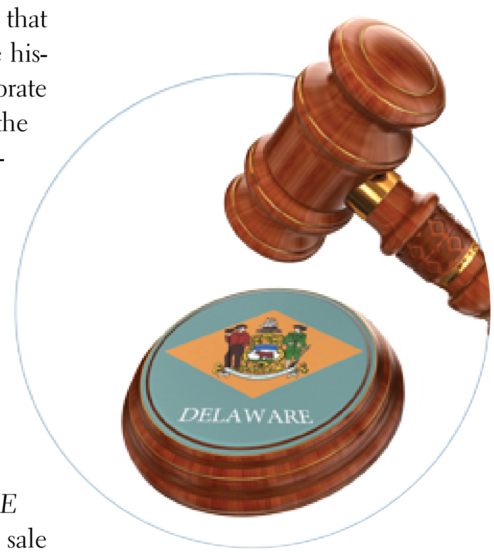
When Directors May Be Personally Liable for Corporate Actions

By Francis G. X. Pileggi

Most corporate directors find some solace in the general principle that when they are acting in their formal corporate capacity and sign an agreement on behalf of a corporation, they are not personally responsible for the acts of the corporation and that limited liability is one of the historic attractions of the corporate form. A recent decision by the Delaware Court of Chancery, however, underscores that, in certain circumstances, a corporate director or officer can be held liable to non-stockholder third parties when personally involved in corporate wrongdoing.

The decision in *Prairie Capital III, L.P. v. Double E Holding Corp.* involved the sale of a company and allegations that the CEO and CFO were actively engaged in manipulating and falsifying sales and revenue figures that the buyer had relied on in its decision to purchase a company. The court's ruling was based on accusations in the pleadings only, and was not a post-trial finding of fact, nor have those claims been proven.

This ruling also provides useful guidance for directors and their attorneys who seek to draft stock purchase agreements (SPA) or other sale documents to renounce liability for potential allegations of either misrepresentation or material omissions. The case began when private equity firm Prairie Capital, the seller, sued portfolio company Double E, the buyer, for the release of funds held in escrow. Double



E then asserted counterclaims and cross-claims for fraud against Prairie Capital and its management, in addition to asserting claims for indemnification. The decision was based on a motion to dismiss the claims for fraud and one of the claims for indemnification. The court granted the motion to dismiss those fraud-related claims based on alleged misrepresentations or omissions outside of the stock purchase agreement. Other claims beyond the scope of this article were also dismissed.

Personal Liability

The director and officer sued in the *Prairie* case argued that they should not be held personally accountable for any allegations of misrepresentations or omissions because the company made the alleged statements or omissions. The court relied on extensive citations from the U.S. Supreme Court and seminal Delaware decisions to recite the truism that a corporation is an artificial entity that can only act through its human agents.

Citing a 1924 Delaware decision, the court explained: "Being a purely metaphysical creature, having no mind with which to think, no will with which to determine and no voice with which to speak, a corporation must depend on the faculties of natural persons to determine for it its policies and direct the agencies through which they are to be effectuated."

The court also explained that a corporate officer would be held personally liable for the torts he commits and cannot shield himself behind the corporation when he is a participant. Rather, it is immaterial that the corporation may also be liable in those situations where a corporate agent participates in corporate fraud. The court cited both Delaware decisions and corporate treatises for the principle that an officer or a director of a corporation who participates in fraud cannot escape personal liability on the grounds that the officer or director was acting for the corporation.

Moreover, regarding contractual provisions that purport to limit or disclaim responsibility for fraud, the court cited prior Delaware public policy prohibiting the enforcement of a contract that seeks to disclaim responsibility for direct fraud or outright lies.

The court assumed the allegations were true only for the purposes of the motion to dismiss, without making findings of fact that those allegations were actually true. Regarding those allegations, the court reasoned that directors who affirmatively encouraged, assisted, or approved of a fraudulent scheme, and directed others to provide false information to buyers, and stood silently by while the transaction was closed under false pretenses, cannot escape liability if those allegations are proven at trial to be true.

Drafting Guidance

Delaware law enforces clauses that identify the specific information on which a party has relied in a deal, and which foreclose reliance on other information. The rationale behind such legal principles is that, by specifying the information on which the parties have relied, the parties minimize the risk of erroneous litigation outcomes by reducing doubts about what was promised and what was represented in connection with a particular transaction or agreement. This also protects against the "double-liar" problem in which a party attempts to shirk its own bargain by saying that it relied on fraudulent inducement representations even though they signed an agreement that promised in a clear integration clause that they would not rely on promises and representations made outside of the four corners of the agreement. Such integration clauses or other clauses that disclaim reliance or have anti-reliance representations must provide clear consent that a party did not rely upon statements outside the four corners of a contract in deciding to sign the contract.

No magic words or specific formula, however, are necessary to disclaim reliance. In reaching this conclusion, the court distinguished two prior Chancery decisions: *Anvil Holding Corp. v. Iron Acquisition Company* and *Transdigm Inc. v. Alcoa Global Fasteners, Inc*. In distinguishing those cases, the court reasoned in the *Prairie* opinion that requiring omissions to be specifically disclaimed would render ineffective provisions that deny reliance on misrepresentations.

In *Prairie*, instead of an anti-reliance clause, the relevant agreement affirmatively described the universe of representations on which it depended. The court explained that in an arm's-length, negotiated agreement, contractual provisions that identify the representations on which a party exclusively relied will limit the universe of information that is in play for purposes of a fraud claim. In such an instance, a party cannot point to extra-contractual information and escape the limits of what it has agreed to rely on by arguing that the extra-contractual information was incomplete. The limitation on the representations in the agreement that the parties relied on will bar not only claims based on extra-contractual representations, but also fraud claims based on extra-contractual omissions. A contrary argument would create a double-liar problem because the representation provision itself would then become a lie if not enforced.

This statement of the law still allows a party to prove that representations within the four corners of an agreement were false or materially misleading, but a party to such an agreement with an appropriate provision cannot claim that the information it received outside of the agreement contained material omissions.

This Delaware opinion is a must-read for directors and their counsel who wish to understand what provisions in their agreement will limit fraud claims, and under what circumstances directors and officers will not be protected from personal liability to third parties for their actions taken on behalf of a corporation. D

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