IN THE COURT OF CHANCERY OF THE STATE OF DELAWARE

HAMPSHIRE GROUP, LIMITED,

Plaintiff,

v.

LUDWIG KUTTNER, CHARLES CLAYTON, and ROGER CLARK,

Defendants.

CHARLES CLAYTON and ROGER CLARK,

Counterclaim Plaintiffs,

v.

HAMPSHIRE GROUP, LIMITED,

Counterclaim Defendant.

CHARLES CLAYTON,

Defendant and
Third-Party Plaintiff,

v.

JOEL GOLDBERG, MICHAEL C. JACKSON, HARVEY L. SPERRY, IRWIN WINTER, MAURA McNERNEY LANGLEY, JONATHAN NORWOOD, and HEATH GOLDEN,

Third-Party Defendants.

C.A. No. 3607-VCS

MEMORANDUM OPINION

Date Submitted: April 12, 2010
Date Decided: July 12, 2010

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STRINE, Vice Chancellor.

I. Introduction

This is an unfortunate case in which it is clear that the parties have spent far more money investigating and litigating over certain matters than those matters involved. The plaintiff in the case, Hampshire Group, Limited ("Hampshire"), is a clothing company that was listed on the NASDAQ until January 2007. Hampshire delisted after filing restated financial statements for the year of 2003 until the quarter ending April 1, 2006 (the "Restatement"). Although the amount of the Restatement was relatively small in proportion to Hampshire's modest revenues of approximately $300 million a year, the events that in part inspired the ultimate decision to restate led the board to terminate Hampshire's CEO, Ludwig Kuttner. This was momentous because Kuttner was Hampshire's founder and largest stockholder, and a number of the board members had served alongside him for decades. Hampshire's board appears to have been inspired to replace Kuttner because three of the company's newer employees wrote the board a stinging screed alleging a score of instances of wrongdoing (the "Internal Review Memorandum"). Although most of these allegations were found to be unsubstantiated after an expensive investigation by outside advisors, some of the allegations were found by the advisors to be meritorious and the board's hand was forced.

In responding to the allegations, the board was careful to limit the scope of its investigation to Kuttner and a few of his subordinates, and purposely avoided looking at its own role or in holding accountable certain more favored officers, including ones who themselves eventually confessed to engaging in purposeful wrongdoing. Instead of a full inquiry that focused on everyone with responsibility, the board's tactic appears to have been to hold Kuttner as CEO primarily responsible for the problematic matters.

To that end, this lawsuit included Kuttner as a defendant and Hampshire accused Kuttner of receiving nearly a million dollars in improper expense reimbursement, knowingly causing the corporation to violate the tax laws in several ways, and thereby also causing the corporation's financial statements to be materially inaccurate. But Hampshire settled with Kuttner, giving him a complete release in exchange for a cash payment of $1.5 million and the receipt of his substantial 30% block of stock for a price of $5 per share, some $1.24 below the prevailing market price.[1]

This left two remaining defendants — Charles Clayton and Roger Clark, two former Hampshire officers and employees — who Hampshire alleges participated in or overlooked these irregularities so as to benefit Kuttner at Hampshire's expense. Most central to Hampshire's case is its allegation that Clayton and Clark breached their fiduciary duties by improperly approving Kuttner's questionable expense reports and being complicitous in a series of supposedly illegal tax avoidance strategies. Because of Clayton and Clark's misconduct, Hampshire argues, the company incurred additional tax liability, was required to undertake an expensive investigation, and had to restate its financial statements.

[1] JX 169 (Hampshire Group, Ltd. Press Release, "Hampshire Group Enters Into Stock Purchase and Settlement Agreement with Ludwig Kuttner (Aug. 4, 2008)); JX 203 (Stock Purchase and Settlement Agreement and Mutual Releases Between Ludwig Kuttner and Hampshire Group, Ltd.).

Although Hampshire's focus narrowed after the internal investigation concluded that many of the allegations made in the Internal Review Memorandum were unsubstantiated, its sprawling claims here still involve great complexity. Most of the damages Hampshire hopes to recover against Clayton and Clark involve its desire to have them pay for the internal investigation.

Clayton and Clark responded to this lawsuit by bringing counterclaims against Hampshire, claiming that press releases issued by Hampshire after their terminations were defamatory, and that Hampshire breached their employment contracts by failing to pay them money, including severance pay and bonuses. Clayton also brought a third-party claim against Hampshire board members and officers for contribution.

In this post-trial opinion, I find that Clayton and Clark are not liable in damages for any payments to Kuttner of excessive expense reimbursements. The evidence on that issue indicates that Clayton and Clark attempted in good faith to perform the difficult task specifically assigned to them by the Hampshire board of processing over a dozen years of expense reports Kuttner had failed to timely file. The board knew Kuttner's expense reports were long overdue, had failed to get him to process them faster, and wanted the reports processed before a key Sarbanes-Oxley requirement came into effect. Clark took the lead in processing Kuttner's reports and did a rational, good-faith job in doing so. He reduced many of the expenses Kuttner sought when not verified, weeded out duplications, and along with Clayton, eventually refused to process some additional reports Kuttner filed for periods that had already been addressed. Although it appears certain that some improper expenses snuck through, Hampshire's allegations that Kuttner received nearly $1 million in excess expense reimbursements seems wildly inflated. Many of the expenses Hampshire challenges appear on their face to have a business purpose and the board and its advisors could have asked for more specification. Rather than do so, they intentionally chose to characterize as many of Kuttner's requests as questionable as they could, an approach contrary to how they handled similar situations with other board members and officers. Indeed, the board's own chosen advisor questioned expenses because the advisor did not even know, among other huge gaps in knowledge, the names of senior officers and a director of the company and questioned who they were when their names appeared on Kuttner's expense reimbursement forms. None of Kuttner, Clayton, nor Clark were asked for input in the review and many of the supposedly unsubstantiated expenses seem to be ones that could have been substantiated easily if the board had chosen to do so, if more in fact was needed than Kuttner's representation and his identification of the expense as a business meeting or dinner.

By contrast, I do conclude that Clayton breached his fiduciary duties by knowingly causing the corporation to reimburse employees of a corporate subsidiary, Item-Eyes, Inc. ("Item-Eyes"), for personal expenses. Although Clayton did not do this to enrich himself, and although the practice was designed to implement agreements reached in order to secure Hampshire's ability to purchase Item-Eyes, Clayton knowingly caused Hampshire to treat as reimbursable business expenses what was in fact concealed compensation to the Item-Eyes' executives. By consciously causing the corporation to violate the law, Clayton breached his duty of loyalty and is responsible for the corporation's costs of investigating and rectifying that misconduct. Likewise, I conclude that Clayton breached his duty of loyalty by participating in and permitting to continue an improper program whereby sweaters without market value were doled out to particular employees, who then gave them to charities and took personal tax deductions for the donation. Although Clayton may have been naïve in his original participation in this minor caper, the Audit Committee specifically instructed on December 8, 2004 that employees not be permitted to act as if the sweaters were donations from themselves personally that were deductible. Clayton, who was the corporation's CFO at that time, circumvented that instruction and personally tried to take deductions for periods after that instruction was given.

I find that both Clayton and Clark breached their fiduciary duties by approving tuition payments that were improperly recorded as charitable donations. Certain checks to Columbia University were recorded as donations by Hampshire when they were in fact tuition payments made on behalf of Kuttner's assistant. Although Clark and Clayton deny that they knew the checks were for tuition, I conclude that both Clayton and Clark knew the true purpose of the checks. Knowing that the checks were not donations, Clayton and Clark should not have recorded them as donations and should have brought the matter to the attention of the board. Only when another employee later raised the issue was the matter taken to the board. Admittedly, the board dealt with the issue by grossing up the assistant's salary to cover her tuition and took no disciplinary action against anyone at the time, and did not even question Clayton or Clark about it. But when litigation arises, all issues get put on the table as this one was. Having knowingly falsified financial records of the company, Clayton and Clark breached their fiduciary duties of loyalty.

Because Clayton and Clark also filed certain certifications regarding the integrity of Hampshire's financial statements and internal controls for the periods in which they knew that the books of the company were false and that improper conduct had occurred, I find another independent basis for a loyalty breach. But that breach only extends to the failure to disclose the specific instances of wrongdoing of which they were aware.

I also find that Hampshire is entitled to recover bonuses paid to Clayton and Clark after November 2005, when a policy requiring the clawback of bonuses for the years that Hampshire restated its financial statements went into effect, until April 1, 2006, the end of the time period for which Hampshire restated its financial statements.

On the counterclaims, I find as follows. Clark and Clayton have not proven their claim that they had reached oral agreements with Kuttner regarding their compensation, or that they are entitled to the modest severance available to them under the corporation's personnel policy. Clark is not entitled to vacation pay because he was told to use his vacation time while he was on administrative leave. But Clayton, who was not instructed to use his vacation time while on leave, can recover for the amount of vacation days given to him under Hampshire's personnel handbook for the period in 2006 before his termination. Clayton and Clark also cannot receive incentive bonuses because they have not established that there was a contractual obligation to pay such bonuses under the circumstances that pertain here. But Clayton and Clark are entitled to a bonus associated with a reserve that Hampshire established to cover any claims due to fraud by a

Hampshire vendor, Link Trading Company, if and when that reserve is reversed. Also, Clayton is not entitled to repayment of expense reports that he failed to submit during his employment, benefits under a supposed "terms of employment" agreement, or damages from the disbursement of his deferred compensation agreement.

Finally, I conclude that neither Clayton nor Clark has proved that he was defamed by Hampshire. Although Hampshire admittedly could have been less awkward in its disclosures, I am unable to conclude that the corporation made any false statements about either that materially injured their reputations. The reality is that Hampshire was a public company and Clayton and Clark were each high-ranking financial officers who shared a good deal of the responsibility for the integrity of Hampshire's financial statements during a period of time for which those statements had to be restated. Although Clayton and Clark may not be responsible in damages for all the problems and misconduct that led to the Restatement and the tax issues the corporation had to address, they were subject to the sort of accountability that is traditionally expected of high-ranking officials in an organization that experiences a failure on their watch. That the investing public was informed that they had been terminated in the wake of the internal investigation is a reality Clayton and Clark signed up for by accepting high-ranking positions in a public company. The disclosures of the corporation did not engage in an adjectival assault on their integrity or competence. To the extent the disclosures in some sense attributed some of the responsibility for the Restatement and tax issues to them, the disclosures were fair and accurate. To the extent that the disclosures about Clayton suggested he had engaged in conduct that was knowingly deceptive, regrettably the disclosures cannot be deemed false. More largely, to the extent that the disclosures suggested that Clayton and Clark were part of a top management regime that ran a very loose shop in terms of financial compliance, they can also not be deemed false.

The remedial implications of these findings are complex, and the record does not permit a factual determination of the extent to which the parties are obligated to each other on a net basis, especially given the substantial payments made by Kuttner in settlement. The parties will be offered a chance to submit additional briefing to nail down the residual issues, if they cannot use the time more productively by settling.

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This opinion proceeds in the following order: Part II describes the parties and the factual background relevant to Hampshire's claims; Part III sets forth my analysis of Hampshire's claims; Part IV resolves Clayton and Clark's counterclaims; Part V discusses the issues that must be addressed to shape a final judgment in the case; and Part VI summarizes the outcomes on the parties' various claims.

II. Factual Background

A. The Parties

Hampshire, a Delaware corporation with its principal place of business in Anderson, South Carolina, is a "leading provider of women's and men's sweaters, wovens and knits, and is a growing designer and marketer of branded apparel in the United States."[2] Hampshire operates through three wholly-owned subsidiaries, Hampshire Designers, Inc. and Item-Eyes for women's apparel, and Hampshire Brands

[2] JX 190 (Hampshire Group, Ltd. Form 10-K (filed April 9, 2009)) at 17.

for men's apparel, which all "offer products under several brand names as well as private label to multiple channels of distribution, including national and regional department stores and mass market retailers."[3]

Kuttner founded Hampshire in 1977, and ran the company as its Chairman and CEO for almost three decades. He and his family owned approximately 30% of Hampshire's outstanding stock. Kuttner's lengthy term as CEO ended in September 2006 when he was asked by the board to resign due to the preliminary findings of an Audit Committee investigation.[4] By all accounts, Kuttner was a flamboyant and energetic leader with a high public profile and a colorful way of dressing.

Many of the Hampshire directors had served on the board with Kuttner for decades. For example, Harvey Sperry had been on the board since 1977, having been a partner at Willkie Farr & Gallagher LLP ("Willkie Farr") during many of those years.[5] Willkie Farr, not coincidentally, was Hampshire's outside corporate counsel for that entire time and continues in that role. Michael Jackson, a former director, served on the board from 1986 to 1996, and 2001 to May 1, 2009.[6] Jackson was also a founding member of Ironwood Partners, LLC ("Ironwood"), a venture capital company that was retained by Hampshire as a financial consultant and with which Kuttner invested, and

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[3] Hampshire Group, "About Hampshire," http://www.hamp.com/about/about.asp (last visited June 14, 2010).
[4] JX 51 (minutes of a Hampshire board meeting (Sept. 25, 2006)).
[5] Tr. at 380-81 (Sperry).
[6] JX 98 (Hampshire Group, Ltd. Form 10-K/A for the fiscal year ending Dec. 31, 2007) ("2007 10-K/A") at Item 10.

was involved in the deferred compensation issue Hampshire raises in this litigation.[7] Joel Goldberg served on the Hampshire board from 1998 to March 26, 2009, at which time he resigned after admitting that he had submitted improper expense reports to the company.[8]

The outside directors of Hampshire were aware of Kuttner's idiosyncrasies and taste for high living, and they indulged it. A good example is that Kuttner replaced his company car, a Lamborghini, with another modest vehicle, a Ferrari.[9] As we shall see, the board was either unwilling to or unable to actually direct Kuttner even when they wanted to do so, and this case largely arose when the board's hand was forced by the Internal Review Memorandum in June 2006 from relatively new employees.[10]

Like Sperry and Jackson, defendant Clayton was a long-time member of the Hampshire team, joining Hampshire one year after Kuttner founded the company, in 1978, as the Vice President of Finance and Controller, working out of Hampshire's South Carolina office. Five years later, in 1983, Kuttner promoted Clayton to CFO.[11] Clayton also served as Hampshire's Treasurer and as the secretary for the Hampshire board and Audit Committee meetings.[12] Clayton held his position as CFO until 2000 when he gave up those duties. Clayton, who is about 71 now,[13] enjoyed only a short respite from being CFO. He was called back to that role in November 2003 when his successor departed.

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[7] JX 1 (Hampshire Group Ltd. Form 10-K/A for the period ending Dec. 31, 2005 (filed May 31, 2007)) ("2005 10-K/A at 52.

[8] JX 244 (Hampshire Group, Ltd. Form 8-K (March 26, 2009); Tr. at 528-29 (Sperry).

[9] JX 105 (Documentation of Meeting with Paul Weiss and Navigant on October 25, 2006) at DT 776 ("Navigant/ Paul Weiss Findings").

[10] JX 502 (Hampshire Internal Review Memorandum (June 14, 2006)).

[11] Tr. at 553 (Clayton).

[12] *Id*. at 691 (Clayton).

[13] *Id*. at 1011 (Winter) (testifying that Clayton was 67 as of September 2006).

Clayton served as CFO from that time until April 1, 2006, and the company looked for a permanent CFO during the latter period of that stint.[14] Like Kuttner, Clayton was terminated by the board in September 2006 due to the preliminary findings of the Audit Committee investigation. As CFO, in 2005 Clayton had earned a salary of $168,000, plus an additional $450,000 in bonuses and other compensation.[15]

Roger Clark began his employment with Hampshire at its South Carolina office in 1998, serving as Vice President-Finance and later Principal Accounting Officer, [16] until he was laid off in December 2006. Clark reported directly to the CFO — who was William Hodge from 2001 to 2003 until Clayton again took over the position[17] — and was charged with overseeing Hampshire's bookkeeping functions, maintaining its ledger, and preparing its financial statements. As Principal Accounting Officer, in 2006 Clark earned $104,000, plus a bonus of approximately $30,000.[18]

As a matter of full context, Clayton and Clark both had business relations with Kuttner during their employment with Hampshire. Specifically, in 2003, Hampshire sold Hampshire Investments, Limited ("HIL") a subsidiary that was involved in real estate investments.[19] That subsidiary was purchased by Kuttner, Clayton, and another

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[14] *Id*. at 553-54 (Clayton).
[15] *See* JX 290 (Hampshire Group, Limited Incentive Bonus Program) (showing Clayton's 2005 salary to be $168,000); JX 305 (Charles W. Clayton's 2005 Form W-2) (reporting $625,520.37 in total income from Hampshire).
[16] Clark was appointed Principal Accounting Officer in 2004, and served in that role concurrent with his position as Vice President-Finance.
[17] Tr. at 11 (Clark), 553-54 (Clayton).
[18] JX 291 (Hampshire Group, Limited Incentive Bonus Program).
[19] Clayton Dep. at 7.

investor.[20] Clark had done HIL's books when it was owned by Hampshire, and continued to fulfill that function for HIL after its sale for a modest fee.[21] Kuttner also helped Clark, through loans, to acquire $50,000, or a 1% stake, in HIL stock.[22]

All of this was known by the Hampshire board and disclosed in Hampshire's financial statements at all relevant times.[23] When Clayton and Clark were terminated by Hampshire, they continued to be employed by HIL but on more lucrative terms than existed before they left Hampshire. In Clark's case, he began to receive a salary of $104,000 — the same salary he made at Hampshire — and also received a one-time bonus of $300,000 for work that both he and his wife did at HIL.[24] In Clayton's case, in 2008 he received a salary from HIL of $80,000 — nearly $50,000 less than his 2006 salary at Hampshire — plus a $400,000 bonus in 2008.[25] Clayton is also a partner with Kuttner in other ventures, including real estate holdings in Texas, and an investment vehicle called CK Holdings LLC.[26]

Clayton and Clark were not the only Hampshire fiduciaries who derived financial benefits from their relationship with Kuttner. As noted, outside director Sperry was a longtime partner at Willkie Farr, and Willkie Farr derived substantial fees from representing Hampshire during Kuttner's many years as Hampshire's leader. Likewise, director Jackson was in the investment business, and Kuttner invested with him and hired

[20] *Id*.
[21] Tr. at 147-48 (Clark).
[22] *Id*.
[23] *E.g.*, 2005 10-K/A at 53 (disclosing that Clayton, Kuttner, and Clark were beneficial owners of HIL).
[24] Tr. at 7-8, 134 (Clark).
[25] JX 675 (summary of Clayton's earnings).
[26] *Id*. at 687-88 (Clayton); Clayton Dep. at 34-35.

his venture capital company as a Hampshire advisor. Director Goldberg rented office space from Hampshire for his company, SK Associates.[27]

B. Hampshire's Board Investigates The Actions Of Kuttner, Clayton, And Clark

Rancor within the long-time Hampshire crew really began when the Hampshire board received a communication it could not ignore. Between 2004 and 2006, Hampshire had hired some new high-ranking employees. Maura McNerney Langley came aboard in April 2004 as Compliance Officer after working for Hampshire's outside advisor, Deloitte & Touche LLP ("Deloitte") on the Hampshire account.[28] Heath Golden, a former Willkie Farr lawyer, came aboard in August 2005 as Vice President of Business Development and Assistant Secretary, was promoted to General Counsel in May 2006, and eventually became CEO in April 2009.[29] Jonathan Norwood joined Hampshire in April 2006 as Vice President and Chief Financial Officer, replacing Clayton, and later took on Clark's role of Principal Accounting Officer.[30]

During the course of their new employment, the three became concerned about loose practices around Hampshire, even though a couple of them participated themselves in a few instances of such practices. In May 2006, these employees let fly with what they styled as an Internal Review Memorandum.[31] The Internal Review Memorandum outlined 23 matters that these employees suspected involved illegal activity or violations

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[27] 2007 10-K/A at 52.
[28] 2005 10-K/A at Item 10; Tr. at 176 (Clark). Langley resigned in July 2009 after submitting an expense report in violation of company policy. Goldberg Dep. at 72.
[29] 2007 10-K/A at Item 10; Tr. at 176 (Clark).
[30] 2007 10-K/A at Item 10; Tr. at 792 (Norwood).
[31] JX 502 (Hampshire Internal Review Memorandum (June 14, 2006)).

of corporate policy. The authors suspected that there was a "a long history of management utilizing Company assets for personal benefit, taking unauthorized compensation in various forms, and engaging in unauthorized related party and other transactions that unduly enriched themselves."[32] The Internal Review Memorandum discussed issues that predominantly involved Kuttner, such as Kuttner's involvement in a stock repurchase program, problems with Kuttner's untimely and undocumented expense reports, mismanagement of deferred compensation funds by Kuttner and Clayton, and the fact that several Hampshire employees — including Clayton and Clark — worked for other companies run by Kuttner.[33] The Memorandum recommended to the board that Kuttner, Clayton, Clark, and Kuttner's two secretaries be put on immediate leave, that they be denied access to the company, and that an internal investigation be undertaken.[34] Absent "appropriate action by the Audit Committee," the Internal Review Memorandum authors said that they would "report [their] findings to the SEC, IRS, and other appropriate authorities."[35]

At this point, Hampshire's board consisted of five members: Kuttner; Joel Goldberg, who served as a member of the board's Audit Committee and chair of the Compensation Committee; Harvey Sperry, a member of the Audit Committee; Irwin Winter, the chair of the Audit Committee; and Michael Jackson.[36] The Internal Review Memorandum was explosive and could not be ignored. The Memorandum and its

[32] *Id*. at i.
[33] *Id*.
[34] *Id*. at i.
[35] *Id*. at ii.
[36] 2007 10-K/A at Item 10.

preliminary findings were presented to the Audit Committee on June 14, 2006. Kuttner, as well as Clark, Clayton, and Kuttner's two assistants, were placed on administrative leave the next week because of their involvement in the issues raised in the Memorandum. The board thereafter launched a full-scale investigation, and hired Navigant Consulting Inc. ("Navigant"), and the law firm of Paul, Weiss, Rifkind, Wharton & Garrison LLP ("Paul Weiss") as its principal outside advisors. Hampshire also hired additional outside advisors, including Ernst & Young and Dixon Hughes to investigate and remedy specific issues that were raised in the Memorandum.[37]

The board also appointed an executive committee, consisting of all of its directors other than Kuttner to direct the affairs of the corporation.[38] The outside advisors were given wide latitude and a huge budget to investigate the issues in the Internal Review Memorandum, but were not authorized to consider what role the board played in the matters raised in the Memorandum.[39] That is, it appears that the outside advisors were instructed to focus their aim on the employees put on leave and not to stir up issues that might implicate the board or other officers.

