03-5053(□)

03-5055(CON); 03-5057(XAP); 03-5063(CON); 03-5067(CON)

IN THE

United States Court of Appeals

FOR THE SECOND CIRCUIT

TRACE INTERNATIONAL HOLDINGS, *Debtor*

JOHN S. PEREIRA, AS TRUSTEE OF TRACE INTERNATIONAL HOLDINGS, INC.,

Plaintiff-Appellee-Cross-Appellant,

TRACE FOAM SUB, INC.,

Plaintiff-Appellee,

ON APPEAL FROM THE ORDER IN THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK AT DOCKET NO. 00 CIV. 619 (SWEET, R.)

BRIEF *AMICUS CURIAE* OF CORPORATE LAW DEPARTMENTS SECTION OF THE LOS ANGELES COUNTY BAR ASSOCIATION, ET AL. IN SUPPORT OF APPELLANT-CROSS-APPELLEE PHILIP SMITH FOR REVERSAL

(additional amici listed on inside cover)

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ANDREA FARACE & FREDERICK MARCUS,
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DOW CHEMICAL CO.,
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Identification and Interest of *Amici*

In addition to a professional association of corporate attorneys, a*mici* include current or retired general counsels of major United States corporations. They bring to this case a unique perspective as to the concerns, activities and responsibilities of those holding the position of corporate general counsel.

- Corporate Law Departments Section of the Los Angeles County Bar Association: Serves more than 600 corporate lawyers in Southern California and is governed by a 33 member executive committee comprised of senior lawyers from local corporations.
- William J. Calise, Jr., Senior Vice President, General Counsel and Secretary, Rockwell Automation, Inc.
- Joseph Craciun, Corporate Counsel, Money Mailer, LLC
- Michael G. Dwyer, President Southern California Chapter of the Association of Corporate Counsel America (ACCA-SoCal) and Senior Attorney, NMB (USA) Inc.
- Hayward D. Fisk, Vice President, General Counsel and Secretary, Computer Sciences Corporation
- George S. Frazza, of Counsel, Patterson, Belknap, Webb & Tyler LLP and General Counsel (Ret.) Johnson & Johnson

- William H. Graham, former Senior Vice President, General Counsel and Secretary, Bethlehem Steel Corporation
- Quentin J. Kennedy, Executive Vice President (Ret.), Federal Paper Board Co. Inc.
- Edwin L. Lewis, Vice President and General Counsel, Photronics, Inc.
- Robert A. Lonergan, Vice President and General Counsel, Rohm and Haas Company
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Some *amici* serve as directors or Advisory Council members of Atlantic Legal Foundation, a public interest law firm established in 1976.[1]

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[1] Two members of Piper Rudnick, LLP, attorneys for Philip Smith and others in the trial court and on this appeal, are affiliated with the Atlantic Legal Foundation ("ALF"): Francis B. Burch, Jr. is a director and Arthur F. Fergenson is a member of the Advisory Council. Neither Mr. Burch nor Mr. Fergenson participated in the decision of ALF's board that ALF prepare this *amicus curiae* brief. They did not participate in this case in the trial court, nor did they participate in the preparation of this brief. Another member of ALF's Advisory Council is a member of LeBoeuf, Lamb, Greene & MacRae, LLP, attorneys for the plaintiff. He likewise did not participate in the decision of ALF's board that ALF prepare this *amicus curiae* brief.

Preliminary Statement

The trial court's treatment of what it acknowledged to be "novel issues of corporate governance" (294 B.R. at 462) will have a significant impact on the legal community. As one commentator (a professor of corporation law at Columbia Law School) has observed, the *Pereira* case "should particularly chill the hearts of inside general counsel. . . ." John C. Coffee, Jr., POST-ENRON JURISPRUDENCE, *N.Y.L.J.* July 17, 2003, p.5 at 15 col. 2.

If not reversed, the *Pereira* decision stands for the proposition that a corporate legal officer who is not found to have committed legal malpractice and does not reap any personal benefit can be held personally liable for a corporate transaction without the benefit of the business judgment rule otherwise applicable to non-self dealing officers and directors because the court, in hindsight, disagrees with the corporate action. The trial court found Smith personally liable for over $20 million simply because the court was not persuaded that the transactions were "entirely fair."

If this decision is allowed to stand, corporate legal officers may be liable for the failure of directors to carry out their obligations, contrary to a central tenet of the Delaware Corporation Law. The trial court established an affirmative duty for corporate legal officers to control and supervise the board of directors, ensuring that directors ferret out, expose and prevent transactions that may damage the corporation and others. The trial court turned the lawyer-client relationship upside down (as it did

the director-officer relationship), creating a "super-director" responsibility which few corporate legal officers would be able to meet. It unreasonably imposes liability on corporate legal officers for omissions of others.

