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United States District Court, S.D. New York.

OFFICIAL COMMITTEE OF THE UNSECURED CREDITORS OF **COLOR TILE**, INC., Plaintiff,
v.
INVESTCORP S.A., Investcorp International Inc., CIP Limited, Corporate Equity Limited, Acquisition Equity Limited, Funding Equity Limited, Planning Equity Limited, Elias N. Hallack, Nemir A. Kirdar, Michael L. Merritt, Paul W. Soldatos, Jon P. Hedley, Charles J. Philippin, E. Garrett Bewkes, III, Walter F. Loeb, Coopers & Lybrand, L.L.P., Investcorp Bank, E.C., ABF Acquisition Corp., Investcorp Holdings Limited, Window Investments Limited, Shades International Limited, Shades Investments Limited, Blinds Equity Limited, Blinds Holdings Limited, AIBC Investcorp Finance B.V., Investcorp Investment Holdings Limited, Acquisition Capital Limited, Corporate Capital Limited, Funding Capital Limited, and Planning Capital Limited, Defendants.

No. 97 CIV. 9261(MGC).
|
Sept. 24, 1999.

Attorneys and Law Firms

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Dewey Ballantine LLP, New York, By Harvey Kurzweil, Esq., Joanna R. Swomley, Esq., for the Moving Defendants.

Kelley Drye & Warren LLP, New York, By Sarah L. Reid, Esq., Co-counsel for Defendant Walter F. Loeb.

OPINION

CEDARBAUM, J.

***1** The plaintiff committee of unsecured creditors of **Color Tile**, Inc. ("**Color Tile**") sues for breach of fiduciary duty, aiding and abetting breach of fiduciary duty, negligence, and fraudulent conveyance. All the defendants except Coopers & Lybrand move to dismiss all the claims asserted against them in the Second Amended and Consolidated Complaint (the "Complaint").

At oral argument, the motion to dismiss the claims that relate to the 1993 transaction—Counts One through Seven and Count Nineteen—was denied. (10/9/98 Tr. at 73). Decision was reserved on Counts Eight through Twelve, which allege that the controlling shareholders and four director defendants are liable for self-interestedly delaying filing **Color Tile's** bankruptcy in 1995. For the reasons that follow, the motion to dismiss Counts Eight through Twelve is now granted.

BACKGROUND

The facts as set forth in the Complaint are as follows.

The plaintiff is the Official Committee of Unsecured Creditors (the "Committee") which was appointed in the 1996 bankruptcies of **Color Tile** and its parent, **Color Tile** Holdings, Inc. ("CT Holdings"). The Committee is empowered to prosecute certain claims, including the claims in this action, on behalf of the estates of **Color Tile** and CT Holdings, the Unsecured Creditors' Trust, and the Consumer Deposit Trust pursuant to a September 17, 1997 Order of the United States Bankruptcy Court for the District of Delaware approving the Global Settlement Agreement among **Color Tile**, CT Holdings, the Committee, and other entities (the "Settlement"). (Compl.¶¶ 13, 15). [1]

Before it ceased doing business, **Color Tile**, a Delaware corporation headquartered in Fort Worth, Texas, was the largest specialty retailer of floor covering products in North America. (*Id.* ¶¶ 15, 36). In 1989, the Luxembourg limited liability company Investcorp S.A. and affiliated entities and individuals referred to in the Complaint as the "Investcorp Group" acquired **Color Tile**. (*Id.* ¶¶ 16, 21, 25–27, 36). The Investcorp Group formed a holding company, CT Holdings, to hold all the common stock of **Color Tile**. (*Id.* ¶¶ 15, 37). Through control of CT Holdings, the Investcorp Group exercised control over the management and operations of **Color Tile** and had the power to vote all of the common stock and elect all of the directors of **Color Tile**. (*Id.* ¶ 37). The moving defendants are all affiliated with the Investcorp Group. Entities not affiliated with the

Investcorp Group owned two classes of preferred stock in Color Tile. *Id.*

In December 1993, the Investcorp Group forced Color Tile to undertake an asset acquisition and a $200 million high-interest debt financing (collectively, the "1993 Transaction"). The 1993 Transaction left Color Tile undercapitalized, without the ability to service its debts as they became due, and without the necessary cash resources to operate its business in a competitive fashion. (*Id.* ¶ 2).