Navigant and Paul Weiss investigated all of the 23 issues raised in the Internal Review Memorandum. Their investigation "included reviews of documentation, interviews with employees of Hampshire group . . . and electronic document and email searches. . . ."[40] Notably, the investigation did not include interviews of the employees

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[37] Tr. at 875-76 (Norwood).
[38] *Id*. at 68-69 (Goldberg), 446 (Sperry), 1001-02 (Winter).
[39] *Id*.
[40] Tr. at 323 (Jennings).

who were put on leave — including Clark, Clayton, and Kuttner.[41] The Audit Committee heard the preliminary findings of Navigant and Paul Weiss on September 20, 2006, and, as a result of those findings, recommended to the board that Kuttner and Clayton be terminated.[42] Navigant and Paul Weiss found that 16 of the 23 issues were not substantiated concerns, but found that 7 of the issues did raise important compliance problems.[43] The board voted to terminate Kuttner and Clayton on September 25, 2006.[44] A public announcement of their termination was made that same day.[45]

The Audit Committee investigation concluded one month later on October 25, 2006, and the board was confronted with large investigation costs. Hampshire spent $2.7 million on fees for Paul Weiss, and another $2.2 million on fees for Navigant.[46] Other outside advisors that Hampshire consulted during the investigation, including Deloitte, cost Hampshire nearly $600,000.[47]

On December 1, 2006, Clark was notified that his employment would be terminated on December 29, 2006.[48] At that time, Clark was admonished to use his remaining vacation time.[49] Although Clark had been subject to investigation in the internal investigation and the results of the investigation linked him to the issues leading

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[41] *Id*.
[42] JX 51 (minutes of the meeting of Hampshire's board of directors (Sept. 25, 2006)).
[43] *See* Navigant/ Paul Weiss Findings; Tr. at 981 (Winter).
[44] JX 51 (minutes of the meeting of Hampshire's board of directors (Sept. 25, 2006)).
[45] JX 307 (Hampshire Group, Ltd. press release regarding termination of employees (Sept. 25, 2006)) ("September Press Release").
[46] JX 166 (summary of Hampshire's expenditures that it claims are related to this litigation).
[47] *Id*.
[48] JX 23 (letter from Heath Golden to Roger Clark (Dec. 1, 2006)).
[49] *Id*.

to the Restatement, he was not formally terminated for cause when his termination was documented. Instead, it was rationalized that his job could be performed by Langley.[50]

Two weeks after Clark was given his termination notice, Hampshire announced that it would restate its annual and quarterly financial statements for the year 2003 through the fiscal quarter ending April 1, 2006 based on the findings of the investigation.[51] The decision to restate came in spite of the finding of Hampshire's outside advisors that there was "no evidence of misleading financial statements."[52] That is, the internal investigation had not found evidence that Kuttner, Clayton, Clark, or others had manipulated Hampshire's earnings in any material way so as to inflate artificially the corporation's reported GAAP earnings. What problems with the books existed were largely due to a failure of the corporation to obtain proper approval for its executive compensation plan as required by § 162(m) of the Internal Revenue Code (the "§ 162(m) Plan").[53] After the investigation was complete, Hampshire restated its financial statements for the year 2003 through the fiscal quarter ending April 1, 2006 in the total amount of nearly $7.7 million.[54] The record indicates that but for the failure of Hampshire to seek stockholder approval of the § 162(m) Plan after 2002, Hampshire may

[50] Tr. at 447 (Sperry); Winter Dep. at 122 (explaining that Clark was terminated because Langley had far superior skills).
[51] JX 239 (Hampshire Group, Ltd. press releases announcing the Restatement (Dec. 13, 2007)).
[52] JX 192 (handwritten notes of John Giannuzzi of Deloitte regarding the conclusions reached at a Paul Weiss/ Navigant Meeting) at DT 1663; Navigant/ Paul Weiss Findings at DT 762 (showing the conclusion of Navigant, Paul Weiss, and Deloitte that Hampshire's "accounting judgments appeared to be appropriate and were appropriately disclosed").
[53] I.R.C. § 162(m)(4)(C)(ii) (permitting an exception to the general practice limiting deductible executive compensation to $1 million per covered employee if, among other things, "the material terms under which the remuneration is to be paid, including the performance goals, are disclosed to shareholders and approved by a majority of the vote").
[54] 2005 10-K/A at 35.

not have restated its financials because the other issues were not of a huge magnitude and could have been rectified in ways that did not require a restatement.[55]

But given the need to rectify the § 162(m) Plan issue and the fact that the corporation needed to ensure that it reserved for the potential financial consequences of several of the issues investigated (for example, the potential tax implications of compensation given to Item-Eyes executives for personal expenses and deferred compensation issues), a full Restatement was made.[56]

Hampshire's December 2006 press release announcing the Restatement explained that the Restatement was, in part, "related to the previously announced $1.45 million of expense reports submitted by the former CEO, Ludwig Kuttner . . . ."[57] The press release also attributed the Restatement to a number of other issues including Hampshire's "accounting and disclosure policies and internal controls."[58] Neither Clayton nor Clark was mentioned in this announcement, but Clark's termination was announced at the same time. I discuss the substance of the various announcements as to Clayton and Clark when considering their defamation claims.

The Restatement caused Hampshire to set aside tax reserves for any potential claims in the amount of $7,698,000. That is, Hampshire's restated financial statements reflected a $7,698,000 reduction in retained earnings as of January 1, 2003, and net

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[55] JX 289 (memorandum to Hampshire Group, Ltd. from Helen Hollifield & Chris White of Deloitte, discussing the amount of the Restatement (May 18, 2007)) at DT 1653; Tr. at 874 (Norwood).
[56] 2005 10-K/A at 35.
[57] JX 239 (Hampshire Group, Ltd. press release announcing the Restatement (Dec. 13, 2007)).
[58] *Id*.

income from 2003 to 2005.[59] A reserve for "tax liabilities related to payroll tax withholdings" in the amount of $1,665,000, and an increase in Hampshire's tax provisions of $5,706,000 accounted for over 95% of the amount of reserves established.[60] The single largest item of the Restatement was a $3,480,000 million reserve that was established for Hampshire's failure to address the problem with the § 162(m) Plan approval.

To put the Restatement in financial perspective, Hampshire's total revenues for the years in question were approximately $300 million and its net income was approximately $13 million.[61] Although the Restatement no doubt dealt with important legal and financial compliance issues, it was not large in comparison to Hampshire's overall P & L picture.

The statute of limitations has expired, or will expire shortly, on many of the potential claims for which reserves were booked. The $3.5 million reserve for § 162(m) exposure has been released because the time period for any suit about that has run.[62] Also, the statute of limitations has lapsed for the claims for which $500,000 was reserved attributable to Hampshire's 2004 tax return, and will expire in 2010 or 2011 on the $620,000 reserved for § 162(m) exposure for possible claims arising from Kuttner's deferred compensation.[63]

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[59] 2005 10-K/A at 35-36.
[60] *Id*.
[61] 2005 10-K/A at 11, 25.
[62] Tr. at 910-11 (Norwood).
[63] *Id*. at 915-16, 930 (Norwood); JX 190 (Hampshire Group, Ltd. Form 10-K (filed Apr. 9, 2009)) at 49.

C. Hampshire Brings Suit

Hampshire commenced suit against Kuttner, Clayton, and Clark on March 7, 2008. It appears Hampshire hoped to reach what was roughly a walk-away accord with Clayton and Clark but was unable to agree on terms when Clayton and Clark wanted some substantial compensation in connection with their termination. The original complaint brought a dog's breakfast of various claims against Kuttner, Clayton, and Clark, all centering on the seven issues that the internal investigation had found to be problematic.

On September 10, 2008, Clayton filed his answer and asserted a series of counterclaims against Hampshire for breach of contract, defamation, and intentional infliction of emotional distress. Clayton also brought third party claims against Hampshire's current and former directors and officers (the "Third Party Defendants")[64] for contribution and defamation.[65] Clark filed his answer and counterclaims against Hampshire on September 19, 2008, alleging breach of contract and defamation. In essence, Clayton and Clark each claimed that Hampshire had shorted them on severance compensation and had defamed them by the way it had announced their termination from the corporation.

The month before Clayton and Clark filed their counterclaims, Hampshire reached a settlement with Kuttner, the principal target of the lawsuit. In exchange for a complete

[64] Clayton's third party claims are brought against Goldberg, Sperry, Winter, Langley, Norwood, and Golden.

[65] Summary judgment was granted on Clayton's intentional infliction of emotional distress counterclaim, and defamation third party claim on September 2, 2009. *See Hampshire Group, Ltd. v. Kuttner et al*, C.A. No. 3607-VCS (Sept. 2, 2009) (TRANSCRIPT).

release, Kuttner paid Hampshire $1.5 million and also sold it and his family's large 30% block at a price of $5 per share. This was a $1.24 per share discount over the market price, which amounted to a discount over market of just over $3 million for Hampshire.[66] Director Sperry admitted that the corporation got an excellent deal on the stock.[67]

The settlement with Kuttner left the litigation in an awkward place. Kuttner never testified at a deposition or trial about the issues in the litigation. Despite sporadic efforts to settle, Hampshire, Clayton, and Clark staggered on, racking up big litigation expenses to pursue matters with relatively small dollar implications. Indeed, it is a sad reality that the investigation and litigation expenses incurred by Hampshire, Clayton, and Clark far exceed any possible financial harm to Hampshire from any of the underlying conduct at issue in the litigation.

D. The Decision's Structure For Resolving The Parties' Claims

The record in this case is both vast and inadequate. By that, I mean that the parties have litigated over a large number of discrete issues and the record has a lot of paper, but there are key aspects of many of the issues that involve spotty or confusing documentation and that were not explained to my satisfaction by witnesses. Where that is the case, and I harbor substantial doubt, my ultimate findings are disciplined, as they should be, by the standard of review and who bears the burden of persuasion.

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[66] Hampshire had just over 8 million outstanding shares, of which Kuttner owned 30%. JX 276 (Hampshire Group, Ltd. Form 10-Q for the Quarterly Period Ending Sept. 27, 2008). Specifically, Kuttner owned 2,390,340 shares. JX 203 (Stock Purchase and Settlement Agreement and Mutual Releases Between Ludwig Kuttner and Hampshire Group, Ltd.) at Tab 4 p. 2. A savings of $1.24 per share amounts to a total discount of $2,964,021.60 off what Kuttner's shares were worth if the stock market price was used.

[67] Tr. at 539 (Sperry).

Because the claims involve such a sprawling time frame and are so diverse, it will be more economical for the reader if I address the facts and legal conclusions as to specific claims simultaneously. I will do so in the following way. In the succeeding section, I address the claims raised by Hampshire against Clayton and Clark. I precede the resolution of those claims with an overview of the basic fiduciary standard that applies to the analysis of those claims. Then, I resolve the claims raised by Clayton and Clark against Hampshire. As a final matter, I address preliminarily what, if any relief, any of the parties should receive on claims on which they have prevailed, and ask the parties for further input based on the resolution of the parties' claims so that a final judgment can be entered on a more reliable and tailored basis than the current briefing permits.

III. Hampshire's Claims Against Clayton And Clark

The seven matters that Hampshire's board deemed worthy of litigation against Clayton and Clark were:

- Kuttner's submission of fraudulent expense reports, and Clark and Clayton's approval of those reports;[68]
- Kuttner and Clayton's approval of additional compensation for the personal expenses of Item-Eyes executives;[69]
- Kuttner and Clayton's allegedly improper investment of their deferred compensation funds, and Clark's improper investment of Kuttner's funds;[70]
- Kuttner and Clayton's establishment of a program allowing employees to take tax deductions for sweater donations that Hampshire made;[71]

[68] Compl. ¶¶ 16-19.
[69] *Id*. ¶¶ 20-22.
[70] *Id*. ¶¶ 23-28.

- Kuttner's payment of his assistant's tuition using amounts coded as "donations" in Hampshire's books;[72]

- Kuttner's direction that Hampshire be deregistered from doing business in New York;[73]

- Kuttner and Clayton's certification related to Hampshire's financial statements.[74]

In its complaint, Hampshire addresses each of these seven matters under a variety of headings. The major one is that as to each matter, Clayton, and in most but not all instances, Clark as well, breached their fiduciary duties.

I next address each of these instances of wrongdoing of which Clayton and Clark are accused after discussing the basic standards of review and liability that are applicable.

A. Breach Of Fiduciary Duty

At the heart of Hampshire's complaint is its claim that both Clayton and Clark breached the fiduciary duties they owed to Hampshire by failing to act with due care, and by using their positions to further Kuttner's interests at the expense of the company. As officers and key employees of Hampshire, both Clayton and Clark owed certain fiduciary duties to the company and its stockholders. As a general matter, our Supreme Court has found that the duties of corporate officers are similar to those of corporate directors.[75] Generally, like directors, Clayton and Clark were expected to pursue the best interests of

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[71] *Id*. ¶¶ 29-32.
[72] *Id*. ¶¶ 33-37.
[73] *Id*. ¶¶ 38-42.
[74] *Id*. ¶¶ 46-47.
[75] *See Gantler v. Stephens*, 965 A.2d 695, 709 (Del. 2009) (holding that "officers of Delaware corporations, like directors, owe fiduciary duties of care and loyalty, and that the fiduciary duties of officers are the same as those of directors").

the company in good faith (*i.e.*, to fulfill their duty of loyalty) and to use the amount of care that a reasonably prudent person would use in similar circumstances (*i.e.*, to fulfill their duty of care).[76]

There are important and interesting questions about the extent to which officers and employees should be more or less exposed to liability for breach of fiduciary duty than corporate directors. The parties in this case have not delved into any of those issues, and I see no justifiable reason for me to do so myself.[77] Indeed, Hampshire embraces the notion that the standard of liability that should apply to Clayton and Clark as to its due care claim requires proof that Clayton and Clark acted with gross negligence.[78] That is the standard used for corporate directors.[79] The reason for that standard is well-known. If corporate fiduciaries were held responsible in damages because a fact-finder, subject to hindsight bias, found they were negligent and caused preventable harm, useful risk-taking would be reduced. Hampshire does not fight with that justification here, and I apply the gross negligence standard.

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[76] *See In re Walt Disney Co. Deriv. Litig.*, 907 A.2d 693, 749 (Del. Ch. 2005) (defining the duties of loyalty and care (quoting *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. 1963))), *aff'd*, 906 A.2d 27 (Del. 2006).

[77] The reader interested in this subject could usefully consult the following back and forth in the *Business Lawyer*: Lyman P.Q. Johnson, *Corporate Officers and the Business Judgment Rule*, 60 BUS. LAW. 439 (Feb. 2005); Lawrence A. Hamermesh & A. Gilchrist Sparks III, *Corporate Officers and the Business Judgment Rule: A Reply to Professor Johnson*, 60 BUS. LAW. 865, 866 (May 2005). *See also* Lyman P.Q. Johnson & David Millon, *Recalling Why Corporate Officers Are Fiduciaries*, 48 WM. & MARY L. REV. 1597 (2005); A. Gilchrist Sparks, III & Lawrence A. Hamermesh, *Common Law Duties of Non-Director Corporate Officers*, 48 BUS. LAW. 215 (1992).

[78] *E.g.*, Hampshire's Opening Post-Trial Brief at 32, 34.

[79] *See Smith v. Van Gorkom*, 488 A.2d 858, 873 (Del. 1985) ("[T]he concept of gross negligence is . . . the proper standard for determining whether a business judgment reached by a board of directors was an informed one.").

When a corporate director or officer engages in self-dealing, the traditional entire fairness standard would apply.[80] When, as here, however, the defendant officers are not accused of self-dealing but of facilitating wrongful action by another (here, Kuttner), the court must examine the officers' state of mind to determine whether they acted in bad faith for a purpose other than advancing the best interests of the corporation.[81] This is an important issue here.

In a rather amazing argument, Hampshire attempts to suggest that Clayton and Clark must prove, as to their processing of Kuttner's expenses, that they did not commit a breach of the duty of loyalty because they were Kuttner's managerial subordinates. As Kuttner's subordinates, Clayton and Clark, Hampshire says, owed their primary source of living to Kuttner's good graces, and they also had outside business dealings with him. Therefore, by analogy to directors, they say that Clayton and Clark were not "independent."

This is cute in a non-praiseworthy sense. If applied as the law, every subordinate would have to prove his loyalty when accused of disloyalty if the underlying matter also implicated the CEO's interests. That would be outrageously unfair. Here, for example, it is absolutely clear that the board, especially Sperry and Jackson, had failed to get Kuttner to timely process his expense reports and knew that they had asked Clayton and Clark to

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[80] *E.g.*, *Gradient OC Master, Ltd. v. NBC Universal, Inc.*, 930 A.2d 104, 130 (Del. Ch. July 12, 2007) (noting that where a plaintiff proves self-dealing, the burden shifts to the defendant to prove entire fairness).

[81] *See In re RJR Nabisco, Inc. S'holders Litig.*, 1989 WL 7036, at *14-15 (Del. Ch. Jan. 31, 1989) (explaining that directors violate their duty of loyalty when, for any reason, they in bad faith place any other interest above that of the corporation's best interest).

process them. That is, the board consciously assigned *subordinates* of Kuttner to process the reports. If there be a status crime here that arises to disloyalty, it would be the decision of Sperry and other board members to put Clayton and Clark in the position they did.

The appropriate approach in these circumstances is to consider all the objective facts, including the relationships that subordinates have with their superiors,[82] and to make the difficult, but necessary, judgment of whether the subordinates acted loyally by trying to do their job for proper corporate purposes in good faith, or acted disloyally by in bad faith putting the self-interest of their superior ahead of the corporation's best interest. The traditional role of the concept of good faith in corporate law is to act as the operating definition of a loyal state of mind.[83] Thus, I look at whether Clayton and Clark have complied with their obligation of loyalty by examining their state of mind.

In so doing, I have considered as context for my final determination the material facts regarding their status as subordinates to Kuttner and as business associates. I have also taken into account that the board was at all relevant times aware of those relationships. That is, I decide this case in full awareness that Clayton and Clark were beholden to Kuttner as their managerial boss and also had valuable outside business relations with him. In making conclusions as to their state of mind, I have taken that into

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[82] *E.g.*, *In re infoUSA Inc. S'holders Litig.*, 2007 WL 3325921, at *23 (Del. Ch. Aug. 13, 2007) (finding that director defendants would have violated their duty of loyalty if they acted to further the interests of the CEO over the interests of the company).

[83] *See* Leo E. Strine, Jr., Lawrence A. Hamermesh, R. Franklin Balotti & Jeffrey M. Gorris, *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 GEO. L. J. 629, 656 (Mar. 2010) ("Loyalty's Core Demand") ("[T]he term good faith is used as it is in the business judgment rule: to define the state of mind of a loyal fiduciary.").

account and recognize that they had a motivation to go along with Kuttner's desires and stay in his good graces. But I also recognize that such a motivation is true of most subordinates in a corporate structure, and that Clayton's and Clark's outside relations with Kuttner were disclosed and were relatively modest at all relevant times that the misconduct at issue in this case occurred.[84]

Like directors, officers also have other contextual obligations as fiduciaries. These include the responsibility to disclose to their superior officer or principal "material information relevant to the affairs of the agency entrusted to them."[85] Liability for a

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[84] As to Clark, Hampshire claims that Clark was in Kuttner's pocket because (1) Clark depended on his salary at Hampshire; (2) Kuttner hired Clark's wife to work at HIL for $12 per hour, and hired Clark to work at HIL *after* Clark was terminated from Hampshire; (3) Clark prepared HIL subsidiaries' tax returns; (4) Kuttner loaned Clark money to buy what amounts to a 1% stake in HIL; and (5) Kuttner promoted Clark to Principal Accounting Officer, a promotion that came with *no* pay increase. Tr. at 6-9, 134, 147-58 (Clark).

As to Clayton, he and Kuttner worked together for almost thirty years, and had an extremely close working relationship as well as a social relationship. Tr. at 92-93 (Clark), 554 (Clayton). Hampshire alleges that Kuttner rarely made a business decision without first discussing it with Clayton, and the two spoke two to three times a day. *Id.* at 386 (Sperry), 1026 (Winter). Clayton and Kuttner were also business partners in a real estate holdings company in Texas, an investment vehicle called CK Holdings LLC, and several furniture companies. Clayton Dep. at 34-35. And, Clayton was one of the three investors, including Kuttner, who purchased HIL from Hampshire in 2003 — an entity of which Kuttner is the controlling shareholder. *Id.* at 6-7. I have considered all these allegations and factored them into my state of mind determinations. I have also factored in the reality that the board knew all of the relevant facts when it assigned Clark and Clayton to get Kuttner's expense reports processed and up to date.

[85] *See Science Accessories Corp. v. Summagraphics Corp.*, 425 A.2d 957, 962 (Del. 1980) ("Encompassed within such general duties of an agent is a duty to disclose information that is relevant to the affairs of the agency entrusted to him."); 2 Model Bus. Corp. Act. Ann. § 8.42(b)(1) (4th ed. 2009) ("The duty of an officer includes the obligation to inform the superior officer to whom, or the board of directors or the committee thereof to which, the officer reports of information about the affairs of the corporation known to the officer, within the scope of the officer's functions, and known to the officer to be material to such superior officer, board, or committee . . . ."); *see also* RESTATEMENT (SECOND) OF AGENCY § 381 (1958) ("Unless otherwise agreed, an agent is subject to a duty to use reasonable efforts to give his principal information which is relevant to affairs entrusted to him and which, as the agent has notice, the principal would desire to have and which can be communicated without violating a superior duty

failure in this regard, however, must be examined under the standards just outlined, to determine whether any failure in information sharing was the product of gross negligence or disloyalty. Likewise, to the extent that an officer is charged with having made a false statement in the course of his duties, the officer's culpability in damages must be considered from the same disciplined perspective.

Officers and employees also face a statutory exposure to liability that is often greater than directors. Unlike directors, corporate officers cannot be shielded from personal liability by 8 *Del. C.* § 102(b)(7), which permits a corporation to offer such protection to directors in a corporate charter. Therefore, unlike the directors of Hampshire, Clark and Clayton can be held liable in damages to Hampshire if they acted with gross negligence and caused injury to the corporation.   In the analysis that follows, I consider whether Clayton and Clark's actions rose to those levels for each of the issues Hampshire complains of in this litigation.

1. <u>Kuttner's Expense Reports</u>

a. <u>The Board Assigns Clark The Task Of Reviewing Kuttner's Delinquent Expense Reports</u>

The major issue in this case involves whether Clayton and Clark breached their fiduciary duties of care and loyalty by improperly processing expense reports submitted by Kuttner. Hampshire claims that Kuttner submitted hundreds of thousands of dollars in improper and unsubstantiated expense claims and was overpaid. Hampshire argues that Clayton and Clark knew that Kuttner was seeking improper expense reimbursement or

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to a third person."); A. Gilchrist Sparks, III & Lawrence A. Hamermesh, 48 BUS. LAW. at 226-29 (describing the corporate officers' duty to keep the board of directors informed).

were at the least grossly negligent in not preventing him from receiving recompense for expenses that were not properly documented or facially improper.