This case is of special importance and concern because of the overwhelming significance and influence of Delaware corporation law and its interpretation to United States corporations. Approximately 40% of NYSE listed companies are incorporated in Delaware and approximately 50% of Fortune 500 companies are incorporated in Delaware. In addition, Delaware corporation law is the model for and influences the interpretation of the corporation laws of other states. Indeed, the Delaware Chancery Court, interpreting Delaware corporation law has been called the "Mother court of corporate law" and has influenced the Model Corporation Act and the statutes of many states.[2]

As is often the case where a privately held corporation is dominated by its controlling shareholder, it appears that Trace International Holdings, Inc. ("Trace") was operated informally, with scant attention given to the practices that now have become standard for publicly held companies. Indeed, Marshall Cogan's influence

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[2] See D. Block, N. Barton and S. Radin, THE BUSINESS JUDGMENT RULE -- FIDUCIARY DUTIES OF CORPORATE DIRECTORS at 2-3 and fn. 14 (2000) and 2002 Cumulative Supplement (2002); *Kamen v. Kemper Financial Servs., Inc.*, 908 F.2d 1338, 1343 (7th Cir. 1990), *rev'd on other grounds*, 500 U.S. 90 (1991); *see also* 1 R. Franklin Belotti and Jesse A. Finkelstein, THE DELAWARE LAW OF CORPORATION AND BUSINESS ORGANIZATIONS, F-1 (3d ed. 2002).

and his self-dealing cannot be justified even in a private setting.

Amici believe that boards of directors and senior management ought to ensure good corporate governance. They also believe that corporate counsel should play a role in corporate governance and that senior management's commitment to creating and sustaining an ethical business culture is the most important factor in improving corporate governance.

Amici do not seek to defend the manner in which Cogan ran Trace; nor do they address the Trace board's lack of supervision and control over Cogan. Rather, this brief focuses solely on the legal standard imposed by the trial court in holding the chief legal officer responsible for the board's neglect. The sole issues this brief will address are: whether the trial court improperly failed to apply, or improperly applied, the business judgment rule to the actions and decisions of the chief corporate legal officer of a non-public Delaware corporation; and whether the trial court failed to distinguish between the responsibilities of the directors and the non-director chief legal officer in establishing compliance procedures.

Statement of the Case

Trace was a holding company with limited operations (294 B.R. at 465); it was not an active business enterprise and did not run a business (Lefkort, Tr. 1476).

Cogan

Trace was founded by Marshall Cogan, its chief executive officer and chairman of its board. Cogan owned more than fifty percent of Trace stock. He was a Harvard Business School graduate and earlier was a senior partner at Cogan, Berlind, Weill & Levitt. The trial court found that Cogan was "a widely respected figure in the investment community" (294 B.R. at 462, 465).

Other Members of the Board

Other board members during the relevant period were also seasoned business executives. Before joining the Trace operation, Andrea Farace was the managing director of investment banking at Lehman Brothers, a leading investment banking firm, and "was sometimes referred to as Trace's in-house investment banker." (294 B.R. at 466). The trial court found that as a director he "regularly kept himself appraised of the financial condition of the company by reviewing the Trace audited financial statements, daily cash reports, non-GAAP balance sheets, and through daily discussions with the principal senior executives. . . ." (294 B.R. at 466). Frederick Marcus, vice chairman of the board, had been a senior executive at Drexel Burnham, another well-known investment banking firm. He kept himself appraised of Trace's financial condition by reviewing financial material and through discussions with senior executives. (294 B.R. at 467). Board member Robert Nelson was a certified

public accountant and had been an auditor at Coopers & Lybrand. He was the chief financial officer and, at one point, chief operating officer. (294 B.R. at 467). Saul Sherman was not an officer or Trace employee. He was the Chairman of Allied Products Corporation, a publicly traded company.[3]

Philip Smith

Philip Smith began his legal career at the Securities and Exchange Commission, where he had worked while attending law school. After five years at the S.E.C., he went to a Washington, D.C. firm where he became a partner several years later (Smith, Tr. 1558), focusing on securities and corporate matters. (*Id.* at 1559). In 1980, he joined Akin, Gump, Strausshaur & Feld and was a partner in the litigation and corporate sections handling matters for Trace, among other clients. He was hired by Trace in January, 1988, as vice president, general counsel and secretary. (*Id.* at 1559).

Smith spent only a small portion of his time on Trace matters (Smith, Tr. 1566-67). His principal employment was as general counsel of two of Trace's operating subsidiaries, Foamex International, Inc. and United Auto Group, Inc., both of which were publicly held (294 B.R. at 483, fn. 27). When he did function on behalf of Trace it was "Generally, to deal with legal issues as they arose and were brought

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[3] Before the transactions at issue, the board included other outsiders: Sidney P. Kriser (an investor), Stuart Hershon (a surgeon), Alan Feld (a senior executive partner at Akin Gump), Charles Lubin (founder of Sara Lee Bakeries) and Stephen Weinroth (an investment banker at Drexel, Burnham). (294 B.R. at 475, fn. 13).

to [his] attention. Most of the time, [he] would use or seek the help of outside counsel." (Smith, Tr. 1559-6).[4]

Smith was not a member of the board of directors of Trace and there was no evidence that he was ever offered a seat on the board. He was not asked to call board meetings, or to establish agendas and procedures or to design and implement compliance programs. He was not asked for advice as to whether an audit committee was required or whether one would be desirable. He viewed his role, pure and simple, to respond with respect to legal issues as they arose and were brought to him.

Notwithstanding his defined and limited role at Trace, Smith was held personally liable for over $20 million in damages flowing from his alleged failure to carry out his corporate duties regarding (1) the so-called Dow transaction and (2) loans to Cogan and others (294 B.R. at 531), of which Smith -- as the trial court found -- was largely unaware.[5]

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[4] Smith was also corporate secretary but he has not been held liable for his duties in that capacity. Practically everyone at Trace held the Vice President title, as did Smith. He ultimately was a Senior Vice President. The trial court found that merely having the vice president title did not entail decision making authority. (294 B.R. at 522). From 1995 to 1998, Trace subsidiaries paid Smith's salary, and his sole compensation from Trace was the use of a company car and an occasional bonus. In 1999, his total compensation from Trace was $60,000. (294 B.R. at 469).