***2** Within months after the 1993 Transaction, it became evident that Color Tile would not have sufficient cash resources to service its debt and competitively operate its floor-covering business. (*Id.* ¶ 7). By September 1994, Color Tile had to borrow an additional $29 million to fund its operations, pay dividends on its preferred stock, and make interest payments. (*Id.* ¶¶ 7, 56). Despite this cash infusion, by the spring of 1995, Color Tile again faced a liquidity crisis. (*Id.* ¶¶ 7, 57). In May and June 1995, an affiliate of the Investcorp Group loaned $15 million to Color Tile to keep it afloat. (*Id.* ¶¶ 8, 57).

By August 1995, despite having received more than $44 million in unforecast borrowings during the prior year, Color Tile was again out of cash. (*Id.* ¶¶ 8, 58). "It was apparent that [the company] was hopelessly insolvent and could not be rescued without truly massive capital infusions." (*Id.* ¶ 8). The Investcorp Group, however, determined neither to arrange for any significant cash infusions nor to take steps to immediately restructure Color Tile so as to preserve whatever value could be salvaged. (*Id.* ¶¶ 8, 58). Rather, from August 1995 until the end of January 1996, the Investcorp Group "dribble[d] in just enough cash to keep Color Tile afloat on a day-to-day basis, without taking steps that could have made Color Tile viable or could have preserved some of its existing value." (*Id.*)

On December 15, 1995, Color Tile defaulted on a $10.4 million interest payment. (*Id.* ¶ 62). On January 24, 1996, it filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code, 11 U.S.C. § 101, *et seq.* (*Id.* ¶ 15). The Committee asserts that the moving defendants should have made Color Tile file for bankruptcy relief sooner.

According to the Complaint, the Investcorp Group's strategy of keeping Color Tile "limping along" for several months after it had become clear, in mid–1995, that Color Tile was in a financial crisis, furthered the Investcorp Group's own interests in two ways. (*Id.* ¶ 10). First, during the summer of 1995, the Investcorp Group was in the process of trying to take the Gucci Group, N.V. public. (*Id.* ¶¶ 10, 59). "The Investcorp Group was concerned that a Color Tile bankruptcy would taint and ultimately jeopardize the success of the Gucci [common stock] offering, from which [the Investcorp Group] stood to earn hundreds of millions of dollars." (*Id.*) The public offering for Gucci was completed in October 1995. (*Id.* ¶ 35). [2]

The second alleged self-interest that Investcorp Group had in delaying Color Tile's bankruptcy was its interest in preserving its good relationship with the bank group that had provided much of the financing for Color Tile's 1993 Transaction. (*Id.* ¶¶ 11, 60). During the summer of 1995, it was discovered that Color Tile had not delivered the stock of American Blind and Wallpaper Factory, Inc. ("ABWF")—the Color Tile subsidiary that owned the assets acquired in the 1993 Transaction—to the bank group. (*Id.* ¶ 11). Color Tile's agreement with the bank group required Color Tile to deliver the ABWF stock to the bank group as collateral. (*Id.* ¶¶ 11, 60). Thus, in the summer of 1995, at a time when it was in dire financial straights, Color Tile had to decide between belatedly transferring the ABWF stock to the bank group and keeping the stock for itself and its creditors. (*Id.*) The Investcorp Group chose to deliver the stock to the bank group (as it was contractually obligated to do) with the alleged objective of furthering the Investcorp Group's own interests in shoring up its long-standing relationship with the bank group, and in particular its lead lender, who had financed many of the Investcorp Group's prior investments in the United States and to whom the Investcorp Group was looking for future financings. (*Id.*) By continuing to operate Color Tile through the end of 1995, well after Color Tile had transferred the ABWF stock to the bank group, [3] the Investcorp Group enabled the bank group to perfect its security interest in the ABWF stock and avoid the operation of the ninety-day statutory preference period, which ran out shortly before Color Tile filed for bankruptcy in January 1996. (*Id.*)

***3** The defendants' alleged self-interested avoidance of bankruptcy relief for Color Tile until January 1996 is hereinafter referred to as the "1995 Avoidance."

It is alleged that the 1995 Avoidance, while beneficial for the Investcorp Group's bank group and Gucci interests,

was detrimental to the interests of **Color Tile**. (*Id.* ¶¶ 12, 61). According to the Complaint, if the Investcorp Group had not been selfishly concerned with completing the Gucci public offering and preserving its relationship with the bank group, **Color Tile** could have taken earlier steps to preserve its salvageable value, (*id.*), that is, it could have restructured or filed for bankruptcy relief in mid or late 1995 rather than waiting until January 1996. (10/9/98 Tr. at 16) ("[W]e are alleging that if they had carried out their fiduciary duties and restructured earlier and not let the company continue for another eight or twelve months, there would have been more assets and the company could have been saved.")

