

ABOUT DAVIDOFF MALITO & HUTCHER LLP

Recent Events:

A Leading Full Service Corporate Law & Government Relations Firm with active practices in:

- Government Relations & Lobbying
- Corporate & Securities
- Mergers & Acquisitions
- Banking, Finance & Venture Capital
- Litigation
- Real Estate
- Land Use & Zoning
- Bankruptcy/Creditor's Rights
- Wills, Trusts & Estates
- Administrative Law
- Construction Law
- Computer & Internet law
- Healthcare Law
- Labor & Employment Law

- On **June 20, 2005**, **Michael Zapson** presented an **Update on Elder Law, Estate Taxes, Healthcare Proxies and Planning Tools** at the **Senior Care in Lynbrook, New York**.
- On **June 9, 2005**, **Neil M. Kaufman** moderated a panel discussion on **Later Stage Venture Capital Financing** at the **2005 Long Island/NY Metro Capital Forum**, presented by the **Long Island Capital Alliance**.
- On **May 5, 2005**, **Neil M. Kaufman** participated in a panel discussion on **Legal and Financing Considerations for Life Sciences Companies** at the **2005 Life Sciences Industry Summit** presented by the **Long Island Life Sciences Initiative**.
- On **April 26, 2005**, **Michael G. Zapson** made a presentation to the **Community Bankers' Mortgage Forum**.
- On **April 22, 2005**, **Howard S. Weiss** participated in a panel discussion on the **Historic and Legal Underpinnings of Land Development Regulation in New York**.
- On **April 5, 2005**, **Michael G. Zapson** hosted a seminar on **Estate Planning**.

For more information regarding any of these events, please contact Neil M. Kaufman at (516) 248-6400 or nmk@dmlegal.com.

The information contained herein is not to be construed as legal advice.

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CORPORATE CHRONICLE

LESSENERED DIRECTOR LIABILITY
IN THE INSOLVENCY CONTEXT

In the midst of an apparent trend toward increasing director liability, New York and Delaware courts have recently limited such liability in the insolvency context. Generally, directors' fiduciary duties of loyalty, care and good faith are owed only to the corporation and its stockholders. When a corporation is insolvent, however, the constituency of those owed fiduciary duties is generally expanded to include its creditors. In *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, 1991 WL 277613 (Del Ch. 1991), the Delaware Chancery Court applied this expansion of fiduciary duty constituencies to when a corporation is in the "zone of insolvency."

The Delaware courts commonly employ two tests to determine whether or not a corporation is insolvent:

- **Balance Sheet Test:** when the corporation's liabilities exceed the reasonable market value of its assets; and
- **Cash Flow/Equity Test:** when the corporation is unable to pay its debts as they become due in the ordinary course of its business.

The Delaware courts, however, have not specified when a corporation is in the "zone of insolvency." Thus, even for an otherwise solvent corporation, a careful fact-intensive analysis must be undertaken to determine whether the risk of future non-payment to creditors is sufficiently evident to expand fiduciary duty constituencies.

When fiduciary duty constituencies are expanded, directors are under an obligation to exercise good-faith judgment in a fully informed effort to maximize the corporation's long-term wealth-creating capacity. In this regard, directors of insolvent corporations should be less apt to adopt high-risk strategies that solely benefit stockholders, who have less downside risk at insolvency, to the detriment of other constituencies, such as creditors. Directors, however, are not required to simply liquidate and pay creditors, unless, in the direc-

tors' informed good-faith judgment, there is no alternative to liquidation. The directors, as fiduciaries of the corporation, may instead continue to operate the corporation's business.

New York courts, until recently, have generally recognized a "deepening insolvency" theory of damages that may result from a separate tort predicated upon the notion that a lender by (i) extending credit in exchange for additional security (or other enhancements) to a financially troubled borrower that has little or no hope of financial recovery and (ii) causing the borrower to remain in business for the lender's benefit, extracts value from the borrowing corporation at the expense of its unsecured creditors. In *In re Global Services Group LLC*, 316 B.R. 451, 459 (Bankr. S.D.N.Y. 2004), the court rejected the "deepening insolvency" theory as applied to directors in light of its flawed premise that "managers of an insolvent limited-liability company are under an absolute duty to liquidate the company, and anyone who knowingly extends credit to the insolvent company breaches an independent duty in the nature of aiding and abetting the manager's wrongdoing."