[5] Plaintiff asserted Smith was liable for several other Trace actions or transactions, but the trial court found him not to be liable for them.

The Dow Transaction

In 1992, Dow Chemical, a "critical supplier" to Foamex (294 B.R. at 486, 488), "one of Trace's most significant assets" (294 B.R. at 501) and one of its "principal investments" (294 B.R. at 470), agreed to fund the purchase of Trace Series A Preferred stock by a third party, which pledged the preferred stock to Dow as security for a $20 million loan used to buy the preferred stock. (*Id.*) In 1997, in response to a demand from Dow, Cogan committed Trace to redeem or to cause the purchase of Dow's investment in Trace over a three-year period, commencing with a $3 million installment by May 1998. (294 B.R. at 486-487). Richards Layton & Finger, a prominent Delaware corporate law firm, advised Smith that Trace could not redeem the Dow stock without also paying dividend arrearages on Trace's *pari passu* convertible preferred stock, which were in excess of $2 million, thus requiring Trace to use $5 million in cash at the time of the first repurchase installment if Trace were to redeem the preferred stock held by Dow. (294 B.R. at 487). To enable Trace to avoid paying the $2 million in dividends to non-Dow holders of preferred stock, Smith structured the transaction so that Cogan personally would purchase the preferred shares held by Dow, using $3 million Trace would lend to Cogan. Cogan would pledge the Dow preferred shares thus acquired to Trace as security for the $3 million loan. (*Id.*)

The $3 million loan was made to Cogan, and Cogan issued a promissory note to Trace in the amount of $3.722 million which included interest. (294 B.R. at 487). A member of Willkie Farr & Gallagher, one of Trace's outside counsel, prepared a note and the attached stock pledge agreement and stock certificate. (*Id.*) At least some of the directors believed that Dow's request for a stock repurchase should be accommodated due to the important relationship Dow had with Foamex. (294 B.R. at 488).

Smith advised that the Dow transaction could be structured as it was. The result and intended effect was that the contractual obligation to Dow would be satisfied and Trace would save millions of dollars in *pari passu* dividends. Cogan would reap no personal benefit. Smith received no personal benefit from this transaction.

The trial court characterized Smith's solution to the problem as "clever" (294 B.R. at 543) but ruled that it was a redemption by Trace at a time when Trace was insolvent (294 B.R. at 534).

The Dow transaction was hardly "secret;" and, the trial court found that "all of the Defendants were aware" of it (294 B.R. at 532, 534).[6] However, the court faulted Smith and the other defendants (294 B.R. at 532) for not bringing the transaction to

[6] Maurice Lefkort, a partner in Willkie, Farr & Gallagher (Lefkort, Tr. 1474) was told that "Trace had structured [the Dow transaction] as a Loan to Mr. Cogan so that he could buy the stock . . . from this Dow entity. . . ." (*Id.* at 1482). Lefkort prepared documents to memorialize the Dow transaction. (*Id.* at 1480-81).

the board: "Had the Defendants exposed the issues to the sunlight of the corporate board room and corporate minutes, they might not have carried through on the plan, as they might have been stopped from doing so by the *pari passu* shareholders." (294 B.R. at 534) As the trial court saw it, the failure to insist on board discussion, investigation and approval was "at the very least a violation of the duty of due care." (294 B.R. at 532) The trial court found that Smith's "active involvement" in the Dow transaction "suggests that it was within his <u>discretionary authority and that he had the ability to prevent the redemption</u>" (294 B.R. at 522) (Emphasis added).

The trial court's treatment of the Dow transaction is premised in large part on its finding that it amounted to redemption by Trace at a time when Trace was insolvent and that the transaction was thus "illegal." (294 B.R. at 463; 531, fn. 76;534). However, the court made no finding (and there was no assertion by plaintiff) that Smith knew -- or even that he should have known -- that Trace was insolvent.

Loans to Cogan and Other Insiders

The trial court summarized a corporate officer's responsibilities for purposes of liability in terms of a two-pronged test: thus, liability might attach where the non-director officer “had discretionary authority in the functional area and the ability to cause or prevent the complained of action” (294 B.R. at 522). The trial court, focusing on the chief legal officer, found that he had broad discretionary authority with respect to advising the board: “Smith, as general counsel, was supposed to advise the board as to its obligations and responsibilities.” (294 B.R. at 500). More specifically, the court pointed to what Smith should have done but failed to do: “he never discussed with the Board the need to establish compliance and monitoring programs or an audit committee and the obligation to supervise and evaluate Cogan as CEO. Thus, it was within his discretionary authority to advise the Board that they should ensure that Cogan was appropriately recompensed.” (294 B.R. at 523).

Smith was absolved of liability for Trace's payment of dividends (294 B.R. at 523) and Cogan's compensation because there was “no evidence that any advice would have resulted in the Board's taking proper action” (*Id.*) However, Smith was found liable for loans to Cogan and other insiders even though such loans were permissible where granted with approval of the board, because Smith did not advise the board that approval was necessary and his advice could have prevented the loans (294 B.R. at 524).