That this matter is in litigation is, in the first instance, a failure of Hampshire's board. Under the corporation's personnel policy (the "Personnel Policy"), expense reports are due, at the latest, two weeks after an employee incurs an expense.[86] The corporation's policies require that the reports "include information indicating time, place, business purpose and topics discussed, and the name and title of each person" present.[87]

For over a *decade*, the Hampshire board knew that Kuttner was not complying with corporate policies and had a large backlog of unsubmitted expense reports. The board also knew that given his role as the leader of a fashion company and his flamboyant nature, Kuttner would purchase samples of fashion products for use in the business, engage in business travel, and wine and dine clients. The company's auditors filed reports with the Audit Committee indicating that they were aware that certain managers had been granted exceptions from Hampshire's expense report filing deadlines by the board.[88] Indeed, accruals for unpaid expenses were on the company's financial statements relating to Kuttner.[89] The board had the power to require Kuttner to submit his expense reports, to set a deadline disallowing reimbursement after a certain date, or

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[86] JX 196 (Hampshire Group, Ltd. Personnel Policies and Benefits Summary (July 2004)) (the "Personnel Policy") at 10.
[87] *Id*.
[88] JX 36 (Hampshire Group, Limited Observations and Recommendations to Management for the Year Ended December 31, 1999) at HAMPDE 137408.
[89] JX 40 (accrued travel expenses for Kuttner and Clayton); JX 729 (accrued travel and entertainment for Kuttner for 2004); Tr. at 414, 459-60 (Sperry), 971-72, 979 (Winter).

even to fire Kuttner if he continued to be delinquent in filing his reports.[90] But instead of exercising that power, the board members just begged Kuttner to submit his reports. At every board meeting, the board pleaded with Kuttner to "[p]lease, please, get th[o]se expenses in."[91] Director Jackson took the first crack at getting Kuttner to submit his reports and, when he failed, Sperry took weak shots at getting Kuttner to do it.[92] He also failed.

So weak was the board that Sperry, who was a member of the board and thus Kuttner's superior, begged Clayton, Kuttner's managerial subordinate, to get Kuttner to bring his reports up to date. Sperry even reached down the chain to Clark, a managerial employee whose stature was such that he had little contact with the board, to get Clark to help, venting to Clark that he needed to get Kuttner "to get those g-d expense reports in."[93]

Sperry, Winter, and the board knew that the unsubmitted expense reports would total hundreds of thousands of dollars. If it were not for accounting issues, they would not have cared, as Sperry viewed Kuttner as extending the company an interest free loan by not claiming his expenses in a timely way.[94] But accounting issues matter, and with the passage of the Sarbanes-Oxley Act of 2002, Hampshire was required to submit an

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[90] Tr. at 459-60 (Sperry).
[91] *Id*. at 412-14, 459-62 (Sperry).
[92] *Id*. at 412-13 (Sperry); Goldberg Dep. at 58.
[93] Tr. at 31 (Clark), 460 (Sperry).
[94] *Id*. at 464-65 (Sperry).

annual internal control report for the fiscal year ending after November 15, 2004.[95] The Audit Committee wanted to get Kuttner's expenses caught up before that date.

Clark got enmeshed in this issue in 2002, which was the first year Clark was charged with processing Kuttner's expense reports. From that time on, the chronology is not as clear as one might expect, given the resources devoted to the issue by Hampshire. But this much is clear. The board knew that Kuttner had a large number of stale expense reports to file. Indeed, the board was aware that additional staff was retained by Kuttner to prepare the reports.[96] The board also knew that Kuttner lived high on the hog, that he had previously submitted expense claims for expenses that were personal rather than business related,[97] that Kuttner would be seeking expenses for a period of years covering more than a decade,[98] and that detailed substantiation of even legitimate business expenses would be hampered by the passage of time and the staling of memory. The board also knew therefore that Clark had not been an employee at Hampshire for many of the years for which Kuttner was seeking recompense, having been hired only in 1998.

In 2002, Clark set about processing the reports. Clark relied principally on Kuttner's personal assistant, Frizzi Linck, to help him. Clark also had his own wife help,

[95] *See* Securities and Exchange Commission, *Corporate Finance Staff Alert: Annual Report Reminders*, *available at* http://www.sec.gov/divisions/corpfin/cfalerts/cfalert030405.htm (last visited July 8, 2010).
[96] Tr. at 546 (Sperry); Goldberg Dep. at 81-83.
[97] JX 48 (letter from Ludwig Kuttner to the Audit Committee regarding the Committee's claim that he had "used company funds to pay for personal expenses" (Nov. 12, 2002)).
[98] Tr. at 421-23 (Sperry) (testifying that the board knew that Kuttner would be submitting expense reports that were years old), 432 (explaining that it was common knowledge at Hampshire that Kuttner's expense reports were delinquent).

getting her to devote her time for free to helping him review the reports.[99] The basic system Clark established for processing Kuttner's delinquent expenses was as follows. First, Kuttner's expense reports were prepared by Linck and additional staff in New York who had been hired solely for the purpose of organizing and preparing Kuttner's reports. Kuttner had to sign the reports, signaling his representation that the expenses were proper business expenses that Hampshire should pay for. Second, the reports were sent to Clark in South Carolina. Clark then reviewed the expense reports to make sure that they were added up correctly, and to eliminate expenses that did not comply with Hampshire's reimbursement policy, such as expenses that lacked a proper business purpose or reports without receipts.[100] Clark also looked for redundancies so that Kuttner did not receive payment twice for the same expenses. Given that many years of expenses were involved, this was a real concern and one Clark worked to address. Finally, Clark would pass the expense reports on to the CFO for approval of payment to Kuttner.

In 2002, the first year that Clark reviewed Kuttner's reports, Kuttner submitted $48,691 of expenses, most of which were from 1989.[101] At that time, Clark became concerned that he would be unable to verify those expenses, especially because he had not started at Hampshire until 1998, and because he had no access to Kuttner's calendar. As a result, Clark took his concerns to Hodge, who was CFO at the time,[102] and established a system for reviewing the reports which involved ensuring that Kuttner had

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[99] *Id*. at 50, 156 (Clark).
[100] *Id*. at 41, 91 (Clark).
[101] *Id*.
[102] *Id*. at 31-32 (Clark).

not previously submitted the pre-1999 expenses for reimbursement before Clark began his review.[103]

As time went on, Clark's task became even more challenging because the pace of Kuttner's preparation of expense reports sped up. In 2003, Kuttner submitted $173,370 worth of expense reports covering seven different years.[104] Clark continued to take his concerns to the CFO, expressing his discomfort with, among other things, verifying whether Kuttner's expenses were proper, the receipts were lacking for some expenses, and the presence of duplicate receipts.[105]

The number of reports submitted by Kuttner continued to grow as pressure mounted to get them all processed. The board's awareness of the problem is demonstrated by the board's attempt in the spring of 2003, upon the advice of the company's outside auditors Deloitte, to settle any unreimbursed expenses with Kuttner in order to have the expenses submitted as promptly as possible.[106] Although the record is disputed about the amount Kuttner was offered, I conclude that the board offered Kuttner a bonus to cover the outstanding amount, and to gross up the amount of the bonus to over $1 million in order to cover Kuttner's taxes, but Kuttner rejected the offer.[107] Kuttner's rejection of such a substantial offer made clear to the board that he sought large amounts

[103] *Id*. at 155-56 (Clark).
[104] JX 69 (summary of Kuttner's expenses).
[105] Tr. at 31-32, 56-58 (Clark), 657-59 (Clayton).
[106] *See* JX 38 (letter from Deloitte & Touche to members of the Hampshire Audit Committee (Apr. 24, 2003)) at HAMPDE 530.
[107] Tr. at 65, 153-54 (Clark), 690-92 (Clayton), 478 (Sperry).

of expense reimbursement. Yet, the board's priority remained to get them processed before the previously described Sarbanes-Oxley deadlines.[108]

As a result, in 2004, Kuttner submitted $900,972 of expense reports, which covered 13 years of expenses.[109] At that time, Irwin Winter, the chair of the Audit Committee, received a "whistle blower" email from Horace Padgett, Hampshire's Manager of Taxation, informing him that Kuttner may have been violating IRS regulations by submitting delinquent expenses.[110] But Deloitte advised the Audit Committee that "it [was] not unreasonable to take a position for the purposes of reporting and tax return preparation to treat the reimbursement amount as paid under an accountable plan and therefore not includible in the employee's W-2."[111] Relying on that advice, the board continued to allow Kuttner to be reimbursed for his delinquent expenses, and Clark continued his task of reviewing almost $1 million worth of expenses.[112] Clark felt the pressure to complete the review by the Sarbanes-Oxley deadline, but was able to finish in time.[113] When Kuttner's late expense reports were finally submitted, the board was relieved, and cared not so much about the amount of the expenses, but "that it was filed and . . . [they] had put it behind [them]."[114]

Even though the large amount of expenses that Clark processed in 2004 are the primary focus of Hampshire's claim, the board did not raise a concern again about

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[108] *Id*. at 53 (Clark).
[109] JX 69 (summary of Kuttner's expenses).
[110] JX 95 (email from Horace Padgett to Irwin Winter (Apr. 1, 2004)).
[111] JX 49 (email from P. Graydon to Horace Padgett (June 24, 2004)) at HAMPDE 1060.
[112] Tr. at 470-71 (Sperry), 970-71 (Winter).
[113] *Id*. at 53 (Clark).
[114] *Id*. at 416 (Sperry).

Kuttner's expense reports until it received the Internal Review Memorandum in June 2006. I believe it is likely that Sperry, Winter, and the other board members were aware of the magnitude of the expenses claimed by Kuttner, were not shocked by them given the number of years they covered, and were simply glad to have put the issue behind them. It was the Internal Review Memorandum that forced them to inquire.

b. Hampshire Claims That Clark's Review Was Deficient

The post-Internal Review Memorandum basis for complaint about the review process has two main features. First, Hampshire argues that Clayton and Clark either knowingly or with gross negligence allowed Kuttner to be reimbursed for improper and unsubstantiated business expenses in violation of company policy. Second, Hampshire alleges that Clayton and Clark tried to cover up their supposedly deficient review, both by concealing the amount of expense reimbursement sought by Kuttner and by failing to go to the board and tell the board that it was hard to pin down exactly all the details on 13 years worth of expense reports. Each of these issues will be discussed in detail below.

i. Hampshire Has Not Proven That Clark And Clayton Knowingly Or With Gross Negligence Approved Unsubstantiated Or Fraudulent Expense Reports

According to Hampshire, Clark and Clayton approved Kuttner's expense reports, despite the fact that many of those reports did not comply with Hampshire policy, which tracks IRS regulations.[115] Mainly, Hampshire takes issue with Clark and Clayton's approval of expenses that were unsubstantiated despite a requirement in Hampshire's personnel handbook that receipts be submitted "for reimbursement of any expense of

[115] Personnel Policy at 9-10; Tr. at 33-34 (Clark).

$25.00 or more," and that all expense reports include information "indicating time, place, business purpose and topics discussed, and the name and title of each person" present.[116]

Indeed, according to Hampshire, the bulk of Kuttner's expense reports were either blatantly fraudulent or lacked documentation of the purpose of the expense, and were approved by Clark and Clayton only to appease Kuttner. The expense reports that Kuttner filled out contained 24 categories of expenses, ranging from lodging and meals, to entertainment and samples.[117] Kuttner would fill in the amount of each expense by date and category and, in some reports, add a brief notation in the "details" section of the report listing the names of individuals and purpose for an expense.[118] Kuttner signed each report, which was then sent to Clark in South Carolina.

Some of Kuttner's approved expense reports listed what appear, upon review with the help of paid consultants and litigators, to be personal expenses as business related, and Clark approved those requests. For example, Clark approved certain purchases from stores that sell sex products, which were listed as "samples",[119] up to 27 restaurant receipts from the same day within a short time period,[120] and expenses incurred by Kuttner's wife and friends.[121] Clark also approved personal travel for Kuttner, such as

[116] Personnel Policy at 10.
[117] *E.g.*, JX 250 (selected expense reports submitted by Kuttner).
[118] *Id*.
[119] JX 606, 607 (showing receipts from adult stores, which were submitted by Kuttner).
[120] JX 618; JX 780 (multiple receipts Kuttner submitted from the same venue at the same time, including 27 receipts from four restaurants at LaGuardia airport within a two hour time frame) at HAMPDE 1516.
[121] Tr. at 59 (Clark).

lodging for both Kuttner and his wife at Vail,[122] and approved reimbursement of Kuttner's wife's expenses during a business trip to Mongolia that Kuttner took to look at factories.[123] There is no doubt that upon close examination these are eyebrow raising, some more than others.[124]

But Clark did not get to review these with the help of suspicious lawyers who, aided by outside consultants, could spend unlimited time identifying the most questionable expenses in a huge number of expense reports. He had to conduct the review alone, while performing his other substantial duties. In this regard, I credit his testimony that the review process was a painful burden to him, which caused him (and his wife) to spend long tedious hours. In those hours, one could easily imagine someone missing some things, that is, if one keeps an open mind and remains conscious of human flaws.

In this respect, Hampshire slights the reality that Clark also eliminated tens of thousands of dollars worth of expenses that Kuttner submitted,[125] and went to his superiors when he encountered questionable expenses, or returned the report to Kuttner

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[122] JX 615 (expense report showing room charges at a hotel in Vail for both Kuttner and his wife); Tr. at 82-84 (Clark).

[123] Tr. at 86-87 (Clark).

[124] Depending on the culture of Mongolia, there might be a plausible business reason for the CEO's wife to accompany him in procuring good relations for the company. The purchases at the adult stores are harder to justify, of course, but involved small amounts of money, and the term "adult store" is not on the receipts.

[125] Tr. at 159 (Clark) (explaining that he had taken between $70,000 and $100,000 of improper expenses off of Kuttner's expense reports); *see, e.g.*, JX 250 (excerpts of Kuttner's expense reports) at HAMPDE 01465 (showing that Clark approved reimbursement to Kuttner of $15,704.48 when $19,817.24 was requested), HAMPDE 02750 (reducing Kuttner's reimbursement from $14,401.93 to $12,722.11 because certain of Kuttner's expenses did not have a receipt or were improper), HAMPDE 09650 (reimbursing Kuttner for $210.55 in expenses when Kuttner had submitted $4,884.93 in receipts).

unapproved.[126] Clark made substantial reductions in the expenses sought by Kuttner and ensured that there was a system to prevent redundant claims.[127] I am not persuaded that Clark did not process the reports in good faith and I do not find suspicious that he had to, in large measure, rely on the representations Kuttner made as to the business purpose of the expenses.

Indeed, given the large volume of expense reports, Hampshire has not shown that any of those expenses were so obviously fraudulent that Clark *must* have known he was approving bogus expenses. Many of the purchases Hampshire complains about could have easily escaped Clark's review because they were for small amounts of money. Hampshire had tee-hee fun at trial pointing to some real oddments in Kuttner's expense reports, particularly certain adult store purchases and certain restaurant receipts. But their oddity far outweighs their financial materiality, because the expenses Hampshire highlighted involve the sort of smaller items that a financial officer like Clark might pay less attention to than larger items. For example, the adult store purchases that Kuttner had characterized as samples — a video tape called "Slick City," a book called "Undressing the Corset," and "lube," — cost under $100 combined.[128] Ideally, Clark should have caught these and made Kuttner explain them or drop them as expense claims.

Prudery and fashion companies, I note, do not necessarily go together. It is possible, one imagines, for the CEO of a clothing company to find useful business

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[126] Tr. at 159 (Clark); JX 250 (excerpts of Kuttner's expense reports) at HAMPDE 16940 (showing Clark had contacted Kuttner to confirm that an expense for a Hampshire group party was a legitimate expenses).
[127] Tr. at 156 (Clark).
[128] *See* JX 607 (receipts from adult stores).

inspiration in clothing and images in adult stores. For example, one of the receipts that Hampshire complains of comes from a clothing store called Shocking the House, which sells "ready-to-wear" corsets, and lace and leather skirts, pants, and tops. It that regard, it is not difficult to conceive of the possibility that Kuttner was purchasing clothing items at these store because he felt that they were on the cutting edge, and could spark new ideas for a Hampshire line.

For example, in the receipt that includes a $20 charge for "lube," the main expenses were for a "geisha wrap" and a "med bk Marilyn Monroe top."[129] Likewise, Kuttner's purchases from Shocking the House were for a "top" and a "blk lace skirt."[130] And, the full title of the book that Hampshire complains of is *Fetish Fashion: Undressing the Corset*, which discusses different styles and types of corsets.[131] Of course, it could be that these were personal rather than professional purchases, but Kuttner was running a fashion company, and it was legitimate for him to make purchases that might inspire ideas for Hampshire. And, by placing the items on his expense report, Kuttner represented that these purchases were for a professional purpose. That said, Kuttner should have had to justify these particular expenses better if Clark focused upon them. Given their small dollar significance, I have no reason to believe he did so focus.

[129] *See* Shocking the House — Luxury Ready To Wear, http://www.shockingthehouse.com.
[129] JX 606 (receipts from adult stores).
[130] *Id*.
[131] *See* Amazon.com, *Fetish Fashion: Undressing the Corset*, http://www.amazon.com/gp/product/1931160066/ref=cm_rpd_product_img.

Likewise, Hampshire presented some very odd receipts from the Coffee Beanery at LaGuardia Airport and other café-type eateries that Kuttner submitted.[132] These appear to be a series of 3 to 14 transactions of less than $10, time-stamped within minutes of each other.[133] Upon close examination, one wonders if Kuttner grabbed them from a trash can or ripped the receipt tape off of a cash register. Clark and Clayton both noted that Kuttner sometimes took multiple employees out to cheaper places and paid for each of their lunches.[134] But I doubt Kuttner did so at LaGuardia, although the explanation is quite plausible as to some of the other places, such as the mid-town Europa Café receipts.[135] The more important point, however, is that the amounts in question are de minimis. With the large amount of reports that Clark had to process, it is plausible that he did not focus on every date, and simply tied in the receipt amounts to what was claimed on the report. Given the small amounts involved, I can understand why he might have missed the odd restaurant duplicates.

Importantly, Hampshire's focus on these oddments highlights a critical problem with its approach, and Navigant's review of Kuttner's expense reports. Much of what Hampshire appears to quibble about is Clark's failure to get Kuttner to spell out in more detail the reason for expenses he claimed that were on their faces clearly related to Hampshire business. Navigant's approach to reviewing Kuttner's expense reports was to

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[132] *See* JX 780 (Kuttner's expense reports) at HAMPDE 3086-87 (11 receipts from the Europa Café for sandwiches and beverages); JX 612 (multiple receipts from Everything Yogurt, Sbarro, Anton's Coffee, and the Coffee Beanery at LaGuardia Airport).
[133] *Id.*
[134] Tr. at 78-79 (Clark), 703 (Clayton).
[135] JX 780 (Kuttner's expense reports) at HAMPDE 3086-87 (11 receipts from the Europa Café for sandwiches and beverages).

categorize any amount claimed as "unsubstantiated" if there was any doubt. Although it admittedly characterized a large amount of Kuttner's submitted expenses as possibly fraudulent (some 43.5%), at trial, the Navigant witness did not make a persuasive showing that large amounts of Kuttner's expenses were in fact fraudulent, and Navigant was unprepared to actually make any definitive accusation of fraud.[136] The testimony focused on small stuff like the items mentioned above. Moreover, Navigant did not even interview Kuttner, Clark, or Clayton to get any insight that might have allowed them to confirm that certain of the claimed expenses were legitimate. Rather, Navigant went out of its way to characterize anything as unsubstantiated if it had any question at all.[137]

For example, many of the reports that Navigant took issue with were flagged because they had an "unknown guest or purpose," were one of multiple receipts obtained in a single time period, or lacked documentation.[138] But Navigant made no attempt to research certain of Kuttner's expenses that were well within the bounds of the proper expenses of a CEO in the fashion industry before marking them as "questionable." For example, an "entertainment" expense of $121, with the notation "Frederique v.d. Wal," — one of the most famous *female* supermodels of the 90's — was marked as questionable by Navigant for having an "unknown guest or purpose."[139] At trial, the

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[136] Tr. at 330-31 (Jennings).
[137] JX 656 (summary of Kuttner's expense report review results); Navigant/ Paul Weiss Findings at DT 763.
[138] *Id*.
[139] JX 605 (expense report showing entertainment expense for Frederique van der Wal); JX 786 (chart showing Navigant's review of Kuttner's expenses) ("Navigant Report") (flagging the same entertainment expense as questionable) at HAMPDE 9868.

Navigant witness thought Frederique was a man, and had no idea who she was.[140] A dinner described as "C. Steinberg: Vogue" was flagged for having an "unknown guest or purpose."[141] Navigant even questioned the purpose of a breakfast Kuttner described as "CFO interview David Tyler" at a time when Hampshire was seeking a new CFO.[142] And a breakfast with Harvey Sperry, a Hampshire board member, was flagged for having an "unknown guest or purpose"![143] Similarly, Navigant marked as questionable a meeting Kuttner had with Hampshire CFO, William Hodge, noting that it did not know who Hodge was![144]

Crucially, both Hampshire and Navigant took a hard-line approach to finding Kuttner's expenses "questionable" while barely making an issue of problematic expense reports submitted by other officers and directors, including authors of the Internal Review Memorandum. Heath Golden, Hampshire's current CEO, was reimbursed over $1,700 for meals and lodging at the Ritz-Carlton during a personal vacation in Puerto Rico.[145] Golden admitted that he sought these improperly[146] and was later rewarded by being made CEO. Maura Langley, the former compliance officer, caused Hampshire to pay for a hotel room for her in San Francisco on a night when she was staying with a family

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[140] Tr. at 266 (Jennings).
[141] JX 314 (selected expense reports of Kuttner) at HAMPDE 2639; Navigant Report at HAMPDE 9847 (marking the same dinner as lacking a known guest or purpose).
[142] JX 314 (selected expense reports of Kuttner) at HAMPDE 2639; Navigant Report at HAMPDE 09822 (making the same breakfast expense as questionable).
[143] Navigant Report at HAMPDE 9822.
[144] Navigant Report at HAMPDE 9807 (asking "who is Bill Hodge?").
[145] JX 2 (expense report of Heath Golden for a vacation in Puerto Rico); Norwood Dep. at 207-08.
[146] Golden Dep. at 46-47.

member.[147] Joel Goldberg, a former Hampshire board member, admitted that he submitted between $25,000 and $27,000 of improper car and hotel expenses.[148] Goldberg was permitted to resign and no public disclosure of his misconduct was made.