DISCUSSION

A. Claim against Director Defendants

Count Twelve alleges that the four directors of **Color Tile** who served in the latter half of 1995, Jon P. Hedley, Charles J. Philippin, E. Garrett Bewkes, III, and Walter F. Loeb, (collectively, the "Director Defendants"), breached their duty of loyalty to **Color Tile** by allowing the 1995 Avoidance to occur. [4]

According to the Complaint, the Director Defendants were self-interested in the 1995 Avoidance by virtue of their employment connections with the Investcorp Group. In 1995, Hedley and Philippin were officers of III, an affiliate of the Investcorp Group. (Compl.¶¶ 30, 31). Bewkes "was a director and officer of III from March 1994 until he left to form his own business." (Compl.¶ 32). Loeb was paid as a consultant by the Investcorp Group on various Investcorp Group investments in unspecified years. (*Id.* ¶ 29). The Committee argues that these allegations of self-interest of the Director Defendants in carrying out the Investcorp Group's wishes suffice to prevent application of the business judgment rule in this case.

"The business judgment rule is a presumption that in making a business decision the directors of a corporation 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." *Parnes v. Bally Entertainment Corp.*, 722 A.2d 1243, 1246 (Del.1999) (internal quotation marks omitted). A plaintiff bears the burden of alleging well-pleaded facts to overcome the presumption and survive a motion to dismiss. *Id.*; *Aronson v. Lewis*, 473 A.2d 805, 812 (Del.1984); *Nebenzahl v. Miller*, Civ. A. No. 13206, 1996 WL 494913, at *2 (Del. Ch. Aug. 29, 1996).

"Directorial interest exists whenever divided loyalties are present, or a director either has received, or is entitled to receive, a personal financial benefit from the challenged transaction which is not equally shared by the stockholders." *Pogostin v. Rice*, 480 A.2d 619, 624 (Del.1984). In this case, viewing the allegations of interest most favorably to the Committee, despite the sparseness of the allegations of director interest, it may well be possible to draw an inference that, in 1995, the Director Defendants' decisions with respect to **Color Tile** were in fact or were likely to be affected by their personal financial interest in maintaining good relations with the controlling shareholder group. *See Friedman v. Beningson*, Civ. A. No. 12232, 1995 WL 716762, at *5 (Del. Ch. Dec. 4, 1995) (allegation that defendant controlling shareholder had ability to affect a director's consulting fees cast doubt on that director's independence); *Kahn v. Tremont Corp.*, Civ. A. No. 12339, 1994 WL 162613, at *2 (Del. Ch. Apr. 22, 1994) (allegation that defendant controlling shareholder indirectly controlled the salaries of directors/officers cast doubt on their independence); *see also Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1167 (Del.1995) (articulating the standard for determining whether an individual director's interest in a challenged board-approved transaction is sufficiently material to conclude that he lacked independence); *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 363–64 (Del.1993) (same).

***4** In any event, the business judgment presumption remains intact because the Complaint does not allege that the Director Defendants' alleged interest was material in bringing about the 1995 Avoidance:

> "Missing is any allegation regarding the composition of the **Color Tile** Board of Directors which allegedly acted or failed to act contrary to the best interests of **Color Tile**—i.e., how many directors there were, how many acted along with the Director Defendants and/or how many failed to act along with the Director Defendants.
>
> Plaintiff's cause of action necessarily stems from a decision that the entire board of directors made or failed to make (it is not clear which), not a decision that the Director Defendants made independently. Thus, plaintiff must plead facts supporting the conclusion that the board as a whole was tainted by the Director Defendants' alleged interest.

> Moreover, plaintiff failed to allege that Messrs. Bewkes, Philippin or Hedley somehow controlled or dominated the remainder of the board."

(4/16/98 Def. Mem. at 38–39).

When an action by a board of directors of a Delaware corporation is challenged, the courts determine whether a conflict of interest of board members has deprived stockholders of a "neutral decision-making body." *Cinerama,* 663 A.2d at 1170. The focus is on whether a *majority* of the corporation's board of directors was neutral and independent in passing on the proposed corporate action. *Id.* at 1167–1170.

> "[A] material interest of one or more directors less than a majority of those voting would [only] rebut the application of the business judgment rule if the plaintiff proved that the interested director controls or dominates the board as a whole or that the interested director failed to disclose his interest in the transaction to the board and a reasonable board member would have regarded the existence of the material interest as a significant fact in the evaluation of the proposed transaction."

Id. at 1168 (internal quotation marks and brackets omitted).