The trial court's treatment of the loans to Cogan and other insiders is somewhat perplexing. The court found that Smith did not know of the Cogan loans until mid-1998 and could be liable for loans that took place after that date. (294 B.R. at 524). However, elsewhere in the decision, the court found that "All Defendants were aware or reasonably should have been aware of the loans [and] are liable for them if the loans were not entirely fair to Trace." (294 B.R. at 537) (Emphasis added). Smith, and the other officers, were held liable for their inaction:

> "There was no process in place for the loans to be approved and, in fact, the officers and directors for the most part could only determine the existence of the loans by reading the daily cash reports. At no time did any officer or director attempt to (1) set up a procedure by which loans would be approved; (2) seek to insure that Cogan had put up collateral or was otherwise able to pay back the loans; (3) investigate the loans to insure that they were fair to the company; or (4) even discuss whether such measures should be put into place. As a result, there was not fair process."

(294 B.R. at 537). Smith also was held liable, based on the same failure to put in place adequate procedures, for loans to Lento ($558,000) and Sinkfeld ($15,000) (294 B.R. at 538).

The MOMA Party

Plaintiff sought to hold Smith and others liable for an "excessively extravagant" (294 B.R. at 539) party on the occasion of Cogan's birthday, paid for by Trace, at the Museum of Modern Art. As with the Dow transaction and Cogan and insider loans, there was no evidence that the MOMA affair had been brought to the attention of, or approved by, the board (294 B.R. at 538). Smith was not aware that Trace paid for the party, "nor was any evidence presented that [he] should have investigated whether it was." (294 B.R. at 524).

While the trial court absolved Smith of any liability for the MOMA event, the court articulated a rationale which is the lynchpin of its findings of Smith's liability for the other transactions: "Smith, as General Counsel, had the obligation to ***direct*** the Board to supervise Cogan and to ensure the financial integrity of Trace" (294 B.R. at 524) (Emphases added).

ARGUMENT

THE TRIAL COURT IMPROPERLY FAILED TO APPLY THE DELAWARE BUSINESS JUDGMENT RULE TO THE LEGAL ADVICE OF THE GENERAL COUNSEL

A. The Delaware business judgment rule.

The Delaware business judgment rule presumes that directors and officers have acted in good faith and in the best interests of the company. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds, Brehm v. Eisner,* 746 A.2d 244, 253 (Del.2000); *Havens v. Attar*, 1997 WL 55957, at *11 (Del. Ch. Jan. 30, 1997) (quoting *Aronson*, 473 A.2d at 812) ("[T]he business judgment rule . . . establishes a presumption that the defendant directors, in making the decision . . . 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.'").

B. The purpose of the business judgment rule.

The policy underlying the business judgment rule is to prevent courts and third parties from "second guessing" business decisions of corporate directors made in good faith and with reasonable information. The business judgment rule is designed to ensure that courts do not in hindsight reverse the judgment of corporate officers and directors who are presumed to have acted in good faith and in the best interests of the company. *Aronson v. Lewis, supra*, *Havens v. Attar, supra* (*quoting Aronson*). *See*

also Federal Deposit Insurance Corp. v. Stahl, 89 F.3d 1510, 1517 (11th Cir. 1996); *Waltuch v. Conticommodity Services, Inc.*, 833 F.Supp. 302, 305-306 (S.D.N.Y. 1993), *aff'd and rev'd on other grounds*, 88 F.3d 87 (2nd Cir. 1996) ("...the court at least in theory will not second-guess the merits of the decision.")

The business judgment rule "operates as both a procedural guide for litigants and a substantive rule of law." *Cinerama, Inc. v. Technicolor, Inc.,supra*, 663 A.2d at 1162 (Del.1995). As a procedural guide, the business judgment presumption is a rule of evidence that places the initial burden of proof on the plaintiff. (*Id.*) A plaintiff challenging a board decision has the burden of rebutting the rule's presumption, and if it fails to meet this evidentiary burden, the business judgment rule attaches to protect corporate officers and directors and their decisions. *Cede & Co. v. Technicolor Inc.,* 634 A.2d 345, 361 (Del.1993). If the rule is rebutted, the burden shifts to the defendant directors and officers, the proponents of the challenged transaction, to prove to the trier of fact the "entire fairness" of the transaction. (*Id.* at 361), but burden-shifting does not create *per se* liability on the part of the directors. *Cinerama, Inc. v. Technicolor, Inc., supra* 663 A.2d at 1162-1164 (Del.1995).

The business judgment rule may be rebutted if plaintiffs show that the directors, in reaching their challenged decision, breached any of their fiduciary duties of good faith, loyalty or due care. *Cede & Co., supra*, 634 A.2d at 361. Only where the transaction involves a conflict of interest or breach of fiduciary duty, the burden shifts

to a defendant to prove the "entire fairness" of the transaction. *Kahn v. Tremont Corp.,* 694 A.2d 422, 428-29 (Del.1997); *Kahn v. Lynch Commun. Sys., Inc.,* 638 A.2d 1110, 1115, 1117 (Del.1994); *In re Croton River Club*, 52 F.3d 41, 44 (2nd Cir. 1995); *Williams v. Geier*, 671 A.2d 1368, 1378, fn. 20 (Del.Ch. 1996); *Cinerama, Inc. v. Technicolor, Inc.*, *supra*; *Cede & Co.*, *supra,* 634 A.2d at 361.

C. The business judgment rule applies to both officers and directors.

Smith's work for Trace was covered by the business judgment rule. As the trial court acknowledged (294 B.R. at 526, fn. 73), decisions of officers as well as directors may be protected by the business judgment rule. *See, e.g., Kaplan v. Centex Corp*., 284 A.2d 119 (Del.Ch. 1971), *Kelly v. Bell*, 254 A.2d 62 (Del. Ch. 1969), *aff'd on other grounds*, 266 A.2d 878 (Del. 1970); *Pogostin v. Rice,* Civ. A. No. 6235, 1983 WL 17985, at *3 (Del.Ch. Aug. 12, 1983); *see also Galef v. Alexander*, 615 F.2d 51, 57 fn. 13 (2nd Cir. 1980) (applying Ohio law).