Perhaps most tellingly, the interim CEO who replaced Kuttner, Michael Culang, submitted $22,000 of expenses for dinners with his family.[149] Hampshire investigated Culang's misconduct after he self-reported to the Audit Committee,[150] and had Navigant conduct an investigation. But both Hampshire and Navigant took a different approach to Culang's expenses than they had taken to Kuttner's. For example, although Navigant treated anything it could not nail down completely involving Kuttner's reports as "questionable" and therefore unsubstantiated, it did just the opposite with Culang. Even though Navigant could not bother to learn that Sperry was a director and Hodge was a CFO of Hampshire, it took the approach with Culang of identifying expenses "by recourse to other information" and "research [Navigant] perfom[ed] in the public domain" specifically to vindicate the propriety of Culang's expenses.[151] In fact, Navigant employees who encountered a questionable expense of Culang's were encouraged to "try Googling certain key names, locations, item descriptions, etc." to substantiate the expense.[152] And, Navigant allowed Culang to review and explain the expenses that it

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[147] *Id*. at 72-73; Winter Dep. at 49.
[148] Goldberg Dep. at 109-111.
[149] JX 99 (memorandum from Michael Culang to Irvin Winter (Dec. 12, 2006)).
[150] *Id*.
[151] JX 106 (opinion letter from Paul Weiss regarding the Navigant investigation into Culang's expenses) at DT 503. Navigant also characterized Culang's submission of multiple receipts as a "mistake." *Id*. at DT 513.
[152] JX 153 (email from Brent Calhoon to Mike Bell (May 8, 2007)).

flagged as being potentially questionable, unlike Kuttner who was never asked about his expenses.[153]

One final and telling example is the expense reports that both Kuttner and Culang submitted for the same trade show that they attended in Las Vegas. Navigant deemed *all* of Kuttner's expenses at that show questionable, including a dinner with the "Hampshire Brands Team and the JC Penney Team."[154] But Culang's dinner with "Kohls Staff" was not questioned, and was paid by Hampshire.[155] Hampshire has not brought claims against Culang, and has even paid for Culang's representation in this litigation.[156]

In conclusion, a person generally familiar with Hampshire's business, like Clark, would not have found many of the items noted by Navigant to be suspicious. When Clark saw a meeting with a board member on Kuttner's expense report, it would have reasonably struck him as legitimate. Ditto to a trip to Puerto Rico or Texas, places where Hampshire did business, to Navigant's apparent ignorance.[157]

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[153] *Id*. at DT 503 (finding that Culang could be relied upon to explain his expenses); JX 154 (email from William Jennings to Brent Calhoon (May 16, 2007)) (discussing whether to disclose that Navigant had allowed Culang to review the items that Navigant identified as potentially improper); *see also* JX 161 (email from Brent Calhoon to Mike Bell (Aug. 31, 2006)) (Navigant employee questioning whether it was reasonable for Kuttner to take out Kuttner's bankers, and being told that Hampshire could "ask LK to explain it" because Navigant "[w]ouldn't want to infer reasonableness with this one").

[154] Navigant Report at HAMPDE 9912; JX 314 (Kuttner's expense report for the Las Vegas trade show) at HAMPDE 2750.

[155] JX 316 (Culang's expense report for the Las Vegas trade show) at MC 1027.

[156] Culang Dep. at 8.

[157] Navigant flagged as questionable Kuttner's trips to Puerto Rico, where Hampshire owned a factory until 2001. Navigant Report at 9803, 9807, 9812, 9817; Tr. at 138 (Clark). Navigant also classified Kuttner's trips to Texas, the Czech Republic, and Russia before HIL was spun off in 2003 as questionable despite the fact that HIL owned property there. Navigant Report at 9803, 9806, 9813; Tr. at 358, 363, 365-66 (Jennings). The reason was Navigant did not know that Hampshire had business operations in those destinations and never asked anyone.

Overall, Hampshire has not met its burden of persuasion to show that Clark did not attempt in good faith to conduct a rational review of Kuttner's expenses. Any such review had to rely in large measure on Kuttner's own word. Although I have little reason to doubt that Kuttner put some past Clark, I do not believe that Clark allowed him to do so knowingly. Rather, Clark did what he could under difficult circumstances — circumstances that the board's own torpor and lack of will largely created.

As to this, I also note a business reality that Clark likely took into account and that Navigant did not. Clark likely tried not to spend much more time and costs reviewing Kuttner's reports than was financially justified, given their amount. By contrast, 18 Navigant employees, charging by the hour, spent thousands of hours reviewing Kuttner's reports.[158] Indeed, the Navigant witness admitted he billed $500 for an hour he spent reviewing a $40 charge.[159] Although I understand that Navigant was engaged in different circumstances, it is contextually important for a reviewing court to understand the time pressures employees operate under and their need to make judgments about how to allocate their time. The clear mandate given to Clark was to help Kuttner's reports be brought up to date in a timely way. He appears to me to have done so in a good faith, rational way that no doubt was imperfect and that was tainted by instances in which he missed poorly documented or improper expenses. Overall, however, I cannot conclude that he acted in bad faith or in a grossly negligent manner.

[158] JX 676 (Navigant invoices for the Hampshire investigation).
[159] Tr. at 284-85 (Jennings).

Likewise, to the extent that Hampshire seeks to implicate Clayton in any wrongdoing by Kuttner, I cannot conclude that Clayton acted either in bad faith or with gross negligence either. Rather, Clayton appears to have supported Clark in reducing expense reports that were not properly documented and refusing to process a substantial amount of additional expenses Kuttner sought to claim for periods that had already been the subject of prior reports. Like Clark, Clayton had to rely in large measure on Kuttner's own representations and could not have been expected to duplicate the review that Clark had done, which came on top of the review and preparation done by Kuttner's assistants and Kuttner himself.[160]

ii. Hampshire Has Not Shown That Clayton And Clark Intentionally Concealed Their Review Of Kuttner's Expense Reports

Hampshire also argues that Clayton and Clark breached their fiduciary duties by concealing the difficulties they had in processing Kuttner's expense reports. Hampshire's argument has several variations.

Among them is the notion that Clayton and Clark did not inform the Audit Committee that, given the lengthy period of time covered by the reports Clark had to

[160] In claiming that Clayton's review was deficient, Hampshire points to Clayton's approval of one of Kuttner's expense reports, which he took out of Norwood's inbox and signed without any review just before Clayton was placed on administrative leave. Clayton admitted that he took the report, which had been approved by Clark, out of Norwood's inbox and signed it without first reviewing it. Tr. at 666-67 (Clayton). I am not sure what to make of this. It might have been done because of delay on Norwood's part or out of pique. Although questionable, this conduct does not convince me that Clayton knowingly processed improper expense reports for Kuttner. As to this issue, I note that it was not the focus of detailed examination at trial and there has been no showing that the report in question was materially flawed. In this regard, Hampshire's post-trial briefs are silent as to any problems with that specific report, they just argue that Clayton did not review it. But none of the CFOs who signed reports did a review. They relied principally on Kuttner's representations, Kuttner's personal staff, and Clark's review of their work. *Id*. at 658 (Clayton).

process, there was less than ideal documentation and information available to him to confirm all the claimed expenses. Hampshire notes that Clark admits that he was not receiving ideal documentation and that he was not well positioned to verify that everything that Kuttner claimed was a business expense was in fact a business expense, especially because a large amount of the expenses were for years before Clark even worked at Hampshire. Clark informed Clayton and Hodge about these difficulties.[161] Hampshire contends that it was a breach of fiduciary duty for Clayton and Clark not to go to the Audit Committee and tell them of the difficulties in the review process. Hampshire posits that the Audit Committee thought it would be non-problematic to process Kuttner's expense reports.

On this score, I conclude that the Audit Committee was well aware that Kuttner's expense reports would be less than ideally compiled and documented. After all, if it was so easy to compile them, Kuttner would have done so a decade before when his memory was fresher. The Audit Committee accepted for years the idea that the expense reports were a burden to put together in a timely way and allowed Kuttner to file them way late. The Audit Committee's key objective was not to make sure that the expense reports were in an ideal form and pristine. If that was its objective, they could have had Kuttner file them with the outside auditors for review. Instead, they asked Kuttner's subordinates to process them. In doing so, I also conclude that the Audit Committee knew that those processing the reports would have to rely predominately on Kuttner's own representation that expenses were for a proper purpose. Clark and Clayton were not instructed to

[161] *Id*. at 31-32 (Clark), 657-59 (Clayton).

independently verify Kuttner's representations; that was not the practice in processing expense reports at Hampshire. They were instructed to process the reports, and to make sure they added up and on their face were justified by a business purpose. Admittedly, one can quibble about whether Clark should have sent back *more* of the reports for lack of an adequate description and whether he overlooked some missing receipts. But it appears that he did a good faith job. For present purposes, I have no doubt though that the Audit Committee realized that whoever had to process the reports would have less than ideal information and that the best a person could do was to make a good faith effort in handling a large volume of reports. In that respect, the board knew that the reports covered a large number of years and that Kuttner had retained additional staff to help him compile the reports.

Hampshire slights the fact that Clark and Clayton were also entitled to rely on the efforts of those staff members, and that Clark took steps to make sure that staff weeded out duplicates and documented the purpose of expenses. Put summarily, the Audit Committee knew it was asking the processing staff to do a very difficult job and there was no breach of fiduciary duty by Clayton and Clark in not telling the Committee about realities it already knew and helped cause.

Hampshire also claims that Clayton and Clark purposely covered up the magnitude of the expenses that Kuttner had submitted in 2004. To support that argument, Hampshire relies principally on two points. First, Hampshire claims that Clayton and Clark allocated certain of the expenses to various Hampshire subsidiaries so as to avoid their detection. For example, Clark and Clayton spread out $137,000 by marking them as "samples" and allocating them to different departments within Hampshire.[162] Hampshire says they did so in order to reduce the potential for detection. But an email from Clark shows that Clark divided the expenses between departments because Kuttner told him that the samples were purchased for different departments.[163] Hampshire tries to argue that the total amount for samples in 2004 is shocking and would have been a red flag if allocated all to the Hampshire parent company. But it ignores the reality that the samples were purchased during a period extending over a decade, and that the amount considered in that context is not shocking. Kuttner was running a fashion company and allocating his purchase of fashion samples to the various subsidiaries whose lines were implicated by the samples is not, on its face, troubling. I am not persuaded by this argument.

Next, Hampshire alleges that Clayton and Clark established an accrual for the purpose of concealing payments to Kuttner. This is a truly odd argument as the accruals were available to Hampshire's auditors and the Audit Committee. From January 2001 to November 2003, Hampshire recorded a monthly accrual of $8,000 for Kuttner's travel expenses.[164] In 2001, the accrual totaled $173,590.24 and, in 2002, it totaled $267,590.24.[165] In 2003, Clayton and Clark allegedly added $125,000 to the accrual for Kuttner's expenses without informing the Audit Committee.[166] But this was also the same period when the Audit Committee was stepping up the pressure to get Kuttner's

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[162] JX 742 (journal entry regarding the classification of sample charges paid by Kuttner) at HAMPDE 146729 (showing that $136,891.29 had been spread out among different departments).
[163] *Id*. at HAMPDE 146730.
[164] JX 40 (accrued travel expenses for Kuttner and Clayton).
[165] *Id*.
[166] *Id*. at HAMPDE 60.

reports current. As the reports came in, the accruals increased. Hampshire admits that the accrual reached $496,207.65 in April 2004.[167] This figure alone belies the notion that the Audit Committee believed that Kuttner's delinquent expense reports were de minimis.

Still, Hampshire says that the accrual masked the reality that Kuttner sought over $900,000 in 2004 because the accrual never reached that amount. But that argument ignores the fact that the accrual was consistently reduced as Kuttner's expenses were reimbursed. In 2004, Hampshire paid out a total of $935,430 of expenses to Kuttner — and only $74,078.06 of the accrual was left at the end of that year.[168] That is, the accrual for 2004 shows, on its face, that Kuttner was reimbursed for nearly $1 million worth of expenses.[169] The board never bothered to inquire about the specifics of the accrual and was not concerned with it because, as Sperry testified, they considered it to be "an interest-[free] loan to the company by Mr. Kuttner . . . ."[170] I believe as a factual matter that the Audit Committee was aware in 2004 of the approximate amounts Kuttner was receiving for his overdue reports and was not at all shocked or concerned by them. As important, Hampshire presented no evidence that the corporation's auditors were not apprised of the amounts paid to Kuttner in 2004.

Finally, Hampshire alleges that it is evidence of scienter that Clayton and Clark kept boxes of Kuttner's expense reports hidden so that other employees could not see them. Kuttner's expense reports were kept "[u]nder wraps or in confidential files"

[167] JX 729 (accrued travel and entertainment for 2004).
[168] *Id.*
[169] *Id.*
[170] Tr. at 464-65 (Sperry).

because "they didn't want them open for other people to review."[171] Hampshire also says that Clark should have asked additional staff to help him review the reports and that his decision not to do reflected his desire to protect Kuttner from having his obviously improper reimbursement requests examined by neutral subordinates.

I am not persuaded by this argument. I find Clark's testimony that his staff was busy with other more important tasks, such as preparing SEC filings, to be credible.[172] As it was, Hampshire had hired additional staff to help Kuttner prepare the reports.[173] Clark had his wife help him on her own time.[174] As to the fact that the CEO's expense reports were not made generally available to other employees, I am not convinced that this is evidence of a dark motive, as opposed to an exercise in prudent discretion. The notion that the CEO's expense reports would be handled with a certain degree of discretion and not be made available for open perusal by employees not involved in their review is not one that strikes me as shocking. The group with the real power — the board — always had the right to review the reports and to turn them over to the corporation's auditors. In sum, Hampshire has not persuaded me that Clark's choices not to engage even more of the company's resources than were already tied up in processing Kuttner's expense reports and not to make the reports part of the office general files were made in bad faith, or are evidence of his knowledge that Kuttner was seeking payments for improper expenses.

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[171] Clark Dep. at 207; Tr. at 668-669 (Clark).
[172] Tr. at 48 (Clark).
[173] *Id*. at 546 (Sperry), 693-94 (Clayton).
[174] *Id*. at 50 (Clark).

2. Hampshire Has Proven That Clayton Breached His Fiduciary Duties By Allowing Hampshire To Reimburse The Item-Eyes Executives For Personal Expenses

The board also investigated expense accounts that Hampshire gave to the executives of Item-Eyes, one of its subsidiaries. In the fall of 2000, Hampshire sought to acquire Item-Eyes, a women's apparel company.[175] The three founders of Item-Eyes (the "Item-Eyes Executives") had long enjoyed a lavish lifestyle because of generous expense accounts that Item-Eyes gave them, and expected that Hampshire would continue to do the same. Thus, one of terms of the deal that Item-Eyes proposed was that each Item-Eyes Executive be given up to $140,000 annually for entertainment and travel expenses.[176]

Clayton, who was charged with negotiating the deal and finalizing the employment agreements with the Item-Eyes Executives, claims that he initially rejected this request.[177] But the Hampshire board wanted to push forward with the acquisition, and told Clayton to find a way to make the deal work.[178] Clayton "compromised" by suggesting a provision that he called a "psychological control," whereby each executive would be given an annual allotment of $140,000 for business expenses beyond what Hampshire typically reimbursed with the understanding that if the IRS disallowed the expenses, the Item-Eyes Executive responsible would repay half of the disallowed amount.[179] The board agreed to this proposal,[180] and I conclude that the company's

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[175] *Id*. at 726-27 (Clayton).
[176] *Id*. at 729 (Clayton).
[177] *Id*. at 562-63 (Clayton); Clayton Dep. at 127-28.
[178] Tr. at 732-33 (Clayton).
[179] *Id*. at 732-34 (Clayton).

outside counsel, Willkie Farr, who scrivened the deal documents, was also aware of the provision.

Under the finalized Item-Eyes employment agreements, which were presented to the board and approved as part of the acquisition agreement,[181] the Item-Eyes Executives were given $140,000 per year for expenses that were "[i]n addition to the normal and customary expenses" that Hampshire typically reimbursed.[182] "Normal and customary expenses" were described to include "expenses related to and in the interest of the Company, including, but not limited to, entertainment, lodging, meal, travel, car rental and like expenses."[183] But the provision expressly required that the Item-Eyes Executives' expenses be "in compliance with GAAP."[184] And, as written, the provision had a club designed to encourage the Item-Eyes Executives to only claim actual business expenses. That club required the Item-Eyes Executives to pay half of any cost or expense that was disallowed in connection with a tax audit back to Hampshire.[185]

As written, the provision makes clear that Hampshire was taking a risk. It was allowing the Item-Eyes Executives to be aggressive in the expense area, by lavishly wining and dining clients, flying first class, staying at luxury hotels, and otherwise going in style when conducting business. But the provision required that the $140,000 annually be for business expenses, however lavish.

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[180] *Id*. at 733-34 (Clayton).
[181] *Id*. at 401, 403, 490-91 (Sperry).
[182] JX 181 (employment agreement of Ellen Becker) at HAMPDE 142-43 (detailing the Item-Eyes executive spending accounts).
[183] *Id*. at HAMPDE 143.
[184] *Id*.
[185] *Id*.

The problem was that in practice the Item-Eyes Executives used the $140,000 provision as extra, tax-free compensation. Hampshire claims that Clayton knew this was happening, turned a blind eye to it, and exposed Hampshire to possible liability by treating the improper payments as reimbursed business expenses.

To prove this contention, Hampshire points to the reality that the Item-Eyes Executives had created a separate set of handwritten books to keep track of reimbursements (the "Expense Logs"). The Expense Logs recorded both recurring monthly expenses, such as car lease payments, and variable expenses, such as personal charges on the Item-Eyes Executives' American Express cards.[186] But the Logs, which are largely indecipherable, do not, on their face, show that clearly personal expenses were being paid by Hampshire. Instead, the Logs simply state "AMEX" or "AT&T" or "Exxon" and the amount of the expense.[187] To understand the nature of the charges reflected in the Expense Logs, the process by which expenses were recorded must be understood.

After Hampshire received the Item-Eyes Executives' American Express bill for each month, a list of each of the charges was created, which made the charges appear as though they were all business-related. This list would be put into the company's ledger.[188] The Item-Eyes Executive would then review the actual American Express bill, and denote expenses "B" for business and "P" for personal, and the items marked "P" were recorded *only* in the Expense Logs in order to keep track of how much the Item-

[186] JX 580 (Expense Log for Ellen Becker).
[187] *Id.*
[188] JX 821 (AMEX bill for Marc Abramson); Tr. at 825 (Norwood).

Eyes Executive had spent out of his or her $140,000 allotment.[189] The Logs, however, did not indicate that they were personal expenses but instead gave a one or two word description of the expenses, such as "AMEX" or "Exxon."[190] The charges that were so obviously personal that reimbursement could not be plausibly justified were marked "check enclosed," and the executive repaid the company for those expenses.[191] For example, an American Express bill of executive Marc Abramson — one of the Item-Eyes Executives — shows a balance of $37,500.31.[192] Abramson paid $10,285.26 of charges marked "check enclosed," but only $2,147.98 of the charges were marked as "business" related — leaving $25,067.07 in personal expenses.[193] $25,067.07 was recorded as "AMEX" in Abramson's Expense Log.[194] Hampshire paid the full amount of the American Express bill, less the charges marked "check enclosed."[195]

Unlike the Expense Logs, which contained only a brief notation about each expense but not that they were personal, the itemized American Express bills clearly show that many of the expenses Hampshire reimbursed were personal. One of Abramson's American Express bills, for example, reflects charges marked "P" for menswear at Neiman Marcus despite the fact that Item-Eyes sold only women's clothing,

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189 JX 821 (AMEX bill for Marc Abramson); Tr. at 837 (Norwood).
190 *E.g.*, JX 580 (Expense Log of Ellen Becker).
191 Tr. at 824 (Norwood).
192 JX 821 (AMEX bill for Marc Abramson).
193 *Id*.
194 JX 728 (Expense Log entries for Abramson) at HAMPDE 146624.
195 JX 821 (AMEX bill for Marc Abramson).

luggage from Bloomingdale's, groceries, and a souvenir from a trip to Dallas, to mention just a few.[196]

Clayton claims that he was not aware of any improper "scheme," but admits that he reviewed the American Express bills from time to time.[197] Clayton was also aware that there were separate hand-written Logs tracking the expenses that did not disclose the personal nature of the underlying expenses.[198] Clayton says he remembers looking at Abramson's American Express bill because he made Abramson repay Hampshire for a trip to Aruba that Abramson had charged and marked with a "P."[199] But Clayton did not request that Abramson repay the rest of the personal expenses that Hampshire had already reimbursed him for. In fact, Clayton admits that he reviewed and approved certain charges, such as Abramson's purchase of a computer for his daughter.[200] The receipt for the computer purchase contains the notation "Marc's Daughter PC Equip & Warranty,"[201] and the amount of the expense was noted on Abramson's Expense Log.[202] Clayton claims that he came upon the charge while reviewing the Expense Logs, and asked Richard Isaacson, Item-Eyes' CFO, about the charge. Clayton argues that Isaacson told him that Abramson had used his American Express for the purchase in order to get

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[196] *Id.*
[197] Tr. at 576 (Clayton).
[198] *Id.* at 589 (Clayton); Clayton Dep. at 148-49.
[199] Tr. at 579-80 (Clayton); Clayton Dep. at 146-57.
[200] Tr. at 593-94 (Clayton).
[201] JX 822 (receipt from Comp USA for a computer and warranty).
[202] JX 727(Expense Log for Item-Eyes Executives) at HAMPDE 146604.

frequent flier miles, but the Expense Logs recorded Abramson's AMEX bill and the computer expense separately.[203]

Clayton also allowed the Item-Eyes Executives to be repaid for past sales taxes that they were assessed out of their expense accounts. In 2002, the Item-Eyes Executives asked that Hampshire pay taxes and interest that the Item-Eyes Executives owed to the state of New York.[204] Kuttner approved the payment, and Clayton reimbursed the Item-Eyes Executives for the taxes and interest that they had paid out of their $140,000 expense allowances although Clayton acknowledges that this was not a business expense.[205] The payment was also recorded in the Expense Logs,[206] with one log showing Clayton's handwritten notation that "1 of 4" sales tax payments had been made to a particular Item-Eyes Executive.[207]

And, Clayton directed Item-Eyes to issue Item-Eyes Executive Ellen Becker a cash "bonus" for $50,000 because she "had not made the trips to Paris or anything that year" and had "accumulated an amount" on the Expense Log.[208] And, when Becker left the company in 2003, Clayton approved a payment of $3,087.89 to her for the remaining

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[203] *Id.* at HAMPDE 146604-06.
[204] JX 732 (letter from Martin Axman, Marc Abramson, and Ellen Becker to Ludwig Kuttner (Aug. 14, 2002)).
[205] *Id.* (showing Clayton's handwriting, noting the amount that was paid to each Item-Eyes Executive); Tr. at 598-600.
[206] JX 580 (Expense Log for Ellen Becker, showing a sales tax payment) at HAMPDE 376; JX 727 (Expense Log for Item-Eyes Executives).
[207] JX 727 (Expense Log for Martin Axman, showing a sales tax payment and Clayton's handwritten notation) at HAMPDE 146602.
[208] JX 712 (letter from Charles Clayton to Ludwig Kuttner and Michael B. Goldsmith, Esq. (Apr. 22, 2004)) at HAMPDE 146535 (noting that Becker had been paid $50,000 in cash); Tr. at 743-44 (Clayton).

balance of her $140,000 expense account for that year.[209] Hampshire ultimately required the Item-Eyes Executives to revise their W-2s for 2003 to 2005 to report the expense accounts as income,[210] and had to repay $30,000 in Medicare taxes.

After considering the evidence, I conclude that Clayton was aware that the Item-Eyes Executives were treating the $140,000 figure as an annual amount that they could spend as they wished. The American Express bill he admits reviewing was largely paid by Hampshire even though most of the items reimbursed were clearly labeled as "P" for personal. I believe that Clayton knew that the Item-Eyes Executives were regularly receiving funds from Hampshire for purely personal expenditures.