There is no allegation in this case that any of the Director Defendants failed to disclose to the rest of the board his alleged interest in the 1995 Avoidance. Thus, under the *Cinerama* formulation for determining if the interest of one or more directors was material to the independence of the entire board, the Complaint fails to rebut the business judgment rule unless it alleges facts from which one could infer that the Director Defendants, through their dominance over the other board members, "so infected or affected the deliberative process of the board as to disarm the board of its presumption of regularity and respect." *Cinerama, Inc. v. Technicolor, Inc.,* 663 A.2d 1134, 1153 (Del. Ch.1994), *aff'd* 663 A.2d 1156 (Del.1995); *see also Nebenzahl v. Miller,* Civ. A. No. 13206, 1996 WL 494913, at *3 (Del. Ch. Aug. 29, 1996) (dismissing fiduciary duty claim against directors; fact that 50% of the directors who voted on proposed merger were interested and held substantial corporate positions and shareholdings was not sufficient to rebut the presumption that the disinterested directors who voted to approve the merger did so independently and in good faith).

***5** The importance of allegations of materiality of the position of a particular interested director defendant with respect to an action or nonaction by the **Color Tile** board as a whole was made clear to the Committee during oral argument on the motion to dismiss the Amended and Consolidated Complaint (the "First Amended Complaint"). (6/25/98 Tr. at 13–36). In response to the comments made at that oral argument, and after receiving a ruling on July 31, 1998 permitting the Committee to make one more round of amendments to the First Amended Complaint, (7/31/98 Tr. at 27–31), [5] in August 1998, the Committee added factual allegations about the composition and independence of the 1993 board with respect to the 1993 Transaction. Significantly, the Committee did not add similar allegations with respect to the 1995 board regarding the 1995 Avoidance. Thus, the Complaint still lacks allegations about the number of directors on the 1995 board or the interestedness or independence of any of the 1995 directors other than the four Director Defendants.

The Committee concedes that under Delaware law, the independence of the majority of the board must be challenged to strip the individual directors of the business judgment presumption. (9/21/98 Pl. Mem. at 14). However, it argues that when the Complaint is read as a whole, under Fed.R.Civ.P. 8(a), it gives rise to the logical conclusion that the Director Defendants, through their connections with **Color Tile's** controlling shareholder group, dominated and controlled the rest of the 1995 **Color Tile** board. The Committee points to the following allegation: "[The Director Defendants'] breach of their fiduciary duties of loyalty proximately caused damages to **Color Tile** in that, absent breach of their fiduciary duties of loyalty, **Color Tile** could have taken steps that would have preserved whatever value of the company was salvageable." (Compl.¶ 156).

This allegation, unaccompanied by any factual allegations about the number of other board members and the nature of their relationship with Color Tile or the defendants, does not undermine the independence of the 1995 board as a whole. "Conclusory allegations alone cannot be the platform for launching an extensive, litigious fishing expedition in the hope of finding something to support them." *Nebenzahl,* 1996 WL 494913, at *3. The fact that the entire Color Tile board could have been replaced by the company's controlling shareholder group, while relevant, is not sufficient to support an inference that the board as a whole lacked independence, absent additional factual allegations demonstrating "that through personal or other relationships the directors are beholden to the controlling person." *Aronson v. Lewis,* 473 A.2d 805, 815 (Del.1984); *see also Friedman v. Beningson,* Civ. A. No. 12232, 1995 WL 716762, at *5 (Del. Ch. Dec. 4, 1995). Because the complaint lacks the basic factual allegations that would allow an inference under Fed.R.Civ.P. 8(a) that the Director Defendants' alleged interest in carrying out the wishes of the controlling shareholder group infected the 1995 board as a whole, the business judgment presumption shields the Director Defendants from a breach of fiduciary duty of loyalty claim based on the 1995 Avoidance. [6]

***6** The Committee's argument that the business judgment presumption does not regularly apply in the case of self-interested transactions with a controlling shareholder, *see Kahn v. Tremont Corp.,* 694 A .2d 422, 428 (Del.1997), is misplaced because the 1995 Avoidance was not a "self-dealing transaction." The CT Holdings Controlling Shareholders did not stand on the other side of any 1995 "transaction" which is under attack. I decline to extend *Kahn* far beyond its facts. What is being attacked here is a self-interested failure to take Color Tile into bankruptcy for a period of several months. *Kahn* does not authorize the automatic removal of the business judgment presumption from every considered decision of a company owned by a controlling shareholder. The presumption is removed only when the corporation affirmatively deals with the controlling shareholder or one of its controlled entities.

The Committee also argues that the Director Defendants may be held liable on the theory that they are joint tortfeasors or co-conspirators. However, the failure to allege that the 1995 Avoidance was the work product of a majority-tainted board precludes the imposition of such liability. Without factual allegations about a majority of the 1995 board, there is no actionable tort to which joint liability could attach. Accordingly, Count Twelve is dismissed for failure to state a claim upon which relief can be granted.