In *Production Resources Group L.L.C. v. NCT Group Inc.*, 2004 WL 2647593 (Del Ch. 2004), the Delaware Chancery court held that the plaintiff's allegation that directors breached their fiduciary duties in connection with perpetuating the existence of the corporation while insolvent (i) could only be asserted as a derivative claim on behalf of the corporation and not a direct claim by the creditor plaintiff and (ii) at most, rose to the level of a duty-of-care claim that could, contrary to the plaintiff's claim, be exculpated by provisions of the corporation's certificate of incorporation. This is particularly significant in light of directors' increasing personal exposure and other recent cases seeming to expand the circumstances in which the conduct of directors may be challenged. Accordingly, at least in the insolvency context, it ap-

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FROM THE EDITOR

Dear clients and friends:

As the merger and acquisition market has boomed and the stock market has remained stable, the Davidoff Malito & Hatcher LLP corporate and securities practice has been expanding at a dynamic rate. Having added new associates, we are poised to continue this growth.

Three of our clients presented at the 2005 Long Island/NY Metro Capital Forum. We look forward to assisting these companies, as well as several of our other clients, in successfully raising growth capital.



Neil M. Kaufman
Senior Partner,
Corporate & Securities
Practice

SUPREME COURT UNANIMOUSLY OVERTURNS ARTHUR ANDERSEN'S CONVICTION

On May 31, 2005, the Supreme Court unanimously overturned the conviction of Arthur Andersen, which was found guilty of obstructing justice in connection with shredding Enron-related documents. The decision is largely symbolic for Arthur Andersen, which lost much of its business leading up to the conviction, lost its ability to audit public companies in the aftermath of the conviction and has shrunken from 28,000 to 200 employees. The Supreme Court held that the jury instructions provided in the case were flawed given that the jurors were not instructed to determine whether Arthur Andersen's employees actually acted dishonestly or destroyed documents in anticipation of a related legal proceeding. Without such a determination, the Supreme Court found that the phrase "knowingly corruptly persuading" document destruction was eviscerated of meaning and transmuted into a concept that could capture even the innocent execution of customary document retention policies.

SUPREME COURT RULES ON LOSS CAUSATION THEORY

On April 19, 2005, the U.S. Supreme Court unanimously reversed the Ninth Circuit Court of Appeals in a fraud-on-the-market securities class action, holding that an inflated purchase price is not a "relevant economic loss" for purposes of making a Rule 10b-5 claim. Plaintiffs in the case argued that they had paid prices

for common stock of Dura Pharmaceuticals, Inc. that were artificially inflated by the company's public statements about two of its products, indicating that one was selling very well and that the other was expected to be quickly approved by the FDA. The company announced at a later date, however, that sales were poor and that the FDA had not approved the product, after which the company's stock price dropped significantly. The district court dismissed the plaintiffs' complaint for a failure to meet the pleading requirements of the Private Securities Litigation Reform Act of 1995, noting a failure to plead (i) a strong inference of scienter in connection with the public statements regarding robust sales and (ii) "loss causation," specifically, in this case, a connection between the alleged misstatements relating to the expected FDA approval and the price decline following the public announcement regarding the failure to obtain FDA approval.

The Ninth Circuit held that the district court erred on both points, specifying that "loss causation does not require pleading a stock price drop following a corrective disclosure or otherwise." In this regard, the Ninth Circuit indicated that it was sufficient to plead "that the price at the time of purchase was overstated and sufficient identification of the cause." The Ninth Circuit's position differed with the position adopted by at least three other circuit courts.

The Supreme Court resolved the split in favor of the other circuits, rejecting the Ninth Circuit's position that a misled investor under these circumstances suffers an immediate and actual loss at the time of purchase. The Supreme Court indicated that "as a matter of pure logic, at the mo-

ment the transaction takes place, the plaintiff has suffered no loss; the inflated purchase payment is offset by ownership of a share that at that instant possesses equivalent value." The Supreme Court held that loss causation must be pled and a defendant must be put on "notice of what the relevant economic loss might be [and] what the causal connection might be between that loss and the misrepresentation," and noted that the plaintiffs in this case failed to allege that the company's stock price fell significantly after the corrective disclosure regarding the truth about the FDA approval and dismissed such claim.

SEC CHARGES MISLEADING PROXY STATEMENT DISCLOSURE BY TYSON FOODS

On April 28, 2005, the Securities and Exchange Commission announced that it had settled enforcement proceedings against Tyson Foods, Inc. and its former Chairman and Chief Executive Officer relating to the misleading disclosure of his \$3 million worth of perquisites and personal benefits contained in proxy statements filed with the SEC from 1997 to 2003. The SEC also charged the company with failing to maintain adequate internal controls relating to the Chairman and CEO's use of company assets. The perquisites and personal benefits involved included personal expenses for oriental rugs, antiques, vacations, chauffeurs, company-owned aircraft, housekeeping, lawn maintenance, automobile maintenance, telephone services, Christmas gift certificates, and personal income taxes associated with these benefits. The SEC noted, among other things, that some of the benefits were mischaracterized as "performance-based bonuses" and certain other benefits were categorized under "travel and entertainment costs" although they were neither "travel" nor "entertainment" oriented. Without admitting or denying wrongdoing, the company and the Chairman and CEO (i) agreed to pay a \$1.5 million penalty and a \$700,000 penalty, respectively and (ii) consented to ceasing and desisting from violating proxy solicitation and periodic reporting provisions and the internal control provisions of the federal securities laws.