Clayton did not view this as a problem for Hampshire unless an expenditure was so blatantly personal that there was a risk of detection. Thus, he made sure that the Item-Eyes Executives paid back funds that were obviously personal expenses, but otherwise allowed them to book as business expenses less obviously personal expenditures, such as meals and smaller trips. In allowing this practice to go forward, Clayton did not intend to harm Hampshire in a business sense. I find credible his testimony that the board wanted the Item-Eyes transaction and that the payments of $140,000 per year were just the cost of getting a good deal done.

What Clayton did not focus upon, however, is that he was consciously causing Hampshire to violate the law.[211] From the get-go, the board and Clayton should have

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[209] JX 720 (fax from Richard Isaacson to Charles Clayton (Sept. 17, 2003)); Tr. at 744-75 (Clayton).
[210] JX 634 (Item-Eyes 2003-2005 payment reconciliations).

dealt with this issue by grossing up the $140,000 for taxes, offering it to the Item-Eyes Executives as compensation, and telling the Item-Eyes Executives to enjoy themselves on their own dime. Instead, Hampshire agreed to a provision that still technically required law compliance. Clayton, I find, knew that the Item-Eyes Executives were not complying with the law and did not stop the practice even when it became clear to him. By doing so, Clayton breached his duty of loyalty.

3. Hampshire Has Not Proven That Clayton And Clark Breached Their Fiduciary Duties As To Hampshire's Deferred Compensation Plans

Hampshire also accuses Clayton and Clark of violating their fiduciary duties by mishandling the corporation's deferred compensation plan (the "Deferred Compensation Plan") for certain top executives, most notably Kuttner and Clayton himself. Specifically, Hampshire claims that Clayton and Clark caused the Plan to be operated in violation of the Internal Revenue Code by allowing Kuttner and Clayton to obtain constructive receipt of funds in the Plan. The board's Compensation Committee was charged with administering Hampshire's executive compensation and deferred compensation programs, but delegated a good deal of responsibility to Clayton to ensure that the Deferred Compensation Plan was managed in compliance with the Internal

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[211] *See Metro Commc'n Corp. BVI v. Advanced Mobilecomm Techs., Inc.*, 854 A.2d 121, 163-64 (Del. Ch. 2004) (finding that directors had violated their duties of loyalty if they had engaged in unlawful bribery because "[u]nder Delaware law, a fiduciary may not choose to manage an entity in an illegal fashion, even if the fiduciary believes that the illegal activity will result in profits for the entity"); *Guttman v. Huang*, 823 A.2d 492, 506 (Del. Ch. 2003) ("[O]ne cannot act loyally as a corporate director by causing the corporation to violate the positive laws it is obliged to obey."); *see also* Loyalty's Core Demand at 652 (noting that directors breach their fiduciary duties when they knowingly cause the corporation to violate the law).

Revenue Code.[212] The Deferred Compensation Plan set aside a portion of Kuttner and Clayton's income in an account that was not taxed pursuant to IRS rules. In order to ensure that the accounts maintained tax-deferred status, the IRS requires that an individual not take constructive receipt of or receive a current benefit from the funds.[213] The Compensation Committee made Clayton, Kuttner and Clark trustees of the Plan.[214]

According to Hampshire, Clayton managed the deferred compensation funds in a way that violated both IRS regulations and the terms of the deferred compensation agreements. First, Hampshire argues that in 2004, when Hampshire terminated a deferred compensation plan called the "Top Hat Plan" and distributed the funds from that Plan,[215] Clayton was given a $214,863 distribution which he rolled into a new Deferred Compensation Plan in violation of his deferred compensation agreement and constructive receipt rules. Specifically, Hampshire alleges that neither the Top Hat Plan nor Clayton's new Deferred Compensation Plan permitted rollovers, and that Clayton was required to pay income taxes on the distribution. Ogletree, Deakins, Nash, Smoak & Stewart, P.C. ("Ogletree"), who Hampshire hired to investigate whether the deferred compensation funds had been properly managed, found that the Top Hat plan did not permit secondary deferrals, that Clayton's Deferred Compensation Plan did not permit rollovers, and that

[212] Tr. at 502-05 (Sperry), 1020-22 (Winter).
[213] *See* 26 C.F.R. § 1.451-2(a) (defining constructive receipt of funds to occur where funds are credited to an individual's account, set apart, or made available such that the person may draw upon them at any time).
[214] Tr. at 719, 721 (Clayton), 860 (Norwood).
[215] JX 571 (Hampshire Group Ltd. 2004 Annual Report) at F-18.

the distribution was "actually and constructively received by Clayton" such that he should have reported it as income.[216]

Hampshire, however, ignores the record evidence that the Compensation Committee expressly approved the rollover by approving Clayton's Deferred Compensation Plan.[217] A new Deferred Compensation Plan for Clayton seems to have taken effect October 21, 2003.[218] The terms of that Plan contemplate that funds from Clayton's prior deferred compensation plan would be rolled over into his new Deferred Compensation Plan, stating that "the benefits under the [earlier] Plan [would be] rolled into [Clayton's] retirement plan."[219]

Hampshire has the burden of persuasion on this issue, and I am not convinced that there was anything sinister in the roll-over of funds from the Top-Hat plan to the new Plan, given that it appears to have been approved by the Compensation Committee. Indeed, the roll-over seems the more natural path. If there was some technical gap, Hampshire has not convinced me that it was other than a good faith mistake in execution, and not the product of bad faith or gross negligence.

Similarly, Hampshire alleges that in 2005 Clayton used funds from his and Kuttner's deferred compensation accounts to invest in mutual funds and the stock of

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[216] JX 701 (memorandum from Ogletree, Deakins, Nash, Smoak & Stewart, P.C. to Hampshire Group, Ltd. (Nov. 14, 2006)) ("Ogletree Memo") at 3.

[217] Tr. at 503-04 (Sperry) (stating that the Compensation Committee had approved Clayton's new deferred compensation plan).

[218] JX 178 (Deferred Compensation Agreement of Charles Clayton (Oct. 21, 2003)) at 1. Hampshire acknowledges that this exhibit is, in fact, Clayton's new deferred compensation agreement but fails to address the language in that agreement permitting rollovers. Hampshire Opening Post-Trial Brief at 19.

[219] JX 178 (Deferred Compensation Agreement of Charles Clayton (Oct. 21, 2003)).

publicly traded companies, and personally directed the investment of those funds by making four or five trades a week.[220] By directing the investment of those funds, Hampshire claims, Clayton took constructive receipt of the funds and was required to report the funds as income under IRS regulations. Ogletree found that Clayton and Kuttner had "unfettered ability to trade at will in the[ir] individual deferred compensation accounts," which would "likely be construed by the Internal Revenue Service as giving Clayton and Kuttner the economic benefit of the deferred compensation funds during 2005 and 2006."[221]

Clayton argues that the Deferred Compensation Plans permitted him to invest in securities, and that he treated the Deferred Compensation Plans much like an IRA account.[222] But Hampshire argues that because Clayton was the beneficiary of the funds he deferred, he was personally barred by IRS rules from directing any trades.

The problems with that argument are two-fold. First, as a factual matter, the board named Clayton, Kuttner, and Clark as the trustees for the plan and knew that Clayton and Kuttner would be making investment decisions.[223] Although director Sperry equivocated at trial, his deposition testimony indicates that he knew Kuttner and Clayton would be able to direct their investments.[224] I find his equivocation at trial unconvincing and

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[220] Tr. at 630 (Clayton).
[221] Ogletree Memo at 3.
[222] Tr. at 627, 630 (Clayton).
[223] *Id*. at 719, 721 (Clayton), 860 (Norwood) (stating that Clayton, Clark, and Kuttner were the trustees of the deferred compensation accounts).
[224] *Id*. at 499-500 (Sperry); Sperry Dep. at 143-44.

believe that Sperry and the other directors knew that Clayton and Kuttner would have influence over the investments.

Second, and relatedly, Hampshire has not made the case that the mere fact that Clayton could cause his deferred compensation account to be invested in different securities violated the constructive receipt rules. I do not pretend to be an expert in this area, but Hampshire has not presented me with adequate authority supporting its position. What authority Hampshire has cited does not focus on whether the beneficiary of a deferred compensation plan can participate in the plan's choice of investments.[225] What it focuses is on is whether the funds were made currently available to the plan participant to meet immediate financial needs. If the plan assets are treated as currently available to meet the participant's immediate needs, then the tax preference given to funds truly set aside for retirement growth is undermined.[226] Here, there is no evidence that Clayton's

[225] Hampshire cites 26 C.F.R. § 1.451-2(a), which states that: "[i]ncome although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given." But the statute suggests that "set apart" or "made available" means having deferred compensation funds on hand to do with whatever one pleases if current needs arise. It is not clear to me that it covers a situation where a beneficiary has the ability to choose the investments for his deferred compensation funds without ever receiving or having any current right to access those funds. Hampshire also relies upon a United States Tax Court decision, which found that a petitioner had violated constructive receipt rules by putting deferred compensation funds in a Charles Schwab account that he transferred money in and out of, and traded in. *Foxworthy, Inc. v. C.I.R.*, 2009 WL 2877850, at *18 (U.S. Tax. Ct. Sept. 9, 2009). But, in that case, the petitioner loaned money to his church and to his "alter-ego" corporation, which the court found demonstrated that he had access to the money and drew upon that money — thus constituting constructive receipt. *Id*. Hampshire has presented no evidence that Clayton ever drew upon the money in his deferred compensation account, or treated it as other than locked-up until he retired.

[226] *See Foxworthy*, 2009 WL 2877850, at *18 ("The constructive receipt doctrine requires a taxpayer who is on the cash method of accounting to recognize income when the taxpayer has an

funds were ever made immediately available to him. At most, there is evidence that he, a Plan trustee named by the Compensation Committee, chose the securities in which Plan funds were invested.[227] I am not persuaded that this constituted constructive receipt[228] And, I certainly am not convinced that Clayton acted in bad faith or with gross negligence in not realizing that was the case, if it was.

In so concluding, I do not ignore evidence that Clayton was more aggressive in investing his own funds than he had advised Kuttner to be in investing his own deferred compensation funds in the past.[229] In a May 1996 letter, Clayton cautioned Kuttner that he should limit his investments of his deferred compensation in outside companies to one

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unqualified, vested right to receive immediate payment of cash.") (emphasis added); *see also* IRS Publication 538 (Mar. 2008), *available at* http://www.irs.gov/publications/p538/ar02.html (last visited June 17, 2010) (explaining that funds are constructively received "when an amount is credited to your account or made available to you without restriction").

[227] *E.g.*, Tr. at 630 (Clayton) (explaining that he made four or five trades a week in his and Kuttner's deferred compensation accounts).

[228] Clayton has provided authority that suggests that unless the plan participant was able to control the plan assets for current use, then the mere fact that the plan participant was able to participate in the investment decision does not in itself constitute constructive receipt. *See Anderson v. Comm'r of Internal Revenue*, 1961 WL 422 (U.S. Tax. Ct. 1961) (finding that a petitioner did not have receipt of funds "[a]lthough the petitioners had a free hand in investments of the money" because "they lacked the ultimate incident of ownership, viz., the power simply to pick up the money, put it in their pockets, and spend it at will and for whatever they deemed advisable"); *see also* I.R.S. Priv. Ltr. Rul. 91-01-011 (Oct. 5, 1990) ("A Plan participant's right to choose from time to time the designated investments in which his deferrals and matching contributions are deemed to be invested under the Plan will not cause those amounts to be includible in his gross income until the taxable year in which those amounts are actually paid . . . ."; I.R.S. Priv. Ltr. Rul. 86-48-011 (1986) ("noting that a deferred income plan participant had not constructively received funds even though the participant could "designate his or her preference for the investment of his or her deferred compensation"). Hampshire has also not dealt with the reality that Clayton was also a trustee of the plan and, in that capacity, might be expected to exercise control over the investment of plan funds. Indeed, Clayton's deferred compensation plan states that Clayton's funds were to be "deposited into one or more investment accounts *under the control of a trustee appointed by the Company*." JX 178 (Deferred Compensation Agreement of Charles Clayton (Oct. 21, 2003)) at ¶ 4.

[229] JX 626 (letter from Charles Clayton to Ludwig Kuttner (May 29, 1996); Clark Dep. at 147-48 (stating that Clayton was known to "preach" about deferred compensation).

trade per quarter to avoid constructive receipt problems.[230] But 1996 is distant in time from the trading Clayton did in the next decade and I am not persuaded that intervening experience did not influence Clayton to believe that mere periodic trading of funds did not constitute constructive receipt so long as it was clear that the funds remained Deferred Compensation Plan funds and could not be accessed by him or used as a resource in any way without immediate tax consequences. On this point, I admit that I am heavily influenced by the lack of any evidence that Clayton ever treated the funds as anything other than tied up in his Deferred Compensation Plan.

Finally, Hampshire claims that both Clayton and Clark knowingly permitted Kuttner to invest his deferred compensation funds in Primary Steel, LP, in violation of his Deferred Compensation Plan which prohibited investments in private companies. In August 2005, Ironwood, a venture capital firm in which former Hampshire board member Michael Jackson was a partner, contacted K Holdings, LLC ("K Holdings") — which is owned by Kuttner — regarding an investment opportunity in Primary Steel, LP.[231] Kuttner received a subscription agreement and wiring instructions from Ironwood, which referenced K Holdings as the investor.[232] But Kuttner decided to invest in Ironwood through his deferred compensation funds and not K Holdings, and forwarded the wiring instructions form to Clark, requesting that Clark change the form to reflect that

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[230] JX 626 (cautioning Kuttner not to trade his deferred compensation funds more than once a quarter, or to invest in any entities controlled by Kuttner).
[231] Tr. at 171 (Clark).
[232] *Id*. at 172 (Clark).

Hampshire would be the investor.[233] Clark discussed the transaction with Clayton, who approved the wire transfer.[234]

Kuttner left Clark a voicemail on August 12, 2005 — before the funds were wired — to ensure that the forms were changed from K Holdings to Hampshire:

> Hi . . . morning, Roger, Ludwig! I don't know if you already did the wire for [the] 191. . . . If you write in reference . . . investment and write on the wire reference . . . HGL . . . investment . . . so . . . to be tied in . . . so that we will be able to change the papers on this later in case anybody ever asks . . . so that we don't get a problem about . . . constructive receipt. So if it's on the wire then nobody can say anything. . . .[235]

Clark wired $191,254.46 to Ironwood later on August 12, and sent the wiring instruction form with the name clearly changed from K Holdings to Hampshire.[236] But Ironwood never made the change, and left the investment under K Holdings' name in its books. Clark discovered the error Ironwood made in September 2006, when Kuttner received a K-1, and tried to make the correction with Ironwood so that the Hampshire Deferred Compensation Plan would be shown on Ironwood's books as the investor. Jackson told Clark that the change could not be made without material costs, and so Kuttner withdrew the funds and returned exactly $191,254.46 back into his deferred compensation account.[237] Ogletree found that the transfer constituted constructive receipt by Kuttner, which should have been reported as income.[238]

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[233] *Id*. at 171-72 (Clark); JX 55 (reply notice from Ironwood Manufacturing Fund regarding a capital contribution for $191,254.46 with instructions from Frizzi Linck to fund out of Kuttner's deferred compensation account).
[234] Tr. at 127 (Clark).
[235] JX 597 (transcript of a voicemail from Kuttner to Clark (Aug. 12, 2002)).
[236] JX 55 (reply notice from Ironwood Manufacturing Fund).
[237] Tr. at 127-28 (Clark).
[238] Ogletree Memo at 4.

Hampshire alleges that Clark and Clayton knew that the Ironwood investment was improper especially because of Kuttner's voice mail. I do not so conclude. For starters, Hampshire has proven that Clark and Clayton were aware that Ironwood was not a public entity, or that they even focused on that issue. Kuttner was, after all, a trustee of the Plan,[239] and presumably knew the rules on that feature. As to the voice-mail, it would be more sinister if Clark was being asked to change something *after-the-fact*. But Clark was being asked to make an investment in the name of the Hampshire Deferred Compensation Plan on Kuttner's behalf using funds allocated by Kuttner to that plan, and to do so up-front. The wire documents clearly indicated that the investment was to be made by the Plan. Clark did not reverse an earlier investment from one made by Kuttner privately into one made by the Plan. Rather, the reversal occurred later when it was determined that Ironwood had not recorded the investment as one by the Plan. It may be that the reversal somehow violated a technical constructive receipt rule. But Hampshire has not shown that Clark or Clayton knew that to be the case.

The more substantial constructive receipt problem is, of course, whether Kuttner intended all along to use his currently available funds to make the investment in Ironwood once he had sufficient funds to do so. If Kuttner intended from the get-go to use his deferred compensation funds just to tide him over until he could get the necessary funds to finance the Ironwood investment himself out of current funds, then there would obviously be a large constructive receipt problem. But Hampshire has not convinced me that that was either Kuttner's intent, or more importantly, that Clayton and Clark knew of

[239] Tr. at 860 (Norwood).

any such intent. Indeed, the way that the reversal came about is contrary to such an intent because Kuttner tried to have Ironwood fix its failure to put the investment in the name of the Deferred Compensation Plan and reversed the transaction only when told by Jackson that there would be large costs if Ironwood put the investment in the Plan's name.[240]

For all these reasons, I conclude that Hampshire has not met its burden of persuasion on its claim that Clayton and Clark breached their fiduciary duties in handling the corporation's Deferred Compensation Plan.

4. Clayton And Clark Breached Their Fiduciary Duties By Falsely Recording Tuition Payments As Charitable Donations

Hampshire next argues that Clark and Clayton breached their fiduciary duties by their role in payments Hampshire made to Columbia University for tuition payments for Kuttner's assistant, Frizzi Linck.[241] These tuition payments were recorded by Clark on Hampshire's books as charitable donations. If they were charitable contributions, there would be no issue as the Hampshire board allowed Kuttner to make $500,000 in charitable contributions on the company's dime annually,[242] which Clayton and Clark were aware of.[243]

But the payments to Columbia were not charitable contributions. Rather, they were for Linck's tuition to attend the Teachers College of Columbia University. In 2002, when Linck enrolled at Teachers College, Kuttner asked Hampshire's tax manager,

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[240] *Id*. at 128 (Clark).
[241] Recall that Linck was mentioned earlier in this opinion as the individual involved in preparing Kuttner's expense reports for submission to Clark.
[242] Tr. at 546-47 (Sperry).
[243] *Id*. at 164 (Clark); 708 (Clayton).

Horace Padgett, whether Hampshire could deduct tuition payments as a charitable donation in order to give his assistant tax-free funds for tuition, but was told that Hampshire did not have a policy that permitted such a deduction.[244] Nonetheless, Kutter requested that Clark or Clayton issue checks for $4,000 — payable to Columbia University, and marked as either a "contribution" or "donation."[245] Clark knew that Kuttner's assistant was attending Columbia, and so he asked Kuttner about the purpose of the check.[246] But, according to Clark, Kuttner insisted that the $4,000 checks were, in fact, charitable donations.[247] Clark was still suspicious, and told Hodge, the CFO at the time, about his concerns. After Clark saw that Hodge had approved the check, Clark continued to approve later checks for $4,000 marked as "donations" to Columbia.[248]

This is a close issue. Clark says he acted on Kuttner's word and Hodge's approval in a Sergeant Schultz manner thereafter, and that he did not in fact know for sure that the payments were not actually donations, but tuition. After considering all the evidence, I do not believe Clark on this score. I find that he knew that the payments, which were being made on a periodic basis more consistent with a tuition schedule than with a

[244] JX 764 (fax from Horace Padgett to Ludwig Kuttner regarding educational assistance (Dec. 11, 2002)).
[245] JX 754 (memo from Ludwig Kuttner to Roger Clark regarding a check to Columbia University (Dec. 19, 2002)); JX 757 (memo from Ludwig Kuttner to Roger Clark regarding a contribution to the Teachers College of Columbia University (Apr. 14, 2003)); JX 760 (check request from Ludwig Kuttner to Roger Clark (Jan. 22, 2004)); JX 759 (Hampshire Charitable Contributions for 2003) (showing that a check marked "contribution" and a check marked "donation" had been paid to 'Teachers College of Colum'); JX 762 (Hampshire Charitable Contributions for 2004) (showing three checks were paid to 'Teachers College of Colum.'); Tr. at 28-29 (Clark).
[246] Tr. at 22 (Clark).
[247] *Id*.
[248] *Id*. at 23 (Clark).

corporate charitable contribution, were for tuition. In so finding, I am influenced by communications Clark received from Linck herself. At one point, Linck sent Clark an email saying that "it [was] time for the next check for Columbia" and that she needed the check as soon as possible "in order to avoid late fees."[249] In fact, when the cancelled checks were returned, all referenced Linck's name and social security number, making it obvious that the checks were not donations.[250]

Clayton, who approved some of the checks, also knew that Linck was attending Teachers College, but never bothered to ask whether the check requests were true charitable donations,[251] even though Clark raised the issue with him.[252] I also conclude that Clayton knew that the checks were for tuition and not donations but did nothing to stop the practice.

The practice only stopped when Langley also became concerned as Compliance Officer, bringing it to Clark's attention, and Clayton thereafter raised the issue with the board.[253] When the Compensation Committee dealt with the practice, it never raised the matter with Clark.[254] Nor did it take employment action against Clayton or Kuttner. Instead, the board authorized a salary increase for Linck to cover the cost of Linck's

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[249] JX 528 (email from Frizzi Linck to Roger Clark).
[250] Navigant Report at DT 765.
[251] JX 644 (check to Teachers College of Columbia University, signed by Charles Clayton); JX 698 (same); Tr. at 717 (Clayton) (admitting that Linck told him that she attended Columbia); Clayton Dep. at 116-117.
[252] Tr. at 717 (Clayton).
[253] *Id*. at 167-68, 206 (Clark).
[254] Jackson Dep. at 207.

tuition.[255] Navigant and Paul Weiss concluded that the tuition payments were not problematic for Hampshire because "[t]he recording of the expenses were appropriately corrected on the Company's general ledger."[256] The testifying board members indicated that they did not consider this issue a fraud.[257]

This is yet another instance in which, however, Clayton and Clark were complicitous in causing the company to violate the law. Charitable contributions and tuition payments are not the same thing. I have no reason to believe that Clayton and Clark were trying to harm Hampshire, but no officer or employee has the right to make a corporation a law breaker.[258] By knowingly causing Hampshire to record tuition payments as charitable contributions, Clark and Clayton violated their duty of loyalty.