D. The business judgment rule's presumption of propriety was not rebutted.

Under Delaware law a plaintiff must prove that a defendant was <u>grossly</u> negligent in performing his duty of care to rebut the presumption of propriety supplied by the business judgment rule. *Brehm v. Eisner*, 746 A.2d 244, 259 (Del. 2000) ("the directors' process [in making a business decision] is actionable only if grossly negligent"); *Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985) ("[T]he concept of gross negligence is . . . the proper standard for determining whether a business

judgment reached by a board of directors was an informed one."); *see also*, *Kahn v. Roberts*, 21 Del. J. Corp. L. 674, 684 (Del. Ch. 1995), *aff'd* 679 A.2d 460 (Del. 1996); *Cede & Co. v. Technicolor, Inc.*, *supra*, 634 A.2d at 364, fn. 31 (Del. 1993); *Aronson v. Lewis*, *supra,* 473 A.2d at 812; *In re Healthco Int'l, Inc.*, 208 B.R. 288, 306 (Bankr. D. Mass. 1997), (applying Delaware law to hold that "under the business judgment rule director liability is predicated upon concepts of gross negligence"); 1 R. Franklin Balotti and Jesse A. Finkelstein, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS 4.33[B] at 4-147 (3d ed. 2002) ("Gross negligence is the standard employed under Delaware law in determining whether a business judgment reached by a board of directors was sufficiently informed to satisfy the directors' duty of care.") To recover for breach of the duty of care against Smith, plaintiff was required to prove that he was grossly negligent in connection with specific transactions.[7]

Gross negligence means "reckless indifference to or a deliberate disregard of the whole body of stockholders" or actions which are "without the bounds or reason." *Tomczak v. Morton Thiokol, Inc.*, [1990 Transfer Binder] Fed. Sec. L. Rep. (CCH), ¶95,585, CA No. 7861, slip opinion at 31 (Del.Ch. April 5, 1990); *Brehm v. Eisner*,

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[7] There was no claim and no proof that Smith's actions involved self-dealing, so he did not have the burden of proving the "entire fairness" of the transactions. *Kahn v. Tremont Corp.,* 694 A.2d 422, 428-29 (Del.1997); *Kahn v. Lynch Commun. Sys., Inc.,* 638 A.2d 1110, 1115, 1117 (Del.1994).

746 A.2d 244, 259 (Del. 2000), *Malpiede v. Townson*, 780 A.2d 1075, 1096 n76 (Del. 2001), *McCall v. Scott*, 250 F.3d 997, 999 (6th Cir. 2001) (applying Delaware law).[8] Plaintiff adduced no evidence that Smith acted with "deliberate disregard of the shareholders" or "without the bounds of reason." Instead, the trial court imposed liability because he did not assert sufficient control over the directors with respect to transactions, some of which he did not know about.

E. The repurchase of Trace preferred stock from Dow.

Smith gave legal advice concerning how to arrange the repurchase of Trace preferred stock from a Dow affiliate, an important supplier to Trace's major subsidiary – Foamex – in a way that would save Trace millions of dollars: that the Dow transaction could be accomplished by the company lending $3 million to Cogan, who would purchase the Dow stock with those funds and pledge the stock to secure his loan, which would bear interest at the rate of the dividend on the stock. The intended result and actual effect was that Dow would have its block of preferred stock

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[8] The trial court used the phrase "gross negligence" only once in its entire 254 page slip opinion, when in footnote 71 (at 294 B.R. 526) the court states: "The Director-Defendants admit that, even under the case law they raise and even under the gross negligence standard that a director or board may be held liable for a 'complete lack of monitoring by the board,' *Cantor v. Perelman,* 235 F.Supp.2d 377, 389 (D.Del.2002), or 'an utter failure to attempt to assure [that] a reasonable information and reporting system exists.' *McCall v. Scott,* 250 F.3d 997, 999 (6th Cir.2001)." But this standard applies only to the director defendants, not to Smith, who was merely an officer, and one with limited managerial responsibilities. Indeed, the trial court's statement is, in its own language, limited to the "Director-Defendants."

purchased, Trace would save the millions of *pari passu* dividends, and Cogan would obtain no benefit. This transaction did not enrich Cogan, Smith or anyone else other than Trace and its shareholders.

Smith's legal advice was not grossly negligent. Indeed, the Delaware Chancery Court later held that a corporation's charter restricting the repurchase of one class of stock while there were dividend arrearages on another *pari passu* class was not violated when the corporation caused such a purchase to be made by its wholly-owned subsidiaries. *In re Sunstates Corporation Shareholder Litigation*, 788 A.2d 530 (Del. Ch. 2001). There was no finding that Smith knew that Trace was "insolvent or in the vicinity of insolvency" when he structured the Dow redemption.[9] It took the trial

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[9] The trial court:

> "[F]ound as a matter of fact that Trace was insolvent or in the vicinity of insolvency during most of the period from 1995 to 1999, when Trace finally filed for bankruptcy. Trace's insolvency means that Cogan and the other director and officer defendants were no longer just liable to Trace and its shareholders, but also to Trace's creditors. In addition, the insolvency rendered certain transactions illegal, such as a redemption and the declaring of dividends. It may therefore be further concluded that, in determining the breadth of duties in the situation as described above, officers and directors must at the very least be sure that the actions of the controlling shareholder (and their inattention thereto) do not run the privately held corporation into the ground."

