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## Bankruptcy Court Imposes *Caremark* Duties on General Counsel

On April 9, 2008, the US Bankruptcy Court for the District of Delaware issued its opinion in *Miller v. McDonald, et al.*, 2008 WL 1002035 (Bkrcty.D.Del.), in which it held that the general counsel of a public company had a duty to implement a system that would provide reasonable monitoring to prevent corporate wrongdoing. The court found that the general counsel's duty arose from two sources. First, Delaware law imposes a duty on directors and senior officers to implement a system that would provide reasonable monitoring of corporate activity. Second, the court cited Section 307 of the Sarbanes-Oxley Act which requires the Securities and Exchange Commission to implement rules that require attorneys to report misconduct to their superiors.

In *Miller*, the bankruptcy trustee filed a 13-count complaint against the senior officers and directors of World Health Alternative, Inc., a health care staffing company, on theories of waste, breach of fiduciary duty and negligent misrepresentation, among other causes of action.

### Facts:

From 2003 until its collapse in September 2005, World Health experienced explosive growth. Management engaged in a number of private-placement financing transactions that provided capital for acquisitions, allowing World Health to acquire a number of companies throughout 2004. Its reported revenues grew from approximately \$3.6 million in 2003, to over \$40 million in 2004. To fund this growth, World Health sold shares of its stock to investors in private placements and secured a credit facility by which it pledged all the assets of World Health and its subsidiaries. During this period of growth, the senior managers engaged in a number of questionable transactions. For example, during a period where World Health was short of cash, the senior managers chartered private jets and leased luxury cars.

The trustee alleged that the senior managers engaged in a number of fraudulent

transactions, including filing fraudulent tax documents to mask an underpayment of tax liabilities in excess of \$4 million and providing fraudulent reports to lenders which induced them to loan amounts that were over \$6 million in excess of the amount allowed by World Health's actual collateral base. The trustee also alleged that senior management released false financial information to the public through earnings releases, conference calls and filings with the Securities and Exchange Commission. In September, 2005, World Health announced that management had discovered \$22 million in previously undetected debt. In February 2006, World Health filed for bankruptcy protection.

### The Court's Ruling:

The general counsel brought a motion to dismiss the complaint under Rule 12(b)(6) of the Federal Rules of Civil Procedure. The general counsel argued that the duties of directors set out in the Delaware case of *In re Caremark Intern. Inc. Derivative Litigation*<sup>1</sup> do not apply to officers and employees. In the *Caremark* case Chancellor Allen noted that the directors of a corporation have a duty to assure that the corporation has monitoring systems that are "reasonably designed to provide to senior management and to the board, timely accurate information..." that enables the corporation's senior management and board to reach "informed judgments" regarding the corporation's performance and legal compliance.<sup>2</sup> Elaborating on this duty, the *Miller* court cited several other cases where the Delaware courts pointed out that the duty of directors to "monitor the potential that others within the organization will violate their duties" was one of the most important duties directors have. This duty requires the director to "exercise good faith judgment" that the corporation has in place a system where the necessary information will reach the director in a "timely manner."<sup>3</sup>

Addressing the general counsel's argument, the court noted that the *Caremark* case itself suggested that the *Caremark* duties would extend to senior officers. Further, the court

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cited *In re Disney Co. Derivative Litigation*<sup>4</sup> where the court held that once a person becomes an officer of a corporation, that officer owes fiduciary duties to the corporation and its stockholders. The court concluded that senior officers owe the corporation and the stockholders<sup>5</sup> the same duties as those owed by directors.

The court went on to cite Section 307 of the Sarbanes-Oxley Act<sup>6</sup>, which requires the Securities and Exchange Commission to enact rules that require lawyers that work for public companies to report compliance issues to senior managers and ultimately the board. The court also took note of several articles that detailed the important role that the general counsel plays in corporate governance.

On the allegation of corporate waste, the general counsel argued that there was no evidence that he personally benefited from the alleged waste. The court held that the general counsel either knew or should have known of the waste and as a fiduciary, should have taken action to prevent such conduct.

Regarding the issue of negligent misrepresentation, the general counsel argued that there was no showing that he had knowledge of the misrepresentations. The court disagreed. Noting that the misrepresentations in question were contained in press releases and filings with the Securities and Exchange Commission, the general counsel should have reviewed these materials and should have “undertaken an examination of the Company’s affairs to ascertain the trustfulness of these disclosures.”<sup>7</sup>

### Conclusion:

While the facts in the *Miller* case are egregious, the case raises important issues for attorneys that serve as general counsel or the senior in-house lawyer for a corporation. Such persons will not only have the fiduciary duties of a senior manager, but will also have a professional responsibility to the corporation and its stockholders. The court’s holding in *Miller* clearly shows that the general counsel has an affirmative duty to put in place systems which will enable him or her to monitor operations of

a corporation to keep track of legal compliance and business performance. It also imposes fiduciary duties on senior officers to the same extent as those owed by directors. Corporations that do not clearly define the responsibilities of in-house counsel, senior officers and directors with regard to financial and business oversight and legal compliance proceed at their peril. The general counsel at World Health turned a blind eye toward ongoing corporate looting and fraud and could not protect himself by saying “I didn’t know.”

<sup>1</sup> 698 A.2d 959 (Del. Ch. 1996)

<sup>2</sup> Id. at 968

<sup>3</sup> *Miller*, at 25, quoting *Stone v. Ritter*, 911 A.2d 362 (Del. 2006)

<sup>4</sup> 2004 WL 2050138 (Del Ch. Sept. 10 2004)

<sup>5</sup> Id. at 3.

<sup>6</sup> 15 U.S.C. §7245 (2005)

<sup>7</sup> *Miller* at 36.

### ABOUT THE AUTHORS

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