5. Clayton, But Not Clark, Breached His Fiduciary Duties By Participating In And Facilitating An Improper Tax Deduction Scheme

Hampshire accuses Clayton and Clark of breaching their fiduciary duty by their involvement in a program whereby unsold or mutilated sweaters made by Hampshire were donated to charities on behalf of various Hampshire employees who, in turn, took

[255] JX 56 (minutes of the Hampshire board of directors meeting (May 19, 2005)) at HAMPDE 134669; Navigant Report at DT 765; Winter Dep. at 16; Goldberg Dep. at 182.
[256] Navigant Report at DT 765.
[257] Tr. at 546 (Sperry); Goldberg Dep. at 183.
[258] Under Delaware law, corporations are only chartered by the state to conduct lawful business by lawful means. *See* Loyalty's Core Demand at 650 (discussing that the DGCL exemplifies the policy that "corporations may only engage in lawful business"); *see also* 8 *Del. C.* § 101(b) ("A corporation may be incorporated or organized under this chapter to conduct or promote any lawful business or purpose, except as may otherwise be provided by the Constitution or other law of this State."); *id*. § 102(a)(3) (stating that a corporation's charter of purpose is legally sufficient if it states that the "purpose of the corporation is to engage *in any lawful act or activity* for which corporations may be organized . . . and by such statement *all lawful acts and activities* shall be within the purposes of the corporation") (emphasis added). Delaware does not charter law breakers.

personal tax deductions. Hampshire could not claim a tax deduction for its surplus sweaters because they were deemed to have no value on the retail market due to their imperfections. Thus, Hampshire donated the sweaters to various charities, and requested that the charities send gift letters reflecting that the donation had been made by a Hampshire employee and attributing a value to the sweaters, which the employee could then use to take a tax deduction.[259]

The problem is that if they had no value if contributed by Hampshire, it is difficult to see how they could have value if contributed to charities on behalf of employees. To be more concrete, one can actually see how remaindered sweaters could have real human value to people in need, as they would keep them warm. What is harder to justify is how they could have "tax value" if the sweaters had no commercial value. The sweaters were perfect for genuine charity in which the giver expects nothing in return.

But that is not what this program was about. The employees "donating" the sweaters were permitted to act as if they owned the sweaters and were personally donating them to charities. Of course, if the sweaters had value and were given to the employees by their employer, that value might, one suspects, also be considered by the IRS to be income to the employee. And Hampshire was taking the position that it could remainder the sweaters precisely because they could not be sold.

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[259] JX 575 (letter from Frizzi Linck to D. Weber regarding a donation receipt with attached letters (Mar. 23, 2005)); JX 637 (memo from Frizzi Linck to S. Ezzouhairy regarding designer sweater donations (Oct. 10, 2003)); JX 700 (letter from Charles Clayton to Linda McAtee requesting letters showing that Kuttner had made sweater donations (Dec. 29, 2004)).

This annual sweater-fest went on for some time. The corporation annually remaindered a large number of sweaters to various charities on behalf of many company employees, officers, and directors who subsequently claimed tax deductions. For example, directors Goldberg and Jackson both took sweater deductions.[260] Culang, who later served as CEO of Hampshire, took tax deductions for sweater donations in 2002, 2003, and 2005.[261] Golden, the former general counsel, current CEO and Internal Review Memorandum author, took a tax deduction in 2005.[262] Clark took just one deduction in 2003 after Kuttner gave him three "donation" receipts for $4,000.[263] Clayton tried to take tax deductions for donations as well.[264]

I cannot conclude that at all times Clayton knew this sweater caper was improper. I cannot conclude at any time that Clark knew. Even many trained lawyers, like Golden, and financial professionals, like Clayton and Clark, may not understand the complex rules governing charitable contributions of tangible items. Given how widespread the practice was at Hampshire, I find it hard to conclude that the program was the product of bad faith or gross negligence. The reality is that the sweaters probably had some sale value and the amounts per sweater attributed were far short of what Hampshire would profitably sell sweaters at in retail stores. Creative tax planning is, for better or worse, a quintessentially American tradition.

[260] JX 94 (showing that Goldberg and Jackson took tax deductions for sweater donations in 2003).
[261] JX 113 (tax form for non-cash charitable contributions for Michael Culang and Judith Daly).
[262] JX 12 (tax form for non-cash charitable contributions for Heath and Lori Golden).
[263] Tr. at 102-03; Clark Dep. at 127-28.
[264] Clayton Dep. at 93-94.

But the problem for Clayton is what he did after he was informed that the program should cease. In December 2004, the Audit Committee received an anonymous whistle blower call reporting the sweater donation program.[265] The Audit Committee told Clayton, who was the CFO at the time, that the sweaters could not be treated as a gift to employees under the tax code.[266] Winter, the chairman of the Audit Committee told Clayton that he could continue to donate sweaters to charity, and even make the donation on behalf of an employee, but that employees were not entitled to a tax deduction from the donation.[267] Clayton confirmed that the sweaters would thereafter "be given, by the company, to charity."[268]

But Clayton continued the sweater donation scheme through 2005 and into 2006. Clayton took tax deductions for himself in 2005 and 2006 after the Audit Committee had informed him that employees were not entitled to donations,[269] and others, including Golden, Culang, and board members Jackson and Goldberg, did the same.[270] The evidence convinces me that Clayton circumvented the Audit Committee's instructions because he was drafting form letters to charities that they could turn into final letters and

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[265] JX 14 (minutes of an Audit Committee and Compensation Committee meeting held on Dec. 8, 2004).
[266] *Id.*
[267] Tr. at 967 (Winter).
[268] JX 14 (minutes of an Audit Committee and Compensation Committee meeting held on Dec. 8, 2004).
[269] JX 677 (letter from Frizzi Linck to Jennifer Canterbury, requesting donation letters for sweaters on behalf of individuals including Clayton (Jan. 27, 2006)).
[270] JX 94 (showing that Goldberg and Jackson took tax deductions for sweater donations in 2003); JX 12 (tax form for non-cash charitable contributions for Heath and Lori Golden for 2005); JX 677 (letter from Frizzi Linck to Jennifer Canterbury, requesting donation letters on behalf of individuals including Culang (Jan. 27, 2006)).

provide Hampshire employees with documentation supporting amounts that they claim as charitable deductions.[271]

It is true that Navigant concluded, that "[t]his issue [did] not have any financial implications for the company, only to individual employees who may have taken improper tax deductions."[272] But Clayton nonetheless knowingly caused the corporation to engage in legally questionable activity by facilitating improper tax deductions by Hampshire's employees, board members, and officers. I find this to be a breach of the duty of loyalty.

As to Clark, by contrast, I find no evidence that he knowingly did anything improper by taking a single tax deduction in 2003, and reiterate that the current Hampshire CEO, a trained lawyer who served for three years as Hampshire's General Counsel, took a similar deduction.

6. Hampshire Has Not Proven That Clayton Breached His Fiduciary Duties By His Role In The Withdrawal Of Hampshire's New York Tax Registration In 1987

Hampshire has also accused Clayton of committing a breach of fiduciary duty in 1987, when Ronald Reagan was still our President. That breach allegedly involved Clayton's involvement in a decision to have Hampshire, as a holding company, withdraw its registration to do business in New York. For some unexplained reason, Clayton did not move to dismiss this claim on grounds of laches even though it is clearly time barred,

[271] JX 652 (letter from Charles Clayton to Pastor Larry Clinksdale (Dec. 14, 2004)) at HAMPDE 125383-84 (requesting a letter reflecting that Kuttner had donated sweaters); JX 700 (letter from Charles Clayton to Linda McAtee (Dec. 29, 2004)) (requesting a letter showing that Kuttner had donated sweaters).
[272] Navigant Report at DT 766.

and even though Hampshire's complaint only raises this claim against Kuttner.[273] Hampshire claims that for 19 years the board and the company's financial and legal advisors were unaware that the parent holding company was no longer registered to do business in New York.

Hampshire claims that Clayton withdrew the registration to aid Kuttner in reducing his personal taxes. As one would suspect, the facts on such a stale claim are murky. In 1977, Hampshire registered in New York because it had key employees and assets there, including Kuttner, and it maintained a New York phone number for itself.[274] In 1987, Hampshire withdrew its registration when Kuttner purchased a home in Virginia that he claimed as his primary residence.[275] Sperry testified that Clayton had not obtained board approval for this action and concealed the fact that he had withdrawn Hampshire's New York registration,[276] although Clayton claims that the board was aware of the withdrawal.[277]

Hampshire claims that Clayton withdrew its registration because he was trying to reduce Kuttner's personal tax liability after Kuttner purchased a home in Virginia. But Clayton argues that he was told by Hampshire's former tax manager in 1982 that, because Kuttner, the CEO, was no longer based in New York, Hampshire could withdraw

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[273] Compl. ¶¶ 39-42. Instead of dropping the claim after settling with Kuttner, Hampshire presented evidence to implicate Clayton.
[274] Tr. at 390-91 (Sperry), 675 (Clayton), 845 (Norwood).
[275] *Id*. at 392 (Sperry).
[276] *Id*. at 392, 577 (Sperry).
[277] *Id*. at 754-55 (Clayton).

its registration.[278] According to Clayton, Hampshire's outside financial advisor also told Hampshire's tax managers that Hampshire did not need to be registered to do business in New York.[279] To support the withdrawal, it appears that Hampshire kept New York-based employees on the payroll of subsidiaries, which continued to be registered and pay taxes in New York.[280] Clayton also claims that he raised the issue with Grant Thornton in December 2005, who told Clayton that Hampshire was not required to register in New York,[281] but, according to Norwood, Grant Thornton never looked into the issue.[282]

When the issue surfaced as part of the internal investigation in 2006 and with new auditors, it was concluded that the registration should not have been withdrawn and that Hampshire had a sufficient presence at all times as a parent company in New York to be required to register.[283] As a result, Hampshire entered discussions with the State of New York, and paid interest for back taxes for the years that it had failed to register.[284]

I am not persuaded that Clayton committed a breach of fiduciary duty with regard to the withdrawal of registration in 1987. Whether it is admirable or not, tax planning is regularly done. With the move of the CEO to Virginia, the fact that most of the corporation's actual production operations were other than in New York, its principal place of business was in South Carolina, and the continued registration of New York subsidiaries, I cannot pierce through the murk of a generation and conclude that Clayton

[278] *Id*. at 748 (Clayton).
[279] *Id*. at 749-50 (Clayton).
[280] *Id*. at 673-75, 749 (Clayton), 850-51 (Norwood).
[281] *Id*. at 724, 752-53 (Clayton).
[282] *Id*. at 849 (Norwood).
[283] *Id*. at 847 (Norwood).
[284] Hampshire Opening Post-Trial Brief Ex. 5.

knowingly caused Hampshire to violate the New York tax laws. Withdrawing the registration of the parent and taking steps, such as booking employees on the books of active subsidiaries, is precisely the sort of engineering that tax planners do all the time.

Clayton's failure to gin up the tax manager and outside auditors from the late 1980s as trial witnesses is explainable by the passage of time, and I find it credible that the tax manager and outside financial advisors were involved in and aware of the original decision to withdraw.[285] Moreover, Sperry admitted that Hampshire engaged in important transactions for which Willkie Farr lawyers, including ones working for Sperry when he was still Hampshire's counsel himself, procured copies of the company's tax registration forms.[286] This includes the transaction that brought Hampshire public.[287] And, I find that Clayton's testimony that the board, and especially Sperry, knew about this issue is at least as credible as Sperry's denial.[288] To me, the most plausible inference is that the corporation's directors, outside counsel, various general counsels, and outside auditors were periodically aware that the parent group was not registered in New York and did not find that troubling. At best, I am persuaded that Clayton, along with the corporation's tax manager, auditors, inside and outside counsel, made and continued an aggressive tax planning move in a hope to reduce Hampshire's tax exposure. I cannot conclude that Clayton acted in bad faith or in gross negligence. In so finding, I admit to

[285] Tr. at 748-49 (Clayton).
[286] *Id*. at 519-30 (Sperry).
[287] *Id*. at 754-55 (Clayton).
[288] *Id*.

being influenced by the fact that Hampshire bears the burden of persuasion and that it has conveniently laid a generation old decision solely at Clayton's door.

7. Hampshire Has Proven That Clark And Clayton Breached Their Fiduciary Duties By Filing False Statements Regarding The Integrity Of Hampshire's Internal Controls And Financial Statements

Finally, Hampshire argues that Clayton and Clark breached their fiduciary duties by making false certifications regarding certain Hampshire financial statements. As CFO, Clayton certified Hampshire's annual reports with the SEC from the 2003 through the first quarter of 2006.[289] Clark as Principal Accounting Officer signed sub-certifications of financial statements from year-end 2003 to 2006.[290] Specifically, Hampshire claims that these financial statements misstated the financial condition of Hampshire, and failed to disclose errors in Kuttner's expense reports, the use of special expense accounts by Item-Eyes Executives, and the allegedly fraudulent sweater and tuition payments.

Clark never signed Hampshire's financial statements. Instead, he internally signed draft financial statements, certifying that the draft statements disclosed the financial condition of Clark's department, and that Clark had "disclosed . . . to the Chief Financial Officer . . . all significant deficiencies and material weaknesses in the design or operation

[289] JX 570-72 (Hampshire Group, Ltd. Form 10-Ks for 2003, 2004, and 2005); JX 680 (Hampshire Group, Ltd. 2005 Form 10-K excerpts showing Kuttner and Clayton certifications (Mar. 31, 2008)); JX 681 (Hampshire Group, Ltd. Form 10-Q for the first quarter of 2006 showing Kuttner and Clayton certifications (May 9, 2006)).

[290] JX 529 (memo from Charles Clayton regarding Sarbanes-Oxley certification for the reporting period ended April 2, 2005 (Apr. 18, 2005)).

of internal controls over financial reporting for which [he] ha[d] responsibility . . . ."[291] Clayton, on the other hand, signed Hampshire's final financial statements, and certified that "based on [his] knowledge," Hampshire's public filings did not "contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made . . . not misleading . . . ."[292]

I have already covered in detail the specific instances of wrongdoing that Hampshire alleges. Only as to the tuition, Item-Eyes, and sweater matters do I conclude that one or more of Clayton or Clark knew of or engaged in improper conduct. I note that as to these matters, it does not appear that any of them resulted in a purposeful overstatement of Hampshire's earnings. Because, however, these instances did involve the circumvention of important legal requirements and in some instances (*i.e.*, the tuition issue and Item-Eyes) the conscious misstatement of the corporation's books and records, it was a breach of the duty of loyalty for Clayton and Clark to sign certifications or sub-certifications without disclosing to the Audit Committee what they knew about those issues. Because I will address any harm caused by Clayton and Clark specifically when addressing the underlying matters, I do not award any separate damages. But I do conclude that when a corporate officer is aware of financial misreporting that involves high-level management and that has evaded the corporation's auditors, and nonetheless certifies that he is not aware of any material weakness in the company's internal controls,

[291] JX 595 (Clark's sub-certification of draft financial statements) at HAMPDE 557.
[292] *E.g.*, JX 570 (Hampshire Group, Ltd. 2003 Annual Report at Ex. 31.2).

he is making a false statement and failing to bring material information to the board, in breach of his duty of loyalty.

B. Hampshire's Remaining Claims

Hampshire has also asserted claims based on the seven preceding issues under a variety of other rubrics than breach of fiduciary duty. For example, raising the same facts that form the basis of their breach of fiduciary duty claims, Hampshire alleges that Clayton and Clark's actions constituted both waste and fraud. Hampshire devoted a meager one and a half pages of its opening post-trial brief to these arguments, and dropped discussion of the claims altogether in its answering post-trial brief.[293] But, for the sake of thoroughness, I now analyze each of these claims.

1. Hampshire Does Not Have Any Basis To Receive Additional Relief From Clayton And Clark For Fraud

Common law fraud in Delaware requires proof of: (1) a false misrepresentation of fact; (2) knowledge or belief that the representation was false; (3) the intention to induce the plaintiff to act or refrain from acting; (4) justifiable reliance on the part of the plaintiff; and (5) damages as a result of the plaintiff's reliance.[294] In the context of fiduciary relationships, fraud occurs through "deliberate concealment of material facts, or by silence in the face of a duty to speak."[295]

Hampshire asserts that Clayton and Clark committed common law fraud by paying Kuttner for unverified expense reports, mischaracterizing Linck's tuition as a charitable

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[293] Hampshire Opening Post-Trial Brief at 38-39.
[294] *See Latesco, L.P. v. Wayport, Inc.*, 2009 WL 2246793 (Del. Ch. July 24, 2009) (listing the elements of common law fraud).
[295] *Albert v. Alex. Brown Mgmt. Servs., Inc.*, 2005 WL 2130607, at *7 (Del. Ch. Aug. 26, 2005).

contribution, and signing false financial statements, and that Clayton committed fraud by supervising the Item-Eyes expense accounts. This is nothing more than a reframing of Hampshire's fiduciary duty claim, and does not support an independent basis for relief.[296] To the extent I have earlier found that Clayton and Clark are responsible for any harm suffered by Hampshire for their failure to disclose information or for their certifications of certain factual statements, I will award relief under the fiduciary duty claim. My conclusion that they breached their duty of loyalty by consciously falsifying corporate records or by making certain false statements covers the same ground. In this regard, it is notable that it is easier to prove liability on the basis of misstatements by a fiduciary than it is for a non-fiduciary, and the more stringent duty of loyalty takes that into account.[297] The fraud claims are superfluous as the more applicable, context-specific disclosure obligations of corporate officers apply.[298]

[296] *Triton Const. Co.*, 2009 WL 1387115, at *20 (rejecting a fraud claim that was premised on the same facts as those underlying a fiduciary duty claim because "liability on a claim for fraud arising out of the same facts" could not entitle the plaintiff to any new relief, and because to award damages for fraud and breach of fiduciary on the same underlying facts would constitute punitive damages); *Albert*, 2005 WL 2130607, at *7 (rejecting a claim for fraud where the allegations underlying the fraud claim rehashed a breach of fiduciary duty claim, and failed to plead with particularity what the defendants obtained through their alleged fraud).
[297] *See Metro Commc'n Corp.*, 854 A.2d at 156-57 (explaining the substantial overlap between fraud claims and fiduciary duty claims, and observing that "the standards that a fiduciary faces are tougher than the common law and equitable fraud standards, which always require proof of reasonable reliance").
[298] To the extent Hampshire wishes to argue equitable fraud, it waited too long. It had ample time to amend its complaint to do so. Moreover, I do not understand how such a claim can improve on the company's ability to subject Clayton and Clark to liability for misdisclosures as a fiduciary. To the extent that they wish to hold corporate officers liable for merely negligent misstatements of fact, they collide with the policy basis for applying a gross negligence standard and I believe that our law would preclude such an application of the concept of equitable fraud. But I need not answer the question because Hampshire did not timely raise an equitable fraud claim.

2. <u>Hampshire Has Not Proven That Clayton And Clark Committed Waste</u>

The waste test is just another way to examine whether a fiduciary breach has been committed.[299] Here, I have examined all the underlying fiduciary duty claims and see no basis to conduct a separate waste analysis.

Hampshire's waste claim is confined to the allegations that Clayton and Clark committed waste by approving Kuttner's expense reports, and that Clayton committed waste by approving payments for the Item-Eyes Executives' personal expenses without receiving consideration for Hampshire.[300] Hampshire has not shown that Clayton and Clark breached their fiduciary duties by approving Kuttner's expense reports, much less demonstrated facts that rise to the high threshold of a waste claim. And, although Hampshire has shown that Clayton breached his duty of loyalty by allowing the Item-Eyes Executives to be reimbursed for personal expenses, they have done so because Clayton caused the corporation to violate the law. I accept as credible Clayton's testimony that it was everyone's understanding that the Item-Eyes Executives were allowed to live like Diddy[301] to the tune of $140,000 annually. As a purely business, and not law compliance matter, it would be difficult to conclude that allowing the Item-Eyes Executives to enjoy their Courvoisier on the company's dime rose to the level of waste,

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[299] *See Sample v. Morgan*, 914 A.2d 647, 669-70 (Del. Ch. 2007) (observing that "[c]laims of waste are sometimes misunderstood as being founded on something other than a breach of fiduciary duty. Conceived more realistically, the doctrine of waste is a residual protection for stockholders that polices the outer boundaries of the broad field of discretion afforded directors by the business judgment rule"); *Disney*, 906 A.2d at 74 (discussing that the "onerous standard for waste is a corollary of the proposition that where business judgment presumptions are applicable, the board's decision will be upheld unless it cannot be attributed to any rational business purpose").

[300] Hampshire's Opening Post-Trial Brief at 39.

[301] *See* Sean John, About Us, http://www.seanjohn.com/#/about/.

as apparently Item-Eyes was a valuable addition and did well.[302] If management and the board had simply grossed up the $140,000 annually for taxes and awarded it as compensation, it would be difficult to say that corporate waste occurred if it motivated the Item-Eyes Executives to kick fashion bootay.[303] The key point, however, is that I have already concluded that Clayton breached his duty of loyalty by knowingly permitting an illegal practice. That is the essence of his violation, not waste.

C <u>Hampshire Has Not Proven Unjust Enrichment, But Has Proven That A Hampshire Policy Requires Clayton And Clark To Repay Their Incentive Bonuses In Part</u>

Hampshire's final claim against Clayton and Clark seeks to recover bonuses paid to Clark and Clayton from the years that Hampshire was required to restate its financial statements on the theory of unjust enrichment. Unjust enrichment is "the unjust retention of a benefit to the loss of another, or the retention of money or property of another against the fundamental principles of justice or equity and good conscience."[304] To prove unjust enrichment, Hampshire must show: "(1) an enrichment, (2) an impoverishment, (3) a relation between the enrichment and the impoverishment, (4) the absence of justification, and (5) the absence of a remedy provided by law."[305] According to Hampshire, it is

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[302] *White v. Panic*, 783 A.2d 543, 554 (Del. 2001); *Disney*, 906 A.2d at 74 (stating that waste will only be found "in the rare unconscionable case where directors intentionally squander or give away corporate assets") (citations omitted).
[303] *See President and Fellows of Harvard College v. Glancy*, 2003 WL 21026784, at *23 (Del. Ch. Mar. 21, 2003) (rejecting a waste claim where the plaintiffs have failed to prove "a complete failure of consideration . . . or that no person of sound business judgment could conclude that [the company] received adequate consideration").
[304] *Schock v. Nash*, 732 A.2d 217, 232 (Del. 1999) (quoting *Fleer Corp. v. Topps Chewing Gum, Inc.*, 539 A.2d 1060, 1062 (Del. 1988)).
[305] *Jackson Nat. Life Ins. Co. v. Kennedy*, 741 A.2d 377, 393 (Del. Ch. 1999) (citations omitted).

unjust to allow Clayton and Clark to retain their incentive-based bonuses (the "Incentive Bonuses") from those years that they were "damaging" Hampshire.[306]

Hampshire bears the burden of persuasion on this issue, and I conclude that it has not met that burden. For starters, I admit to being reluctant to craft a per se rule in equity that corporate officers responsible for helping prepare financial statements must automatically disgorge their bonuses for any year in which the company's financial statements are restated. In Sarbanes-Oxley, Congress crafted a provision that requires public company CEOs and CFOs to disgorge bonuses if there is a restatement because of material noncompliance.[307] That provision does not create a private right of action and Hampshire cannot rely upon it here, even as to Clayton, who as CFO, was subject to the statute.[308]

The absence of a statute, of course, does not mean that equity cannot supply a remedy and that unjust enrichment may not have a role. As Hampshire notes, I put in place a strong unjust remedy in the case of *In re HealthSouth Corp. S'holders Litig.*[309] In that case, the former Chairman and CEO of HealthSouth, Richard Scrushy, signed financial statements that were materially inaccurate to the tune of $2 billion.[310] When HealthSouth's stock price was boosted artificially by the financial statements, Scrushy transacted with the corporation to reduce a $25 million debt he owed the company by

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[306] Hampshire Opening Post-Trial Brief at 39.
[307] Sarbanes-Oxley Act of 2002, § 304, 15 U.S.C.A. § 7243.
[308] *See, e.g.*, *Neer v. Pelino*, 389 F. Supp. 2d 648 (E.D. Pa. 2005) (holding that Section 304 of the Sarbanes-Oxley Act is enforceable only by the SEC and does not provide private plaintiffs standing to bring a claim against a CEO or CFO); *In re BISYS Group Inc.*, 396 F. Supp. 2d 463 (S.D.N.Y. 2005) (same); *Kogan v. Robinson*, 432 F. Supp. 2d 1075 (S.D. Calif. 2006) (same).
[309] 845 A.2d 1096 (Del. Ch. 2003).
[310] *Id*. at 1099.

purporting to pay off that debt by giving the company stock that was supposedly equal in value to the debt.[311] I held that Scrushy had been unjustly enriched, and the buyback transaction was rescinded.[312] That holding was based in large part on the fact that the market price of HealthSouth's stock, which was paid to Scrushy for his shares, was based primarily on the inflated financial statements.[313] Without finding that Scrushy as CEO knew that the financial statements were materially inflated, I concluded that he was unjustly enriched because he had caused the corporation to enter into a self-dealing transaction with himself using the market price as the objective indicator of fairness.[314] Having done so and having been responsible, as the corporation's CEO, for overseeing the affairs of the corporation, including importantly the preparation of financial statements, Scrushy had unjustly benefited from the falsely inflated market price of the company's stock and reduce a debt he owed to the corporation in cold, hard cash.[315]

I do not find *HealthSouth* to be controlling here for a few reasons. That case dealt with a situation where it was clear that senior corporate officers had taken action to purposely inflate the corporation's GAAP earnings by a material amount and to thereby artificially lift its stock price.[316] In that context, when the CEO of the corporation causes the company to enter into a transaction with himself using the market price as the litmus test for fairness and the market price is fundamentally tainted, it is far easier to see a

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[311] *Id*. at 1100.
[312] *Id*. at 1105-06.
[313] *Id*. at 1106.
[314] *Id*.
[315] *Id*.
[316] *Id*. at 1100-03.

gross injustice than in the circumstances here. When the underlying accounting misconduct is designed to pump up the corporation's stock price, there is an obvious danger that equity should address that officers and employees have cooked the books in part to increase the amount of their own bonuses and compensation.

