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Rare case of a breach of care and loyalty

By Marc Boiron

In *Palmer v. Reali*, the U.S. District Court for the District of Delaware denied a motion to dismiss claims of breach of the fiduciary duties of care and loyalty against officers of a Delaware corporation, which is a rare claim under Delaware law.

In 2010, Reali and Slattery were elected as president and chief financial officer, respectively, of TranS1, Inc. During that year, TranS1's revenue dropped 12.4 percent as compared to the previous year. In 2011, Reali was elected as chief executive officer and as a director on TranS1's board of directors. In that year, TranS1's revenue dropped another 27 percent as compared to the previous year. Nonetheless, the base salaries of Reali and Slattery were increased to $360,000 and $293,550, respectively, with the opportunity to obtain bonuses equal to 50 percent and 40 percent, respectively, of their base salaries. In early 2012, the base salaries of Reali and Slattery were increased to $370,000 and $298,443, respectively, and they received non-equity incentive payments of $189,975 and $120,091, respectively, and stock options valued at $352,800 and $272,167, respectively.

In mid-2012, Reali and Slattery presented to TranS1's board of directors financial forecasts for TranS1, which included a base scenario that required TranS1 to raise $80 million, an upside scenario that required TranS1 to raise $79 million, and a downside scenario that would require raising as much as $100 million. By the end of summer 2012, TranS1's revenues were lower and expenses were higher than the forecast. Reali and Slattery revised their previous forecast to lower revenue projections in 2012 but increase TranS1's projected growth through 2017.

In March 2013, based on aggressive pro forma projections prepared by Reali, TranS1 entered into a merger agreement with Baxano Surgical, Inc., and, upon closing of the merger, TranS1 changed its name to Baxano Surgical, Inc.

In the same month, Reali revised downward the revenue guidance of Baxano, as a combined entity, for the first quarter of 2013, moved the location of Baxano's principal office and spent significant capital renovating the new office and paying employees' severance and relocation expenses.

In August 2013, Baxano reported financial results and, in connection therewith, lowered guidance it had given a few months earlier by 30 percent. The following month, Slattery resigned as CFO and received a severance payment in connection therewith.

Between October 2013 and April 2014, Reali and other members of Baxano's management presented several projections that contained unreasonable revenue forecasts. In reliance on those forecasts, among other things, Baxano's board of directors permitted Reali to take several actions detrimental to Baxano, including (i) obtaining a credit facility to draw up to $15 million in cash, which Reali used to improve Baxano's cash position to receive a total of $80,000 in cash for achieving certain bonus targets; (ii) borrowing additional capital, which was used in part for the payment of bonuses; (iii) leasing additional space at its principal offices; and (iv) issuing additional shares of common stock to raise capital for operations.

In November 2014, Baxano filed a voluntary petition for relief in bankruptcy court. As a result of Baxano's reorganization under Chapter 11 of the United States Bankruptcy Code, the Baxano Liquidation Trust became the successor in interest to Baxano.

John Palmer, as the liquidation trustee of the Baxano Liquidation Trust, filed a complaint alleging, among other things, that Reali and Slattery, as officers of Baxano, breached their fiduciary duties of loyalty and care. The court denied the defendants' motion to dismiss the claims.

With respect to the claims for breach of the duty of care, the court held that all of Palmer's allegations could plausibly give rise to a breach of the duty of care. Palmer alleged that Reali and Slattery were grossly negligent for preparing forecasts that lacked any reasonable basis and for presenting them to the Baxano's board of directors. The court noted that Reali and Slattery presented to Baxano's board of directors forecasts showing a growth rate in excess of 40 percent annually when Baxano's revenues were dropping almost 20 percent annually. Similarly, the pro forma revenue growth projections that Reali and Slattery presented to Baxano's board of directors in connection with the merger were unreasonable and unrealistic, which caused the board of directors to be misinformed at the time of the merger. Lastly, the court found that Reali's failure to wind up Baxano and to instead pay bonuses, increase expenses and lease additional office space suggests that Reali's business decisions were not made with the care that an ordinarily careful and prudent person would have used in similar circumstances.

With respect to the claims for breach of the duty of loyalty, the court held that all of Palmer's allegations could plausibly give rise to a breach of the duty of loyalty. Palmer alleged that Reali and Slattery put their interests in personal convenience, increased compensation and maintaining employment ahead of the best interests of Baxano. Palmer relied on the fact that the unreasonable forecasts prepared, and the credit facility enter into and drawn on, by Reali and Slattery were done to maintain their employment and increase their compensation. The decision to relocate to move the principal office to Raleigh, North Carolina, allegedly was made only because Reali and Slattery lived there at the time, without regard for Baxano's best interests.

This decision is a rare case that involves a breach of fiduciary duty of an officer and provides two important reminders for officers. First, an officer should not expect the same level of protection from liability for breach of fiduciary duty as the protection that directors receive under Delaware law even though they have the same fiduciary duties as directors. Delaware courts have provided substantial guidance on the presumptions and standards of review that apply to directors and on their duties of disclosure and oversight. The same guidance has not been developed with respect to officers, in large part, because significantly fewer breach of fiduciary duty cases are brought against officers than against directors. As the court in Reali indicated, the defendants were not able to cite any Delaware case to support their position that the business judgment rule applies to officers, a basic principle in the context of a director's actions. It remains unclear under Delaware law whether the business judgment presumption applying to directors — that in making a business decision, the director acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the corporation — would apply to an officer.

Second, officers of Delaware corporations, unlike directors, do not benefit from exculpation under DGCL Section 102(b)(7). Section 102(b)(7) permits a corporation to include a provision in its certificate of incorporation that eliminates the personal liability of a director to the corporation and its stockholders for monetary damages for breach of the fiduciary duty of care. Although other states permit a corporation to eliminate the personal liability of an officer for damages arising out of certain actions, the Delaware courts have concluded without question that Section 102(b)(7) does not exculpate officers for damages. Therefore, officers may be found liable for a breach of the duty of care.

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