(294 B.R. at 463) (Emphasis added).

court to go to some pains to show that by one expert's calculations Trace was "in the vicinity of insolvency." (294 B.R at. 501). The agreement to repurchase the Dow preferred was made in October 1997, at a time when, even by one of the trial court's own measures, Trace had a negative value of only $5.1 million, and at the end of the most recent calendar year, at December 1996, had a positive balance sheet value of $51.4 million (294 B.R. at 509). More important, the trial court's finding of insolvency is clearly hindsight, and depends on lengthy, complex and subtle calculations of the value of various Trace subsidiaries and the court's evaluation of conflicting expert opinions (294 B.R. at 501-510). There simply is no evidence that Smith knew or could have known that Trace was insolvent at the time of the Dow redemption.

The trial court seemed to be swayed by the fact that "Smith was heavily involved in setting the stage for the Dow repurchase and in concocting the eventual subterfuge to cover the redemption." (294 B.R. at 522) (Emphasis added). The court used the word "subterfuge" twice in the same paragraph describing Smith's role. While the court may have thought Smith was being "too clever by half" in structuring the redemption of the preferred stock to avoid paying dividends, notwithstanding the trial court's use of pejorative language, his direct involvement in a legal strategy is hardly the basis for imposing liability. It is not at all clear how the trial court distinguished between "creative lawyering" and "subterfuge." Although the board

took no formal action, the trial court itself found that all of the defendants (which included all members of the board at the relevant time) "were aware of the challenged Dow repurchase."[10] (294 B.R. at 532). A Willkie Farr partner drafted instruments documenting the transaction and he made no objection to it. (Lefkort, Tr. 1474, 1480-81).

At worst, Smith may have been wrong in not insisting that the board of Trace formally consider and approve the transaction – which doubtless would have happened. For all that appears, he acted in good faith and in what he thought was in Trace's best interests, consistent with his ethical obligations as counsel.

THE TRIAL COURT FAILED TO DISTINGUISH BETWEEN THE RESPONSIBILITIES OF DIRECTORS AND THE OBLIGATIONS OF THE CHIEF LEGAL OFFICER

The trial court found that Cogan arranged to take more than $10 million in personal loans but that Smith was not consulted about their propriety. Indeed, the court found that Smith only learned of these loans in mid-1998, well after most had been made, when they first appeared in a footnote in Trace's audited 1997 financial statements (294 B.R. at 523-24). Prior to that date, Coopers & Lybrand did not

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[10] At the time of the Dow redemption, Trace's board consisted of Cogan, Farace, Marcus, Nelson and Sherman, all of whom are defendants. Thus the board did know of this transaction. Since the holders of *pari passu* preferred stock (other than Cogan) did not sit on the board, and there is no reason to believe they had access to board minutes, they would not have learned of the transaction even had the board formally acted.

consider the total amount of those loans to be material and, therefore, they were not noted in prior audited financials. The auditors did not bring the loans to Smith's attention earlier.

The court did not find that Smith gave any legal advice about those loans or that he was asked about them or about any procedure for approving officer, director or shareholder loans. Smith did not personally benefit from these loans to Cogan and others.

A. Smith's discretionary authority.

The trial court found that Smith had not met his obligations to Trace principally because he had not fulfilled his "discretionary authority." The scope of this authority came not from the Trace by-laws and was not derived from any instruction or invitation Smith was given by the board or by the chief executive officer. Rather, the trial court simply concluded as a matter of law that a general counsel was responsible for educating and directing the board, and consequently liable when the board does not do its job. The equation is simple: if the chief legal officer does not adequately educate and supervise the board, he or she is liable for the board's neglect. No authority is cited for such a sweeping rule of law which reverses the roles of the board and corporate officers under Delaware law.[11]

The essential error in the trial court's analysis is the reversal of the traditional role of the client and lawyer. As stated succinctly by one leading authority, "the client by and large controls the actions of the lawyer, not vice versa." 1 G. Hazard and W.

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[11] Section 141(a) of the Delaware General Corporation Law provides: "The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors. . . ." Officers titles and duties "shall be stated in the bylaws or in a resolution of the board of directors. . . ." (*Id.* §142). "A fundamental precept of Delaware corporation law is that it is the board of directors, and neither the shareholders nor managers [officers] that has the ultimate responsibility for management of the enterprise." *In re Bally's Grand Derivative Litig*. Consol. C.A. No. 14644, Slip Opinion at 16 (Del.Ch. June 4, 1997)(citations omitted); "[I]t is with the board and not with the officers of the corporation that the ultimate responsibility lies." *Id. See also Grimes v. Donald*, CA No. 13358, slip opinion at 1-2 (Del.Ch. Jan. 11, 1995), *aff'd*, 673 A.2d 1202 (Del. 1996).

Hodes, THE LAW OF LAWYERING §2.1 at 2.4 (3d ed). The lawyer is an agent: "the relationship between lawyer and client is at the heart of the law of lawyering. Because that relationship is essentially one of agency, the law establishes elaborate ground rules under which the agent-lawyer must serve the principal-client." (*Id*. §2.1 at 2.3). The Model Rules of Professional Conduct echo the law of agency: Model Rule 2.1 Comment [5] provides that a lawyer is not required to give advice unless and until asked by the client. *See Science Accessories Corp. v. Summagraphics Corp.*, 425 A.2d 957 (Del. 1980).