CURRENT NEWS & NOTES

SEC CHAIRMAN DONALDSON RESIGNS AND REPLACEMENT NOMINATED

On June 2, 2005, President Bush nominated California Representative Christopher Cox to serve as the Chairman of the Securities and Exchange Commission, a day after SEC Chairman William H. Donaldson announced that he would resign effective June 30, 2005.

PCAOB REVOKES PUBLIC ACCOUNTING FIRM'S REGISTRATION

On May 24, 2005, the Public Company Accounting Oversight Board revoked the registration of Goldstein and Morris, CPAs, P.C., barred the firm's managing director from association with a registered accounting firm and censured two partners in the firm in connection with finding that they concealed information and furnished false information to the PCAOB in relation to one of its inspections. Accounting firms that are not registered with PCAOB may not audit the financial statements of public companies. The PCAOB found that the parties attempted to conceal the fact that the accounting firm had prepared financial statements for two public company audit clients in violation of the auditor independence requirements of the Sarbanes-Oxley Act of 2002. The PCAOB also determined that the partners back dated documents once they became aware of an imminent inspection.

SEC AND PCAOB ISSUE SECTION 404 INTERPRETIVE GUIDANCE

On May 16, 2005, the SEC and the Public Company Accounting Oversight Board provided Section 404 interpretive guidance to public companies and their auditors. As part of its guidance, the SEC encouraged flexibility in the implementation of internal control reporting requirements, indicating that "[r]egistered public accounting firms should recognize that there is a zone of reasonable conduct by companies that should be recognized as acceptable in the implementation of Section 404."

SEC ISSUES IPO ALLOCATION CONDUCT GUIDANCE

On April 7, 2005, the SEC Division of Market Regulation issued an interpretive release (Release Nos. 33-8565; 34-51500; IC-26828) relating to activities that underwriters are prohibited from conducting in connection with initial public offering allocations. The release sets forth guidance regarding legitimate book-building and includes examples of SEC enforcement cases pertaining to violations of Regulation M, which prohibits underwriters, among others, from bidding for, purchasing or attempting to induce any person to bid for or purchase an offered security during a restricted period.

NEW SEC ENFORCEMENT DIRECTOR NAMED

On May 12, 2005, SEC Chairman Donaldson named Linda Chatman Thomsen as the Director of the Division of Enforcement. She succeeded Stephen M. Cutler, who resigned at the end of April 2005 to return to private practice.

SEC COMMENT LETTERS AND RESPONSES ARE PUBLICLY AVAILABLE

On May 12, 2005, the SEC began publicly releasing all comment and response letters relating to disclosure filings made after August 2, 2004 and reviewed by the Divisions of Corporation Finance and Investment Management. Instructions regarding the retrieval of these documents from the SEC database are available at the following Internet address:
<http://www.sec.gov/answers/edgarletters.htm>.

SEC DIVISION OF CORPORATION FINANCE MOVES TO NEW HEADQUARTERS

As of May 20, 2005, the Division of Corporation Finance of the SEC had completed its move to Station Place, located at 100 F Street NE, Washington, D.C. 20549 from 450 Fifth Street, NW, Washington, D.C. 20549. The other divisions of the SEC located in Washington, D.C. are also being relocated to the new address.

DM&H COMPANY SPOTLIGHT: LONG ISLAND FIBER EXCHANGE, INC.

Our client Long Island Fiber Exchange, Inc. has built a network of over 120 miles of fiber optic cables throughout Long Island, primarily by providing dark fiber to school districts, municipalities and other large institutional customers with multiple locations in need of connectivity. As a low cost, flexible and high quality provider, the company is poised to continue winning substantial bids on new projects throughout the region. Ultimately, the company expects to own a grid of fiber optic cable covering the region, through which it can offer the types of internet connectivity services we are all coming to expect, including video, telephony and communication.



Long Island Fiber Exchange, Inc. was a presenter at the 2005 Long Island/NY Metro Capital Forum, and is in the process of deciding on its optimal financing route. We look forward to continuing to provide strategic and legal advice to help the company continue its successful trajectory.