To apply that approach in every case where there has been a restatement would create a strict liability rule in equity that could be counterproductive for stockholders and erode some of the important values served by the business judgment rule. Although I in no way applaud the financial management philosophy that prevailed at Hampshire, either at the managerial or the board level, there is no evidence that Clayton and Clark — or even Kuttner — sought to portray artificially Hampshire to the capital markets as more profitable than it was. Indeed, to the extent that Kuttner actually took out more expenses than he should have, he reduced the profitability of the corporation on its books and records. That is also true for the Item-Eyes situation.

In circumstances like these when the Restatement does not involve earnings inflation but more targeted problems and when any harm caused by those problems is remediable in damages as a remedy for breach of fiduciary duty, I believe it would be unwise to use the crude tool of unjust enrichment to strip an executive of any bonus earned during the period in question. As we shall see, corporations can deal with this problem through contracting, and a court should be reluctant to craft a blanket rule. *HealthSouth* did not set out a blanket rule, and I do not believe it covers this situation.

That is especially so when Hampshire has not persuasively outlined the extent to which the Incentive Bonuses due to Clayton and Clark were overstated as a result of the

Restatement. The Incentive Bonuses were calculated under a formula that is not at all clear. But, admittedly, the formula appears to give equal weight to Hampshire's net income along with net sales.[317] Thus, an increase in net income would tend to increase Clayton and Clark's Incentive Bonuses. But most of the Restatement was attributable to a problem that I do not find is properly laid at the doorstep of either Clayton or Clark. Nearly half of the Restatement[318] was the result of Hampshire's failure to obtain shareholder approval for its § 162(m) Plan as required by the Internal Revenue Code.[319] Late in the litigation and without amending its complaint to fairly raise the issue and, thus, without subjecting the issue fairly to discovery, Hampshire has argued that it was Clayton's job as CFO to make sure that approval of Hampshire's § 162(m) Plan was on the annual meeting agenda. I do not so conclude. The corporation had a general counsel and long-standing outside counsel, Sperry's former firm, Willkie Farr, that helped prepare the corporation's SEC filings for the annual meeting. As part of counsel's role, it should have helped the financial professionals understand what items needed to be approved by stockholders. Trial testimony also indicated that the executive compensation plan was under the purview of the board's Compensation Committee.[320] I

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[317] *See* JX 290 (Hampshire Group, Limited Incentive Bonus Program for Charles Clayton); JX 291 (Hampshire Group, Limited Incentive Bonus Program for Roger Clark).
[318] *See* JX 289 (memorandum from Helen Hollifield and Chris White of Deloitte (May 18, 2007)) (discussing the amount of the restatement and attributing $3.5 million to the § 162(m) issue).
[319] *See* I.R.C. § 162(m)(4)(C)(ii).
[320] For example, Winter, a member of the Compensation Committee, explained that the requirement of § 162(m) were not met in part because of certain board resolutions that would have ensured compliance were never put into effect. *See* Winter Dep. at 57. Similarly, an internal analysis of Hampshire's § 162(m) problem concluded that no board documentation or

find no basis to conclude that Clayton was grossly negligent because he, as a non-lawyer, did not catch a legal issue that the corporation's General Counsel, outside counsel, and Compensation Committee did not.

Moreover, there were other items in the Restatement — such as Kuttner's expenses — that related to issues that I do not find were the result of a breach of fiduciary duty by Clayton or Clark. To strip their Incentive Bonuses because they were financial officers alone, rather than as a result of breach of duty, seems to be a crude tool, not in keeping with equity's preference to do situationally-specific justice.

In this regard, I am also conscious that it is possible to conceive of a stripping of a bonus as not a damages award, but a restitutionary one. But Clark's situation points out the difficulty of that. Although Clark made a base salary that was roughly twice the median family wage ($104,000), his salary was hardly lavish.[321] Most of the junior lawyers who worked on this case make annual salaries greater than that. Clark's annual Incentive Bonuses were in the $30,000 range.[322] It is likely that he depended on those Bonuses to pay a lot of his bills. That is also true for Clayton, even though he was paid more in compensation.[323] To strip them of all of those Bonuses after the fact on the basis that the financial statements for those years had to be restated in certain ways seems disproportionate when more proportionate remedies are available.

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certification regarding approval of executive bonus plans could be found. *See* JX 797 (Hampshire analysis of § 162(m) issues from 1999-2005).

[321] U.S. CENSUS BUREAU, INCOME, POVERTY, AND HEALTH INSURANCE COVERAGE IN THE UNITED STATES: 2008 5 (2009), *available at* http://www.census.gov/prod/2009pubs/p60-236.pdf (stating that median family income in the United States in 2008 was $50,303).

[322] *See* JX 291 (calculation of Clark's 2006 bonus).

[323] *See* JX 290 (calculation of Clayton's 2005 and 2006 bonuses) (showing a bonus of $399,821 in 2005 and $168,000 in 2006).

To that point, it is also worth noting that in stark contrast to the situation in *HealthSouth*, the Restatement here did not involve issues that fundamentally mis-portrayed Hampshire's status. Most of the Restatement was simply reductions in reported earnings resulting from increases in reserves to take into account possible liabilities for taxes and penalties due to certain misreporting. As it turns out, most of those liabilities have not come to pass, and the reserves are almost entirely eliminated and restored to the balance sheet as earnings.[324] Having more nuanced tools available to rectify any wrongdoing by Clayton and Clark, I cannot conclude that all of their bonuses were unjustly received.

Before concluding, I address an alternative ground that provides a stronger basis for recoupment of part of Clark and Clayton's Incentive Bonuses. Hampshire also seeks to claw back Clark and Clayton's Bonuses by pointing to a memorandum that Kuttner, of all people, put out on November 23, 2005 (the "Clawback Memorandum"). The Memorandum states in pertinent part:

> I want to remind everyone that we established a policy some time ago that applies to the CEO and the CFO of the company based on the SEC's requirements: "If numbers have to be re-stated, the bonus for that year for the CEO and CFO, by law, will be eliminated." This rule should be applied also to all persons involved in giving input for or putting the numbers together to emphasize that we should record and report any possible liabilities right away, so that we don't have any un-recorded or under-recorded liabilities on our books. If there is uncertainty, you can report the issues in question immediately with a range of possible liability so that we

[324] *See* Tr. at 910-11, 915-16, 930 (Norwood) (indicating that the reserve for approximately $3.5 million for the § 162(m) issue has expired, that a reserve for approximately $500,000 has expired, and that a reserve for approximately $600,000 will expire in 2010 or 2011).

> can then all together evaluate which way to go and then we are all together on the same boat.[325]

The Memorandum was sent to several officers who were materially involved in the preparation of Hampshire's financial statements, including Clayton and Clark.[326]

Because neither Clayton nor Clark, as will be seen, had written contracts entitling them to bonuses of any kind and were at-will employees, I have little difficulty concluding that this policy put them on notice that Hampshire had the right to claw back any bonus compensation for periods *after* the policy was announced. The Memorandum's offhand reference to the policy going into effect as to the CEO and CFO at an earlier time is not supplemented by Hampshire with any convincing proof. Because Hampshire does not document that supposed policy or the date of its adoption, I can only conclude that this reference was just a way of stating that § 304 of the Sarbanes-Oxley Act had earlier become effective as law.

For Hampshire to announce that it was retroactively subjecting bonuses for periods before the policy went into effect to clawback would be equitably problematic. But on a prospective basis, it is entirely legitimate for an employer to make clear that the award of a bonus to certain employees for future periods was subject to a clawback right if the financial statements for those periods had to be restated. Clayton and Clark knew about the policy after receiving the Clawback Memorandum, and thus only knew that

[325] JX 590 (memo from Ludwig Kuttner to Charles Clayton, Roger Clark, Michael Culang and others (Nov. 23, 2005)).
[326] *Id*.

their bonuses for periods after November 2005 were subject to the clawback Kuttner announced.[327]

Thus, to the limited extent that Clayton and Clark received Incentive Bonuses after the Clawback Memorandum, Hampshire has the right to receive them back. In so ruling, I note that Hampshire has been less than consistent in applying the policy. Contrary to the memo, Hampshire has not sought a clawback from all who were subject to the policy by its terms, that is, all "persons involved in giving input" for Hampshire's numbers.[328] For example, Culang, who was the CEO of Hampshire Designers, Inc. and Hampshire Brands before becoming Hampshire's interim CEO, was not asked to pay back his bonus when the corporation parted company with him and he received a million dollar plus severance package. But this is not a discrimination case under the 14th Amendment, it is a corporate law case and there is no injustice in holding Clayton and Clark to the policy under which they claimed Incentive Bonuses after the Clawback Memorandum of November 23, 2005.

In this regard, it is worth noting that the Kuttner policy,[329] although from an ironic source, is a good example of the company-specific flexibility that corporations retain to create more healthy incentives for employees to be scrupulous in complying with their financial reporting and legal obligations. By subjecting the receipt of bonuses to a clawback condition, employers can create an incentive for compliance, but also shape the

[327] Tr. at 210-211 (Clark), 677-79 (Clayton); Clark Dep. at 340; Clayton Dep. at 246.
[328] *Id.*
[329] That Kuttner wrote this Memorandum suggests that he was not engaged in pumping up the numbers, however much he may have been siphoning off extras for himself. Such improper siphoning, of course, would lower, not inflate, reported earnings.

way they do it and the employees to whom the policy should apply in a way that is contextually appropriate. To fashion a blanket rule of equity that any incentive compensation should be stripped automatically from any employee involved in financial reporting for periods for which a restatement was filed would preclude such private ordering, and substitute a judicial judgment for the business judgment investors bargain for.

IV. Clayton And Clark's Counterclaims

Clayton and Clark have both brought counterclaims under South Carolina law[330] against Hampshire for breach of contract and defamation. Clayton's breach of contract counterclaim demands payment of: vacation pay; so-called Incentive Bonuses; a bonus related to a contract for a Hampshire vendor (a "Link Bonus"); a 401(k) contribution; severance pay; unreimbursed travel expenses; and "terms of employment" benefits. He also seeks to recover for purported damages that Hampshire caused to his deferred compensation funds. Clark's breach of contract counterclaim is similar, and seeks payment of: vacation pay; a 2006 Incentive Bonus; a Link Bonus; and severance pay. To

[330] Clark and Clayton do not have employment contracts that contain choice of law clauses. Therefore, choice of law questions are governed by the most significant relationship test set forth in the Restatement (Second) of Conflicts of Laws. To determine which state has the most significant relationship, the following factors are considered: (1) the place where the injury occurred; (2) the place where the conduct causing the injury occurred; (3) the domicil, residence, nationality, place of incorporation, and place of business of the parties, and (d) the place where the relationship, if any, between the parties is centered. *See* RESTATEMENT (SECOND) OF CONFLICTS OF LAWS § 145(1) (1971); *Travelers Indem. Co. v. Lake*, 594 A.2d 38, 46-47 (Del. 1991). The parties agree that the balance of all of these factors points to South Carolina.

prove a breach of contract, Clayton and Clark have the burden to prove "the existence of the contract, its breach, and the damages caused by the breach."[331]

Both Clayton and Clark also bring defamation counterclaims, arguing that Hampshire press releases falsely implied that Clark and Clayton had been terminated for participating in wrongdoing at Hampshire. Clayton and Clark also request indemnification from Hampshire.

Clayton has also brought a third party claim for contribution against the Third Party Defendants — certain of Hampshire's current and former directors and officers — alleging that the Third Party Defendants had knowledge of and participated in each of the issues that Hampshire raises in its complaint. I deal with that claim, as well as Clayton and Clark's request for indemnification, in the last section addressing the final judgment. For now, I focus on the direct claims Clayton and Clark have made against Hampshire.

A. <u>Hampshire Terminates Clayton and Clark</u>

As mentioned earlier in this opinion, Kuttner and Clayton were terminated on September 25, 2006, and Clark remained on administrative leave at that time. The minutes of a September 25, 2006 board meeting explain that Navigant and Paul Weiss had presented their preliminary findings to the Audit Committee on September 20, 2006 and based on that report, Winter recommended that Kuttner and Clayton be terminated immediately.[332] The board approved that recommendation by a vote of 4-1, with Kuttner

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[331] *Branche Builders, Inc. v. Coggins*, 686 S.E.2d 200, 202 (S.C. App. 2009) (citations omitted); *see also* 23 WILLISTON ON CONTRACTS § 63:14 (4th ed.) ("The plaintiff or party alleging the breach has the burden of proof on all of its breach of contract claims.").
[332] JX 51 (minutes of the board meeting of Hampshire's board of directors (Sept. 25, 2006)).

voting against it.[333] But, at trial, Sperry and Winter testified that Clayton was terminated primarily because Norwood had already been hired to replace him, and not because of the findings of the investigation.[334] That is, the board chose not fire Clayton for cause, although they recognized that they could have.[335]

Clark was informed on December 1, 2006 that his employment would end effective December 29, 2006.[336] The board had decided that Clark's "services were no longer required" because his duties could be performed by someone else — namely, Langley, one of the authors of the Internal Review Memorandum.[337] Clark's job performance was not discussed by the board in reaching this decision,[338] and Clark's personnel file states that he had been laid off and was entitled to severance and vacation pay.[339] The board offered to pay Clark for his accrued vacation, severance pay, and 2006 incentive bonus if Clark were to release all claims against Hampshire, but Clark refused, claiming that he was owed more severance pay and an additional bonus.[340]

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[333] *Id.*

[334] Tr. at 445 (Sperry), 1010-1012 (Winter); Winter Dep. at 121-22 (explaining that Norwood had been hired to replace Clayton because Norwood had superior skills).

[335] Tr. at 1010 (Winter).

[336] JX 23 (letter from Heath Golden to Roger Clark (Dec. 1, 2006)).

[337] Tr. at 447 (Sperry); Winter Dep. at 122 (explaining that Clark was terminated because Langley had superior skills).

[338] *Id.*

[339] JX 304 (termination checklist, payroll action form, and memo regarding a pay request from Hampshire) at HAMPDE 778.

[340] JX 23 (letter from Heath Golden to Roger Clark (Dec. 1, 2006)); JX 26 (letter from Michael Jackson to Roger Clark (Feb. 13, 2007)).

B. Analysis

1. Breach Of Contract

Clayton and Clark's breach of contract claims allege that Hampshire has failed to provide them with benefits that they are due under their employment contracts.

a. Clayton, But Not Clark, Has Shown That He Is Entitled To Some Vacation Pay

Clayton and Clark argue that they are entitled to recover for unpaid vacation days. Under South Carolina's Payment of Wages Act, "when an employer separates an employee from the payroll for any reason, the employer shall pay all wages due to the employee within forty-eight hours of the time of separation or the next regular payday which may not exceed thirty days."[341] "Wages" are defined by the statute to include "vacation, holiday, and sick leave payments which are due to an employee under any employer policy or employment contract."[342]

[341] *Id*. § 41-10-50.

[342] *Id*. § 41-10-10(2). In conducting independent research, I found South Carolina cases holding that an employee's breach of his duty of loyalty works a forfeiture of the employee's right to claim any compensation under both statutory and common law theories. *See Futch v. McAllister Towing of Georgetown, Inc*., 518 S.E.2d 591, 594-95 (S.C. 1999) ("This Court's precedent establishes that an employee who breaches the common law duty of loyalty to an employer . . . forfeits the right to compensation." (citing *Schuermann v. Am. KA-RO Corp.*, 367 S.E.2d 159, 160 (S.C. 1988) (holding that an employee who had been fired for cause for breaches of his duty of loyalty gave his employer the right to void his employment contract))); *Berry v. Goodyear Tire & Rubber Co.*, 242 S.E.2d 551, 552-53 (S.C. 1978) (finding that an employee had abandoned his employment contract by acting disloyally to his employer, and could no longer recover any employment benefits after the employee breached his duty of loyalty). If this were the case, all of Clayton and Clark's breach of contract claims would be unsustainable. But Hampshire did not rely on this line of cases or this argument. Although I love shrimp and grits, I do not pretend to be an expert in South Carolina employment law and will not rely on an argument an aggressive litigant like Hampshire could have made but did not. Given my lack of familiarity with South Carolina contract law, I choose to address the merits of each of Clayton and Clark's counterclaims based on the arguments the parties actually made.

I reject Clark's vacation claim. Clark was specifically informed on December 1, 2006 that he was being terminated on December 29, 2006 and should use up his remaining vacation time.[343] That specific notice informed him that his previous status as being on paid leave without any job responsibilities was now qualified by a duty to use up his remaining vacation time. Having no duties to prevent him from taking vacation, Clark should have used it up. Moreover, I reject Clark's claim that he had an extra week of vacation time for 2005 that he was permitted to hold over under an unspecified policy that Clayton had implemented.[344] Under Hampshire's Personnel Policy, holdover vacation time was discouraged, and employees were given five holdover days only if a supervisor had cancelled their vacation and it could not be rescheduled during the remainder of the year.[345]

I grant Clayton some vacation pay. In sharp contrast to Clark, Clayton was never told that he had to use his vacation time while on paid leave he did not request.[346] Although he was on involuntary paid leave from June 21, 2006 until his termination on September 25, 2006, Clayton was not told that he had to use his vacation time if he wished to claim it. Having been put on unpaid leave, Clayton had no notice that he

[343] JX 23 (letter from Heath Golden to Roger Clark (Dec. 1, 2006)); Tr. at 200-01 (Clark) (acknowledging that he was told to take his vacation days during his administrative leave, but did not do so).
[344] Tr. at 182 (Clark).
[345] Personnel Policy at 6.
[346] Hampshire argues that an email from Clayton discussing the terms of Item Eyes Executive Ellen Becker's termination shows that he knew employees had to use their vacation time while on paid leave. JX 705 (email from Charles Clayton to Richard Isaacson (Aug. 26, 2003)). In that email, Clayton opined that "vacation is not an issue since Ellen is on paid leave." *Id.* But it is possible that Becker, like Clark, had been told to take her vacation time while on leave, and that Clayton's opinion was based on Becker having been given that notice.

should have been putting in for vacation during this unusual status declared by the board itself.

I thus award Clayton his vacation time for the period January 1, 2006 until June 12, 2006 when Clayton was put on leave. But I do not award him any held-over days from previous years. Clayton argues that he had "permission" from Kuttner to carry over 10 vacation days or that, alternatively, he should be given five carry-over days under the Hampshire Personnel Policy which allows an employee to carry over five vacation days into the following year if an employee's vacation is cancelled by their supervisor.[347] The only support for his claim that he could not use the time earlier is his own testimony that Kuttner asked him not to take a scheduled vacation and orally promised him he could keep the days, plus five more.[348] I am not persuaded that Clayton was unable to use the days on this basis because there is no written documentation of any request for approval for a carry-over and I am not prepared to base an award on Clayton's mere say so. Moreover, if he had holdover days, the Personnel Policy required that those days be used by March 31 or be forfeited.[349] I award Clayton only those vacation days that he was entitled to under Hampshire's Personnel Policy for the period of 2006 before he was put on leave, which I quantify in the final remedies section.[350]

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[347] Clayton's Opening Post-Trial Brief at 45-46; Personnel Policy at 6 ("In the event that an employee's vacation, which was scheduled late in the year is cancelled by their supervisor and cannot reasonably be scheduled during the remainder of the year, the employee may carryover up to five (5) unused vacation days into the following year, which must be used by March 31, or will be forfeited.").
[348] Tr. at 767-68 (Clayton).
[349] Personnel Policy at 6.
[350] Clayton and Clark claim that, if they are given vacation pay, § 41-10-80(C) of the Payment of Wages Act provides that "[i]n case of any failure to pay wages due to an employee as required

b. Clayton And Clark Have Proven That They Are Entitled To Link Bonuses But Not To Incentive Bonuses

Next, Clayton and Clark seek payment of certain bonuses that were never paid. In particular, they claim that they are entitled to Incentive Bonuses which were paid to Hampshire management based on the employee's level of compensation and Hampshire's sales and net income for the year,[351] and so-called Link Bonuses, which were supposedly promised to employees when Hampshire reversed a $7.5 million reserve that it had taken to protect against the possibility that Link Trading Company, a Hampshire vendor, or authorities brought claims against Hampshire for fraud.[352]

In both cases, there is impartial evidence that employees like Clayton and Clark were promised, as an inducement to continued employment, that they would receive these bonuses if certain criteria were met. That evidence includes calculations of Clark's Incentive Bonus sent to him by Willkie Farr.[353] That calculation offered to pay him his full 2006 Incentive Bonus if he and the company entered into a settlement of any claims he had.[354] This corroborates the abundant evidence that the corporation had promised

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by Section 41-10-40 or 41-10-50, the employee *may* recover in a civil action an amount equal to three times the full amount of unpaid wages, plus costs and reasonable attorney's fees as the court may allow." S.C. Code § 41-10-80(C). Any trebling under the Payment of Wages Act is discretionary and given the record about Clayton's performance, I do not treble.