The report and testimony of Plaintiff's expert Irving Kagan cites no authority for his opinion as to the obligations of a general counsel. Kagan did not attempt to bolster his views with any empirical data or discussion of the practices of general counsel of privately held companies. (Kagan, Tr. 579). Moreover, Kagan did not specifically address how the chief legal officer should go about educating the board when he or she has not been asked to do so.

Kagan's opinion, we submit, confuses the roles of an audit committee and the general counsel. Kagan on the one hand argues that the audit committee "is truly the ultimate 'watchdog' for ensuring" the appropriate corporate cultural climate (Exhibit 172 at 5), while charging the general counsel with the obligation to implement decisions the board should have made: "His duty, as general counsel, was to educate and counsel the Board on its leading role, recommend necessary and appropriate

measures to fulfill its fiduciary obligations, and implement the decisions it should have made (but did not) to set the tone for the company." (*Id*. at 10).

Kagan's opinion, and the trial court's reasoning, completely neglects other safeguards upon which the board is entitled to rely in monitoring senior management: the Trace directors were entitled to rely on the advise of its certified public accountants. 1 D. Block, N. Barton, S. Radin, THE BUSINESS JUDGMENT RULE, 198-224 (5th ed. 1998). An essential part of the auditors' function is to review the corporation's internal controls and to advise as to their adequacy. See T. Shroyer, Accountant Liability §15.13 (1991); R. Kay and D. Searfoss, HANDBOOK OF ACCOUNTING AND AUDITING 8.1 et seq. (2d ed. 1995).

Directors naturally look to the auditors -- not to the general counsel -- to bring weaknesses in the internal control structure of the sort found lacking at Trace. The general counsel is in place to handle legal concerns, not to ensure that financial matters such as dividends, excessive insider compensation and loans are detected and prevented.

The trial court ruled that Smith failed to meet his obligation to advise the board on the "need to establish compliance and monitoring procedures or an audit committee. . . ." (294 B.R. at 523). It may have been far better if Trace had an audit committee with the kind of broad authority Kagan described as well as a formal policy prohibiting loans to insiders absent prior board approval; but the law does not compel

the general counsel to impose these precautions. According to the testimony of Willkie Farr partner Maurice Lefkort "There is no requirement that private companies have audit committees." (Lefkort, Tr. 1475) and "In my experience it is not standard practice for them [non-public companies] to have audit committees." (*Id*.). Unless Smith was tasked by the board to design, implement and monitor good governance safeguards -- and failed to do so -- he cannot be held responsible for ensuing board failures.

Lawyers' obligations to clients must evolve as the world of commerce has become faster, more complicated and geographically diverse. There are procedures already in place to alter a lawyer's professional obligations and to publish appropriate changes. What has happened here, however, is that a lawyer who believed he could properly function in a limited, responsive legal role -- one he believed to satisfy his professional obligations -- has been saddled with ruinous consequences because of his failure to meet obligations of which he was unaware and which were imposed after the fact by the trial court.

We do not fault the trial court's requiring a lawyer to meet the demanding requirements of his or her profession. However, we question whether dramatic changes in a lawyer's responsibility to his or her client can fairly be established after the fact in civil litigation involving the negligent activities of his or her client. If the role of corporate counsel is to be expanded the change should come from legislation,

regulation or possibly from codes of professional conduct in advance so that professionals can govern their conduct accordingly.

In addition to imposing a general supervisory obligation over the board on general counsel, the steps required to satisfy counsel's responsibilities, as defined by the trial court, are so obscure as to require counsel to function at his or her extreme peril. For example, can it be seriously suggested that experienced business executives need a tutorial as to essential responsibilities of a director? What if the general counsel recommended the appointment of an audit committee but the directors (or some of them) disagreed? Must the general counsel lecture an experienced business person on all the relevant provisions of the applicable U.S. and foreign business law or only those he thinks might conceivably be breached in the operation of the company's business? What if the general counsel compiles educational material and distributes it to the board, but knows that it will be ignored? On a different level, must the general counsel ensure that the board monitors the CEO's use of the company's car and driver, or satisfy him or herself that the company airplane is not used for personal excursions?

It might be argued that the trial court's holding governs the affirmative obligations only of a chief legal officer -- a lawyer employed (even on a part-time basis, as was Smith) by the corporation with a responsibility to the board. But such a limited application is not evident in the trial court's description of Smith's

obligations and is by no means certain. Outside counsel relied upon regularly by senior management for general business advice and counsel are likewise employed by the corporation. Is the lead partner of a firm which from time-to-time gives legal advice to senior management and directors obligated, without invitation, to carry out the kind of compliance procedures for which the trial court found Smith personally liable? We think not.

B. Smith's authority to cause or prevent board action.

The trial court found that Smith had the “ability to prevent” the loans, presumably after he learned of them. But under the conditions prevailing in the Trace boardroom, it is likely that extravagant loans to Cogan and others would have been approved. Some directors actually know of some Logan loans and did not object (294 B.R. at 492). There was no evidence to support the trial court’s speculative finding that the objection of lawyer Smith (and a recitation of Delaware law as to director approval of loans) would have made any difference; and no basis on which to conclude that a properly educated board would have acted any differently. Smith might be faulted if he had been asked if loans to insiders were permitted under Delaware Law and if he failed to give the appropriate legal advice. His ignorance of Delaware law (294 B.R. at 500) is quite irrelevant since he was not asked to give any legal advice about the loans.

