section 174 has no applicability because they did not authorize or declare a dividend to IMI. (Id.) In their words, "If the contracted for [services were] not in fact received by GNP, that is not the responsibility of the Outside Directors. There is no case law making the directors personally responsible for the performance of a contract by another party." (Id.) In addition, the Outside Directors contend that the Trustee's position is internally inconsistent because it would treat only a portion of the service fees agreement as a dividend; according to the Outside Directors, the Trustee's concession that any portion of the payments that were made pursuant to a service fees agreement establishes that the payments cannot properly be characterized as dividends. (Docket No. 106 at 10-11.)

In support of his theory, the Trustee relies on two bankruptcy cases in which leveraged buy out ("LBO") transactions were held to be actionable under Section 174 because the economic substance of the transactions was that corporate assets were being transferred to shareholders. See In re Buckhead, 178 B.R. 956, 969-70 (D. Del. 1994); Crowthers McCall Pattern, Inc., 129 B.R. 992, 1000-1001 (S.D.N.Y. 1991). Both Buckhead and Crowthers support the proposition that the court must look to the economic substance of a challenged transaction rather than its form to determine whether the transaction's ultimate effect is to transfer corporate assets to a corporation's shareholders. Buckhead, 178 B.R. at 970; Crowthers McCall, 129 B.R. at 1001. So stated, the rule might be considered to capture the payments made under the IMI service fees agreement, because these payments effectively transferred GNP assets to IMI, its sole shareholder. But stated so broadly, the rule would capture virtually any transaction between a corporation and its shareholders so long as a plaintiff had a justifiable basis to maintain that the transaction was not at a fair price or value. Where to draw the line is not at all obvious in this context. The second wrinkle concerns the fact that the Outside Directors did not act with respect to the subject transaction, and therefore did not "declare" an illegal dividend, although it would appear they had a fiduciary obligation to act under the circumstances. The Trustee has not presented any case in which directors have been subjected to liability under Section 174 for failing to act with respect to management fees paid to a shareholder. On the other hand, given the recurring nature of the payments in this case, which unquestionably had the ultimate effect of transferring corporate assets to GNP's shareholder, the payments made during the Outside Directors' tenure could be characterized as dividends (and given GNP's insolvency, illegal dividends). Moreover, inaction, when there is a fiduciary duty to act, is really just the other side of the action coin. The Outside Directors have not pointed to any case applying Section 174 that hinges liability on the ministerial act of a board room vote. Finally, the actual sums GNP paid to IMI in a given year, ostensibly under this "agreement," do not appear to have ever equaled the amount that the agreement actually called for, nor is there any suggestion in the evidentiary record that the payments equaled the amount ultimately paid to the individuals performing executive services. To the contrary, based on the annual figures for these payments,[13] they appear to have been based on some undisclosed discretionary factors (with the discretion ultimately being exercised by Bedard and/or Kass), which further suggests that the agreement was simply a tool for vacuuming assets out of the failing GNP and into its shareholder, IMI. Because the court is being placed in the position of having to draw some rather fine lines well before the defendants have made any attempt to carry their burden of demonstrating the entire fairness of the subject transaction, I recommend that the court deny the Outside Directors' motion with respect to the "illegal dividend" claims (Counts IX and X).

2. Corporate waste

Like the illegal dividend claims, the Trustee's waste claim concerns only the payments made to IMI pursuant to the service fees agreement, not the asset transfers to IMI in connection with the KFCU loan facility. (Docket No. 58, Count V.) The Outside Directors argue that they are entitled to summary judgment against this claim because, among other reasons, the Trustee has failed to generate as a genuine issue whether the IMI service fees agreement was "in effect a gift." (Docket No. 87 at 15; see also Docket No. 106 at 5.) The legal standard a plaintiff must meet to establish waste is onerous. "[W]aste entails an exchange of corporate assets for consideration so disproportionately small as to lie beyond the range at which any reasonable person might be willing to trade. Most often the claim is associated with a transfer of corporate

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[13] For ease of reference: GNP paid to IMI $638,000 in 1999, $1,474.000 in 2000, $475,000 in 2001 and $565,000 in 2002, for a total of $3,152,000. According to the trustee these payments were distributed over a 39-month period. (Docket No. 96 at 20.)

assets that serves no corporate purpose; or for which no consideration at all is received. Such a transfer is in effect a gift." Lewis v. Vogelstein, 699 A.2d 327, 336 (Del. Ch. 1997) (citation omitted). Thus, waste is "confined to unconscionable cases where directors irrationally squander or give away corporate assets." Brehm v. Eisner, 746 A.2d 244, 263 (Del. 2000).

The Trustee argues that the IMI service fees agreement constituted waste because it called for GNP to pay IMI $2.1 million annually for executive services, even though the ultimate executive personnel who actually provided services to GNP (Bedard, the credit analyst and a secretary) received salaries totaling somewhere in the vicinity of $300,000. (Docket No. 96 at 20.) The Outside Directors point out, however, that GNP never paid $2.1 million to IMI in any given year and that the Trustee has admitted that valuable services were provided by Bedard. (Docket No. 106 at 6.) As with the illegal dividend claims, the court is being asked to view these transactions as something other than what IMI and the inside directors initially sought to structure them as. But once the "service fees agreement" label is stripped from these payments, the picture that is left simply portrays an insolvent corporation making millions of dollars in payments to its sole shareholder while the board of directors sits by and watches. And once again, IMI's willingness to accept less than full payment under the "agreement" than it was "due" tends in itself to demonstrate that the "agreement" had no real basis in equity or fairness. Unless and until the defendants can show that the transaction was entirely fair, as they are obligated to do for this self-dealing transaction, my inclination is to think that to the extent payments were unfair, and therefore unreasonable, they could not constitute anything else but a "gift" (or illegal dividend) to IMI. Accordingly, I recommend that the court deny the Outside Directors' motion with respect to the waste claim (Count V) so that it may more fully evaluate the facts and circumstances in the context of the defendants' "entire fairness" presentation.

Conclusion

For the reasons stated herein, I **DENY** the Trustee's motion to strike (Docket No. 95) and RECOMMEND that the court **DENY** the Outside Directors' motion for summary judgment (Docket No. 87).

NOTICE

> A party may file objections to those specified portions of a magistrate judge's report or proposed findings or recommended decisions entered pursuant to 28 U.S.C. § 636(b)(1)(B) for which *de novo* review by the district court is sought, together with a supporting memorandum, and request for oral argument before the district judge, if any is sought, within ten (10) days of being served with a copy thereof. A responsive memorandum and any request for oral argument before the district judge shall be filed within ten (10) days after the filing of the objection.
>
> Failure to file a timely objection shall constitute a waiver of the right to *de novo* review by the district court and to appeal the district court's order.

/s/ Margaret J. Kravchuk
U.S. Magistrate Judge

Dated November 23, 2004

TRUSTEE OF GREAT NORTHERN PAPER INC v. BEDARD et al
Assigned to: JUDGE GEORGE Z. SINGAL
Cause: 28:1332 Diversity-Other Contract

Date Filed: 11/17/2003
Jury Demand: None
Nature of Suit: 190 Contract: Other
Jurisdiction: Diversity

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