B. Claims against CT Holdings Controlling Shareholders

Counts Eight and Nine assert that by bringing about the 1995 Avoidance through their shareholder control over Color Tile, the "CT Holdings Controlling Shareholders" [7] breached their fiduciary duties of loyalty and care to the company. Counts Ten and Eleven are identical except that they allege breach of the duties of loyalty and care running to Color Tile's creditors rather than Color Tile itself. [8]

These counts fail to state a claim of breach of fiduciary duty against the controlling shareholder group because they do not allege that a majority of the board of directors that deliberated on the 1995 Avoidance was beholden to and carrying out the wishes of the CT Holdings Controlling Shareholders. Thus, there is no allegation that the shareholder control that was exerted over Color Tile's board was material to the overall independence of the board such that the business judgment rule cloaking the 1995 Avoidance may be considered rebutted.

CONCLUSION

For the foregoing reasons, the moving defendants' motion to dismiss Counts Eight through Twelve is granted. With respect to Counts One through Seven and Count Nineteen, all of which concern the 1993 Transaction, the motion to dismiss was previously denied in an oral opinion in open court. (10/9/98 Tr. at 73).

SO ORDERED.

All Citations

Not Reported in F.Supp.2d, 1999 WL 754015

Footnotes

1 The parties' earlier submissions on subject matter jurisdiction show that, under the Settlement, recoveries from this and other actions will be distributed to the **Color Tile** and CT Holdings estates, the Consumer Deposit Trust, and the Unsecured Creditors' Trust under the formula specified in the Settlement. In its Order approving the Settlement, the Delaware Bankruptcy Court retained jurisdiction to resolve disputes that arise with respect to distribution under the Settlement of any litigation proceeds. The Bankruptcy Court is expected to spend at least the next two to four years resolving objections to claims against the litigation proceeds.

2 There is no explanation in the Complaint as to why the public offering of Saks Fifth Avenue stock by the Investcorp Group in 1996, (Compl.¶ 35), did not cause a further delay of **Color Tile's** bankruptcy filing.

3 The date on which the ABWF stock was transferred to the bank group is not specified in the Complaint but is implied to have been in the late summer or early fall of 1995.

4 The parties dispute whether the Committee's basic complaint in Counts Eight through Twelve, that the entities and individuals controlling **Color Tile** are liable because they self-interestedly delayed the timing of **Color Tile's** bankruptcy filing, states a cognizable breach of fiduciary duty claim. *Cf. Schacht v. Brown,* 711 F.2d 1343, 1345, 1348 (7th Cir.1983); *McHale v. Huff (In re Huff),* 109 B.R. 506, 508 (Bankr.S.D.Fla.1989). For purposes of this motion, the issue need not be decided.

5 In ruling from the bench, I stated, "I will grant [Coopers & Lybrand's motion to dismiss] with leave to amend the complaint, although I think this is the last time you should amend your complaint. So you should do any amending you are planning to do." (7/31/98 Tr. at 31).

6 The Committee argues that the cited Delaware cases are distinguishable because they concern application of Del. Ch. Ct. Rule 23.1, which sets forth a pleading "with particularity" standard for shareholder derivative suits. The pleading standard that applies is not determinative of the outcome in this case. Even under the basic notice pleading requirement of Fed.R.Civ.P. 8(a), the Complaint's incomplete allegations about the identity and independence of the directors on the 1995 board are insufficient to rebut the business judgment presumption.

7 The CT Holdings Controlling Shareholders are (1) a Luxembourg limited liability company called Investcorp SA ("SA"); (2) three of the principal officers of SA: Elias N. Hallack, Nemir A. Kirdar, and Michael L. Merritt; and (3) five Cayman Islands corporations: CIP Limited, Corporate Equity Limited, Acquisition Equity Limited, Funding Equity Limited, and Planning Equity Limited. (Compl.¶¶ 1, 16, 21, 25–27). Kirdar, Hallack, Merritt, and the five Cayman Islands corporations owned the voting stock of CT Holdings. (*Id.* ¶¶ 21, 25–27). Through contractual arrangements with the Cayman Islands corporations (*Id.* ¶ 21) and Kirdar, Hallack, and Merritt, SA had the right to vote all the voting stock of CT Holdings. (*Id.* ¶ 1).

8 The parties have not briefed the issue of whether the claims asserted in Counts Ten and Eleven are property of **Color Tile** such that the Committee may properly assert them. Since the claims are dismissed on a different ground, resolution of this issue is unnecessary.