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## Litigation - USA

### Decision May Open Doors to Breach of Fiduciary Duty Claim

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#### Facts

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While US corporate lawyers and directors were busy reading and analyzing the Delaware Chancery Court's decision in *In re The Walt Disney Company Derivative Litigation*<sup>(1)</sup> - a decision affirming the presumption afforded directors under the business judgement rule - the Third Circuit issued a little-noticed ruling that could make federal courts a more hospitable forum for breach of fiduciary duty claims under Delaware law.

On August 3 2005 the US Court of Appeals for the Third Circuit held in *In re Tower Air, Inc*<sup>(2)</sup> that allegations of breach of fiduciary duty under Delaware law in actions brought in federal court must be evaluated under the federal notice pleading standard of Federal Rule of Civil Procedure 8, rather than under Delaware cases interpreting the identically worded provisions of Delaware Chancery Court Rule 8. The district court, applying Chancery Rule 8 and cases interpreting that rule, had dismissed all of the plaintiff's claims for failure to allege specific, well-pleaded facts to rebut the presumption of the business judgement rule. The Third Circuit reversed in part, finding that the district court erred by applying the heightened pleading standards that Delaware courts have grafted onto Chancery Rule 8 in an action brought in federal court.

#### Facts

Tower Air, a Delaware corporation, was founded in 1982 by defendant-appellee Morris Nachtomi. Nachtomi served in various capacities at Tower Air, including chairman of the board and chief executive officer, as well as the company's president. Nachtomi and his family owned a substantial majority of outstanding common stock and a controlling interest in Tower Air.

Tower Air began to run into financial and operating difficulties in the mid-1990s. Nachtomi controlled the company with very little oversight from the other directors of Tower Air. Nachtomi's decisions - including the addition of a Santo Domingo route (because his daughter requested it) and a cut in ticket prices so substantial that the company would not profit on certain flights even if its aircraft were entirely full - caused the company to lose a significant amount of money. In addition, Nachtomi and the other directors failed to ensure that used passenger tickets valued at \$1 million were processed for payment. Tower Air's directors also authorized Nachtomi to purchase several new jet engines at a cost of millions of dollars without ever discussing the need for new engines, the state of the old engines or the financial impact of buying new engines. Furthermore, Nachtomi and the other directors failed to address safety and maintenance issues regarding Tower Air planes.

Tower Air's collapse culminated in a voluntary petition for Chapter 11 relief in 2000. The plaintiff-appellant was appointed trustee for Tower Air's bankruptcy estate. In June 2001 the plaintiff sued Tower Air's directors and officers for monetary and punitive damages, and other relief, as Tower

Air's representative and for the benefit of its creditors and other parties in interest. In October 2001 the plaintiff filed an amended complaint alleging that the defendants breached their fiduciary duties of loyalty, good faith and due care, grossly mismanaged Tower Air and wasted corporate assets.

### **District Court Decision**

The district court evaluated the plaintiff's claims under the pleading standard of Chancery Rule 8 and applied case law interpreting that rule. Delaware courts have interpreted Chancery Rule 8 - the language of which is identical to Federal Rule of Civil Procedure 8 - to require that a plaintiff allege specific, well-pleaded facts to overcome a motion to dismiss. Thus, the district court's analysis of the plaintiff's claims focused on whether the plaintiff had alleged specific facts with particularity to support his claims. The district court dismissed the plaintiff's claims, concluding that the plaintiff had failed to allege specific facts sufficient to rebut the presumption of the business judgement rule.

### **Third Circuit Decision**

The Third Circuit reversed the district court's dismissal of all but one of the plaintiff's claims. The court held that the district court had erroneously evaluated the plaintiff's claims under Chancery Rule 8 and, in so doing, had mistakenly assumed that Delaware's pleading cases were interchangeable with federal notice pleading cases. Although Chancery Rule 8 mirrors the language of Federal Rule of Civil Procedure 8, the Delaware courts have interpreted Chancery Rule 8 to require pleading facts with specificity.<sup>(3)</sup> Conversely, as the Supreme Court recently reiterated in *Swierkiewicz v Sorema*,<sup>(4)</sup> Federal Rule of Civil Procedure 8 does not require a claimant to set out in detail the facts on which a claim is based. Following *Swierkiewicz*, the Third Circuit concluded that the district court had improperly applied Chancery Rule 8. In so doing, the district court had pre-empted discovery on certain claims by imposing a heightened pleading standard at odds with Federal Rule of Civil Procedure 8.

According to the Third Circuit, Federal Rule of Civil Procedure 8 requires only that a plaintiff allege supporting facts to the extent necessary to provide the defendant with fair notice of the plaintiff's claim and the grounds upon which it rests. In addition, in breach of fiduciary duty cases, the plaintiff must plead around the business judgement rule. To overcome the business judgement rule, a plaintiff must plead that the defendants did not act in good faith and on an informed basis. A plaintiff may overcome the presumption of good faith by establishing that a decision was so egregious as to constitute corporate waste. The burden is to show irrationality, such that no reasonable businessperson could possibly authorize the action in good faith, or that the decision was so far beyond the bounds of reasonable business judgement that its only explanation is bad faith. A plaintiff may overcome the presumption that the defendants acted on an informed basis by establishing that a decision was the product of an irrational process, or that the directors failed to establish an information and reporting system reasonably designed to provide senior management and the board with information regarding the corporation's legal compliance and business performance.

In sum, according to the Third Circuit, claims of breach of fiduciary duty under Delaware law brought in federal court must be evaluated under the notice pleading standard of Federal Rule of Civil Procedure 8, not Delaware case law applying Chancery Rule 8. Thus, a plaintiff's complaint in federal court alleging breaches of fiduciary duty under Delaware law will survive a motion to dismiss if the complaint "sets out a simple and brief statement of claims of irrationality or inattention and gives the directors and officers fair notice of the grounds of those claims".<sup>(5)</sup> The plaintiff is not required to plead facts with specificity. Applying that standard to the facts of *Tower Air*, the Third Circuit found that the plaintiff had met his burden with respect to all but one of his claims.

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### **Endnotes**

- (1) No Civ A 15452, 2005 WL 1875804 (Del Ch August 9 2005).
- (2) 416 F 3d 229 (3rd Cir 2005).
- (3) Compare Del Ch Ct R 8 ("A pleading which sets forth a claim for relief ...shall contain...a short and plain statement of the claim showing that the pleader is entitled to relief") with Fed R Civ P 8 ("A pleading which sets forth a claim for relief ...shall contain...a short and plain statement of the claim showing that the pleader is entitled to relief").
- (4) 534, US 506, 512 (2002).
- (5) 2005 WL 1813272, at \*7.

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