The trial court's reasoning rides on the premise that the chief legal officer's counsel will be followed by the board. But a lawyer has no enforcement weapon in his or her arsenal; a moral carrot but no stick. A lawyer's only recourse, in a situation where the board does not bend to the lawyer's judgment, is to resign and begin the search for a new job.

C. The trial court failed to apply the business judgment rule with respect to Smith's responsibilities for insider loans.

It appears that the court put on all of the defendants, including Smith, the burden of proving the "entire fairness" of the loans to Cogan (294 B.R. at 537). But as the trial court acknowledged (in the absence of a more particularized inquiry) it is not the law that non-conflicted corporate officers can be held to the "entire fairness" standard (294 B.R. at 527). The trial court, applying its "particularized inquiry," stated:

> "Even if the non-Cogan defendants are correct that their lack of oversight was not a breach of their fiduciary duties, there is an alternative ground on which they all would be liable for the loans. The Defendants' compensation expert, Mines, concluded that the loans received by Cogan were part of his compensation. Thus, as it has been concluded that Cogan received excess compensation merely from his salary, without consideration of the loans, all Defendants liable for permitting Cogan to receive excess compensation would also be liable for permitting Cogan to receive the loans, in excess of what has already been deemed excess compensation."

(294 B.R. at 537, fn. 83). The problem with that logic as to Smith is that the trial

court held that the non-director officer defendants were not liable for Cogan's excess compensation, because they could not have prevented the “complacent” Board from approving it (294 B.R. at 523).

“Fairness” becomes an issue only if the presumption of the business judgment rule,[12] is defeated. Where the presumption of the business judgment rule is not rebutted, “the entire fairness inquiry. . . simply has no application.” *Williams v. Geier,* 671 A.2d 1368, 1378 fn.20 and1384 (Del. 1996). That rebuttal requires the plaintiff to prove that there was a breach of either the duty of loyalty or the duty of care by the individual otherwise entitled to the protection of the business judgment rule. *Cede & Co. v. Technicolor, Inc., supra,* 634 A.2d at 361, 368; *In re Tri-Star Pictures, Inc., Litig.,* 634 A.2d 319, 333 (Del. 1993).

In this case, there was no proof that Smith was involved in self-dealing, or had some other conflict of interest or that he acted in bad faith. The only possible basis for avoiding the business judgment rule and imposing on Smith the exacting burden of showing the “entire fairness” of the insider loan and stock redemption transactions was that he breached a duty of “due care.” There is a presumption that corporate directors and offficers have exercised due care, *Cede & Co. v. Technicolor, Inc., supra*

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[12] The presumption is that directors and officers have acted in good faith and in the best interests of the company. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds, Brehm v. Eisner,* 746 A.2d 244, 253 (Del.2000); *Havens v. Attar*, 1997 WL 55957, at *11 (Del. Ch. Jan. 30, 1997).

634 A.2d at 367, and that presumption can be overcome only if plaintiff can show gross negligence. *Kahn* v. *Roberts,* 21 Del. J. Corp. L. 674, 684 (Del.Ch. Dec. 6, 1995) *aff'd on other grounds,* 679 A.2d 460 (Del. 1996). As noted above, the trial court did not find that Smith was grossly negligent. Thus, the imposition on him of the burden of showing the "entire fairness" of the transactions for which he was found liable was error.

C. The failure of the trial court to apply the business judgment rule will have a significant negative impact on corporate legal officers.

The trial court itself noted that:

> "The...difficult question posed by this lawsuit is what role the officers and directors should play when confronted by, or at least peripherally aware of, the possibility that a controlling shareholder (who also happens to be their boss) is acting in his own best interests instead of those of the corporation. Given the lack of public accountability present in a closely held private corporation, it is arguable that such officers and directors owe a greater duty to the corporation and its shareholders to keep a sharp eye on the controlling shareholder. At the very least, they must uphold the same standard of care as required of officers and directors of public companies or private companies that are not so dominated by a founder/controlling shareholder. They cannot turn a blind eye when the controlling shareholder goes awry, nor can they simply assume that all's right with the corporation without any exercise of diligence to ensure that that is the case."

(294 B.R. at 663) (Emphasis added).

The problem with the trial court's decision is that it does not rest on solid evidence and does not articulate a discernable and practical standard for corporate legal officers.

First, as to Smith, the Dow transaction did not benefit Cogan. Actually, since he was one of the *pari passu* shareholders he stood to benefit if Trace had not taken the route it did (Smith, Tr. 1579). It cannot fairly be said that Smith was "peripherally aware" of the Cogan loans about which he was not consulted and of which he was largely ignorant.

Second, if the decision in *Pereira* is allowed to stand, corporate legal officers risk liability when they have not committed malpractice, have not self-dealt, have not colluded with other officers or directors and have not been grossly negligent. Mere proximity to senior management and peripheral awareness – an elusive standard at best – are all that is required to fix personal liability. The new duty of corporate legal officers established, in effect, by the trial court, is to be omniscient, infallible and with unlimited authority. That standard is impossible for corporate legal officers to meet, and will not only unreasonably impose liability on corporate legal officers, but also deter highly competent individuals from continuing to serve or accepting in-house legal positions.

CONCLUSION

The trial court's decision regarding Philip Smith should be reversed. In depriving Smith of the protection of the business judgment rule and in foisting on him a legal obligation he was not asked to undertake, the trial court has fashioned an intolerable, unnecessary and unworkable responsibility for corporate chief legal officers.

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Respectfully submitted,

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