[351] Tr. 136 (Clark), 761-73 (Clayton).

[352] JX 301 (Hampshire Group, Ltd. Form 10-K for the period ending Dec. 31, 2002 (filed Mar. 31, 2003)) at F-17.

[353] JX 291 (letter from Robert Kheel to Roger Clark (Mar. 15, 2007)).

[354] *Id*. ("The Company is distributing to its eligible employees a 2006 compensation bonus. As I referenced in my letter of February 22, 2007, enclosed is [a] check . . . in the amount of $19,456.84, representing your bonus less applicable withholding. Your endorsement and deposit of this check *will reflect your agreement with the terms of my various letters*.") (emphasis added).

senior executives like Clark and Clayton that they would receive Incentive Bonuses if they met certain criteria.

But, the years for which Clayton and Clark seek payment of their incentive bonuses are 2005 and 2006, years covered, in part, by the Restatement. Specifically, Clayton seeks $50,000 worth of his 2005 Incentive Bonus that Hampshire admits it withheld, and a pro rated portion of his 2006 Incentive Bonus up until the time that he was terminated totaling $113,400.[355] Clark seeks payment of his 2006 Incentive Bonus which, as just discussed, Hampshire offered to pay in exchange for Clark's release of any claims against Hampshire.[356]

The period after November 2005, when the Kuttner Clawback Memorandum was issued, and the period up to April 1, 2006 are periods I have found are subject to clawback. The obscure terms of the Incentive Bonus calculation presented by Clayton and Clark indicate: "[e]ach level of performance shall be absolute and shall not be prorated."[357] This suggests that proration was not available to eligible employees and, arguably, means that Clayton and Clark should not have received anything for 2005 or 2006 due to the clawback policy. As it was, Clayton received $ 231,821 of his 2005 Incentive Bonus, but complains he is due another $50,000.[358] Clark received his 2005 Incentive Bonus and, thus, seeks no additional amount for that year. Neither Clayton nor

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[355] JX 177 (Damages of Charles W. Clayton).
[356] JX 258 (Damages of Roger B. Clark); JX 291 (letter from Robert Kheel to Roger Clark (Mar. 15, 2007)).
[357] JX 291 (letter from Robert Kheel to Roger Clark (Mar. 15, 2007)) at RC 235.
[358] JX 199 (letter from Robert J. Kheel, Esquire to Jonathan G. Kortmansky, Esquire (Jan. 10, 2007)).

Clark received any incentive compensation for 2006, and claim that they are due Incentive Bonuses for that year, irrespective of the facts that: i) the period of 2006 up until April 1, 2006 was subject to the Restatement; and ii) neither Clayton nor Clark performed any work for Hampshire after they were put on leave on June 21, 2006.

I disagree. Clayton and Clark have the burden of persuasion on this issue. Although I conclude that certain Hampshire employees, including Clayton and Clark, were generally promised that if the corporation met certain performance targets as to net sales and net income, and those employees were on the job, they would receive Incentive Bonuses at various levels. That reality does not convince me that this very generalized inducement extended to cover the situation here. That is, Clayton and Clark have not persuaded me that Hampshire employees were promised unconditional and unaltered eligibility for incentive compensation during periods when they were put on administrative leave, did no work during that time, and were later terminated — especially where, as here, the company has demonstrated that there was a basis to terminate the employees for cause. Although I recognize that Hampshire did not specifically terminate either Clayton or Clark for cause on the dates of their termination, the reality is that Hampshire could have and by not immediately crying cause gave Clayton and Clark a chance to move on with more dignity and room to secure future employment.

Given the reality that Clayton and Clark performed no work after June 21, 2006 and were not entitled to bonuses for the period from November 2005 to April 1, 2006 anyway under the Clawback Memorandum, that Clayton and Clark have not proven that their Incentive Bonuses were subject to proration, and that Hampshire has proven that it had grounds to terminate Clayton and Clark for cause, I cannot conclude that they are entitled any additional incentive compensation as a matter of contract in these circumstances.

I find differently as to the so-called Link Bonuses. There appears to be no dispute that Clayton, Clark and other employees were promised that they would receive their share of a bonus pool when a reserve of $7.5 million that Hampshire established to cover any claims related to alleged fraud associated with Link Trading Company, a Hampshire vendor, was released.[359] Clayton claims that he is entitled to an $89,000 Link Bonus, and Clark seeks a Link Bonus totaling $24,000.[360] Hampshire argues that Clayton and Clark should not be permitted to receive Link Bonuses under the Clawback Memorandum, but points to no provision in the Clawback Memorandum suggesting that this would be the case. Indeed, nowhere does the Clawback Memorandum mention any sort of non-Incentive-based Bonuses.[361]

Hampshire claims that the reserve for the outstanding liability related to Link still exists, which Clayton and Clark do not dispute.[362] Thus, I will put in place an order requiring Clayton and Clark to be paid Link Bonuses when Hampshire reverses its

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[359] JX 301 (Hampshire Group, Ltd. Form 10-K for the period ending Dec. 31, 2002 (filed Mar. 31, 2003)) at F-17. Hampshire acknowledged in its opening pre-trial brief that it had agreed to give a Link Bonus to employees including Clayton and Clark if and when the reserve for any claims related to the Link fraud was reversed. Hampshire's Opening Pre-Trial Brief at 30.
[360] JX 177 (Damages of Charles W. Clayton); JX 258 (Damages of Roger B. Clark).
[361] Clawback Memorandum at CC-DEL 120.
[362] Hampshire's Opening Pre-Trial Brief at 30.

outstanding reserves for the "estimated costs of inventory purchases and losses for matters arising from" the alleged Link fraud.[363]

c. Clayton And Clark Are Not Entitled To Severance Pay

Clayton and Clark also seek to recover severance pay from Hampshire. Clayton argues that he is entitled to a total of $344,584 — $260,584 for six months of his 2004-2005 average salary, bonus and perks, and $84,000 for six months additional salary for failure to find work — based upon an alleged oral agreement with Kuttner.[364] Clark also relies upon a conversation with Kuttner for his severance claims, requesting $81,000 based upon six months average pay for 2004-2005.[365] In the alternative, Clayton and Clark seek severance pay based upon the policy in Hampshire's personnel handbook ("the Personnel Policy")[366] — amounting to $16,000 for Clark and $42,000 for Clayton.[367] I reject Clayton and Clark's claim for severance.

As to their argument that they had reached oral contracts with Kuttner binding Hampshire to pay them six months in severance, I find that Clayton and Clark have not met their burden of persuasion. Clayton claims that that he had a conversation with Kuttner followed a meeting in New York during an unspecified year in which another executive was given six months termination pay.[368] According to Clayton, after the meeting he asked Kuttner "what about myself?" to which Kuttner responded that Clayton

[363] JX 301 (Hampshire Group, Ltd. Form 10-K for the period ending Dec. 31, 2002 (filed Mar. 31, 2003)) at F-17.
[364] JX 177 (Damages of Charles W. Clayton).
[365] JX 258 (Damages of Roger B. Clark).
[366] Personnel Policy at 16.
[367] JX 177 (Damages of Charles W. Clayton); JX 258 (Damages of Roger B. Clark).
[368] Tr. at 768 (Clayton).

would also get six months severance based on average earnings and perks over the previous two years, plus an additional six months salary if Clayton subsequently failed to find work.[369] Clark claims that his conversation with Kuttner took place after a series of layoffs during an, again, unspecified year, which prompted Clark to ask Kuttner what effects the layoffs would have on him. Kuttner supposedly told Clark that the laid off employees were given six months severance, and Kuttner would make "the same commitment" to Clark.[370] Neither Clayton nor Clark ever had these "agreements" reduced to writing and actually executed as a formal contract, and Kuttner's side of the story is not available because he was neither deposed nor called as a witness at trial.

To substantiate their claims for six months of severance pay, Clayton and Clark attempt to establish a course of performance. But, course of performance is a doctrine that typically applies when a court is faced with a problem of contract interpretation,[371] not in an effort to prove that a contract exists in the first place. Here, Clayton and Clark say Kuttner was a serial maker of oral employment agreements with subordinates and that the board rubber-stamped his promises later. I am not persuaded by this argument, which is supported by evidence that certain other executives of Hampshire and its subsidiaries were given six months severance when they left Hampshire.

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[369] *Id*. at 768-69 (Clayton).
[370] *Id*. at 137 (Clark).
[371] *Weisz Graphics Div. of Fred B. Johnson Co., Inc. v. Peck Indus., Inc.*, 304 S.E.2d 146, 150 n.2 (S.C. App. 1991) (using course of dealing and course of performance to the missing terms of a contract); RESTATEMENT (SECOND) OF CONTRACTS § 202(4) (noting that, in certain cases, course of performance is given great weight in interpreting an agreement).

I find that the circumstances that Clayton and Clark rely upon which are actual employment contracts do not sufficiently substantiate their claims. For example, two of the agreements that they point to are for Michael Culang, and set the prospective terms of Culang's employment.[372] Clayton and Clark were at-will employees, and had no such employment contracts. Indeed, the existence of actual employment contracts granting certain employees six months severance pay belies Clayton and Clark's argument that Kuttner's usual practice was to make oral agreements for severance.

The other situation that Clayton and Clark rely upon involves a memorandum of understanding reached between Hampshire and Horace Padgett, who left Hampshire shortly before Clark,[373] giving Padgett six months of severance pay in exchange for Padgett's release of any claims against Hamsphire.[374] This was apparently a bargained for severance package involving several features, and does not show clearly that Kuttner had promised everyone, or even Padgett himself, six months severance.[375] But, crucially,

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[372] JX 115 (letter from Michael Culang to Eugene Warsaw (Oct. 18, 1997)); JX 306 (Employment Agreement between Hampshire Designers, Inc. and Michael Culang (July 1, 2005)); *see also* JX 300 (Hampshire Group Ltd. Form 8-K for the period ending Apr. 3, 2007 (filed Apr. 5, 2007)) (setting forth the terms of Norwood's employment agreement, signed by Culang, giving Norwood six months severance); JX 298 (summary of R. McGovern Termination Terms (Feb. 27, 2007)) (discussing McGovern's right to six months severance under the terms of her employment agreement).

[373] Tr. at 135 (Clark).

[374] JX 73 (memorandum of understanding between Hampshire and Horace Padgett (June 19, 2006)).

[375] JX 502 (Hampshire Internal Review Memorandum (June 14, 2006)) (indicating that Padgett should have received severance of only $23,500 and suggesting that Padgett received $75,000 as a settlement because Kuttner was forcing him out for raising uncomfortable issues and refusing to sign tax returns because of concerns Padgett had over aggressive positions taken by other managers).

Clayton and Clark rejected Hampshire attempts to come to a settlement agreement with them and chose instead to bring these counterclaims.

Furthermore, Clayton and Clark's argument that the board routinely rubber-stamped Kuttner's promises cuts against them. This shows that Clayton and Clark knew that the board retained ultimate authority and that they were banking on Kuttner's clout to get them what they wanted. Notably, others, like Culang, demanded an actual contract with Hampshire.

Moreover, Clayton and Clark's testimony is too vague to meet their burden of persuasion. They are unable to even cite to the *year* that Kuttner made these alleged promises. Instead, all I have is their say-so that Kuttner, at some point in time, made assurances to them that they would receive certain benefits. I am not persuaded that that is in fact the case, much less that these oral agreements entitled them to severance in a situation when there were grounds to dismiss them for cause, as there were here. That is one of the many reasons why there are written contracts, because they cover situations that commonly happen and reliably record a genuine bargain reached on a specific date. At most, Clayton and Clark have inclined me to believe that Kuttner assured them they would get fair treatment at his hands if they were terminated while he was CEO. They have not come close to spelling out the terms of an enforceable agreement by Kuttner on Hampshire's behalf that unconditionally entitled them to lengthy severance under circumstances like those that now pertain.

In so finding, I also am influenced by the reality that Kuttner's supposed oral promise would have overridden the written severance policy that actually existed at

Hampshire. Hampshire's Personnel Policy stated that eligible employees would receive severance pay of one week per year of employment at Hampshire, up to a total of three month's base salary.[376]

Although the question is not free from doubt, on balance, I find that Hampshire's Personnel Policy establishes a binding promise requiring it to pay severance to *eligible employees*. Under South Carolina law, courts will imply employment contracts for at-will employees where an employer "couch[es] a handbook, bulletin, or other similar material in mandatory terms . . . ."[377] If an employer wishes to issue such written policies, but intends to continue at-will employment, the employer must put a conspicuous disclaimer in its handbook,[378] but may still be held to certain mandatory promises that it makes in the written policies.[379]

The second page of Hampshire's Personnel Policy contains a conspicuous disclaimer, stating that:

> THIS HANDBOOK IS NOT AN EMPLOYMENT CONTRACT. YOUR EMPLOYMENT WITH THE COMPANY IS OF AN 'AT WILL' NATURE. . . . THIS EMPLOYMENT 'AT WILL' RELATIONSHIP MAY NOT BE CHANGED BY ANY WRITTEN DOCUMENT OR BY ORAL STATEMENT UNLESS ITS CHANGE IS SPECIFICALLY ACKNOWLEDGED IN WRITING AND APPROVED BY AN AUTHORIZED COMPANY OFFICER.[380]

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[376] Personnel Policy at 16.
[377] *Small v. Springs Indus. Inc.*, 357 S.E.2d 452, 455 (S.C. 1987).
[378] *Conner*, 560 S.E.2d 606, 611 (S.C. 2002) (citing *Small*, 357 S.E.2d at 455).
[379] *Id*. (holding that a genuine issue of material fact existed as to whether mandatory language in an employee handbook created an valid contract, even where the handbook contained effective disclaimers); *Fleming v. Borden*, 450 S.E.2d 589, 596 (S.C. 1994) (holding that a "disclaimer is merely one factor to consider in ascertaining whether the handbook as a whole conveys credible promises that should be enforced").
[380] Personnel Policy at 2.

The last page of the Personnel Policy also contains a prominent disclaimer stating that "[t]he information contained in this Personnel Policies and Benefit Summary may NOT be construed as creating a contract of employment or tenure, expressly, impliedly, or as implied in the law."[381] But the Policy also contains mandatory language providing that "[e]ligible employees *will* receive severance pay."[382] The extent of the severance due is spelled out in the Policy as one week per year of employment, up to a total of three months' salary.[383] Given the existence of a written policy, any derogation of that policy by contract should have been done in writing, as it was for certain employees, and not orally. This clash cuts against the notion that Kuttner made binding oral agreements with Clayton and Clark promising more than the written Policy offered, especially when the written Policy was so carefully couched.

If it were not for my findings of disloyalty, I would award Clayton and Clark severance consistent with the Plan. Although the Plan's terms including both promises and a disclaimer establishes an ambiguity under South Carolina law,[384] the best resolution of that ambiguity is a memorandum written by Norwood two months after Clark was terminated, directing that Clark be paid $16,000 in severance, and a "payroll action form" stating that Clark was entitled to severance.[385] Given both the mandatory language in the Personnel Policy, and Hampshire's acknowledgement of that policy, I would find that

[381] *Id*. at 43.
[382] *Id*. at 16 (emphasis added).
[383] *Id*.
[384] *See Fleming*, 450 S.E.2d at 463-64 ("[A] handbook that contains both promissory language and a disclaimer should be viewed as inherently ambiguous." (quoting Stephen F. Befort, *Employee Handbooks and the Legal Effect of Disclaimers*, 13 INDUS. REL. L. J. 326, 375-76 (1991-92))).
[385] JX 304 (Clark's personnel file) at HAMPDE 779, 791.

Hampshire is required to pay Clayton and Clark severance consistent with that policy. Under that Policy, Clark would be entitled to eight weeks of severance pay, and Clayton would be entitled to three months of severance pay.[386]

But I decline to award Clayton and Clark severance pay for two reasons. First, Hampshire offered to make that level of payment when it was attempting to consensually resolve its differences with Clark. A consensual resolution did not occur. Second, and more importantly, Hampshire has now shown that Clark and Clayton have engaged in breaches of their duties of loyalty to Hampshire. Under the Personnel Policy, no severance is due to an employee if an employee engages in willful misconduct.[387] Because Hampshire has now proven in litigation that Clayton and Clark knowingly acted with disloyal intent, I find that no severance is due Clayton or Clark under the Personnel Policy.

d. Clayton Has Not Proven That He Is Entitled To Terms Of Employment Benefits Or Reimbursement Of Travel Expenses

Clayton also claims that he is owed (1) benefits under an alleged "terms of employment" agreement, and (2) payment of unreimbursed travel expenses. These claims are also meritless. First, Clayton claims that under a "terms of employment"

[386] Hampshire's Personnel Policy provides that employees were entitled to one week of severance pay for each year that they worked at Hampshire, up to a total of three months of severance pay. Personnel Policy at 16. Clark was employed at Hampshire for eight years, and thus is entitled to eight weeks of severance pay. Clayton began his employment at Hampshire in 1978, and can receive three months of severance pay.

[387] Personnel Policy at 16. Under the terms of the Personnel Policy, only eligible employees are entitled to severance pay. *Id*. "Eligible employees" are defined as those who were full time, employed for at least six continuous months, and were not terminated due to "(i) elimination of operations, (ii) elimination of job because of organization change, or (iii) unsatisfactory performance which is not willful." *Id*. (emphasis added). The policy also provides that employees who have been terminated for "cause" cannot receive severance pay. *Id*.

agreement, he can recover $20,750 for his company car, and $2,610 for the value of computer equipment that Hampshire was supposed to transfer to him after his termination.[388] But, the so-called terms of employment agreement is nothing more than a list of Clayton's responsibilities and benefits without any signature lines or proof that the agreement was executed.[389] At trial, Clayton provided no other evidence indicating that those terms were actually agreed upon, and I do not find persuasive his mere word that they were.[390] It is more plausible that Clayton himself authored this document, and Hampshire declined to agree to it. Otherwise, it would have been executed by the proper parties. Thus, Clayton cannot recover any payment from Hampshire for a company car or computer equipment.

Clayton also seeks repayment of $35,059 worth of unreimbursed travel expenses. Specifically, he asks that Hampshire reimburse him for a total of 82 expense reports from 2004 to 2006, which he never bothered to submit for payment while he was employed at Hampshire.[391] Hampshire's Personnel Policy clearly states that all employee benefits "cease on the effective date" of the employee's dismissal.[392] Had Clayton wanted his travel expenses reimbursed, he should have submitted the reports while he was still employed by Hampshire. The board's imprudent and timorous tolerance of tardy reports of Kuttner does not create a right on Clayton's part to get further indulgence.

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[388] JX 177 (Damages of Charles W. Clayton).
[389] JX 197 (Terms of Employment of Charles Clayton).
[390] Tr. at 774-75 (Clayton).
[391] *Id*. at 764-65 (Clayton).
[392] Personnel Policy at 16.

e. Clayton Cannot Recover Damages For The Allegedly Premature Payout Of Clayton's Deferred Compensation Funds

Finally, Clayton argues that Hampshire's premature distribution of his deferred compensation funds caused him $139,735 of damages.[393] Hampshire distributed Clayton's deferred compensation funds to him in July 2007, upon the advice of Willkie Farr and Ogletree, allegedly to remedy Clayton's violation of the constructive receipt rules.[394] Although I do not conclude that Clayton breached his fiduciary duties by mismanaging the Deferred Compensation Plan, the question is a close one and Clayton has not persuaded me that Hampshire had any contractual duty to continue the Plan that it believed Clayton had breached. Hampshire appears to have made a good faith judgment that the Plan's management had resulted in a constructive receipt violation and distributed the funds to Clayton. All Clayton was required to do was to pay the taxes that would eventually have been due when he received those funds as income. In deciding this issue, I rely upon who has the burden of persuasion.

The burden of persuasion on this murky issue benefited Clayton as to the fiduciary duty claim against him. It now benefits Hampshire when Clayton has the burden of persuasion. Neither party has demonstrated its position on constructive receipt in a reliable way or its claim related to that question. Each will be left as they stand on the issue.

[393] JX 296 (Damages From Premature Distribution of the Deferred Compensation Account of Charles Clayton).
[394] JX 201 (letter from Robert J. Kheel, Esquire to Franklin B. Velie, Esquire (June 19, 2007)); JX 684 (memorandum from Ogletree, Deakins, Nash, Smoak & Stewart, P.C. to Hampshire Group, Ltd. (Nov. 14, 2006)).

2. Defamation

a. Relevant Factual Background

Clayton was terminated on September 25, 2006, and, although the board chose to fire him without cause, there were grounds for terminating him for cause. The same day Clayton was terminated, Hampshire published a press release (the "September Press Release") about the Audit Committee investigation and the termination of Kuttner and Clayton. The relevant portions of that Press Release are as follows:

> Hampshire Group, Limited today announced that its Board of Directors has terminated the employment of Ludwig Kuttner, Hampshire's Chief Executive Officer. Mr. Kuttner had previously been placed on administrative leave in connection with the previously announced Audit Committee investigation.
>
> Although the investigation is still continuing, the Audit Committee's findings indicate that, among other issues still being reviewed, Mr. Kuttner submitted expense reports for approximately $1.45 million over a period of approximately 10 years, a substantial portion of which were fraudulent or not substantiated in accordance with Company policy.
>
> *The Company also announced that the Board has terminated the employment of Charles Clayton, the Company's Executive Vice President and Treasurer, who has also been placed on administrative leave.*
>
> Michael Jackson, Chairman of the Board, stated: "*The Board and management will not tolerate the type of wrongful conduct brought to the attention of the Audit Committee as part of this investigation or any other type of improper conduct. We expect our officers and employees to conduct the business of the Company at the highest level of business ethics*.[395]

[395] JX 307 (Hampshire Group, Ltd. press release regarding termination of employees (Sept. 25, 2006)) ("September Press Release") (emphasis added).

The September Press Release was filed with a Form 8-K the following day,[396] and was picked up in the Anderson Independent Mail, a newspaper in Clayton's hometown, on September 27, 2006.[397]

On May 31, 2007 — after Clark had been fired on December 29, 2006, and after the Audit Committee Investigation was completed — Hampshire issued another press release (the "May Press Release"), which summarized the investigation, the terminations associated therewith, and Hampshire's Restatement of its financials. Notably, the May Press Release described the scope of that investigation as follows:

> [Hampshire] announced on June 22, 2006 that the Audit Committee commenced an investigation related to, among other things, the misuse and misappropriation of assets for personal benefit, certain related party transactions, tax reporting, internal control deficiencies and financial reporting and accounting for expense reimbursements, in each case involving certain members of [Hampshire's] senior management.[398]

The May Press Release then noted that Kuttner, Clayton, and Clark had initially been placed on administrative leave, and stated that they were later terminated, explicitly tying Kuttner's firing to the findings of the investigation:

> Pending the outcome of the investigation, the Board placed Ludwig Kuttner, [Hampshire's] Chief Executive Officer, Charles Clayton, [Hampshire's] Executive Vice President, Treasurer, and former Chief Financial Officer, Roger Clark, [Hampshire's] Vice President of Finance and Principal Accounting Officer, and two personal assistants on administrative leave.

[396] JX 191 (Hampshire Group, Ltd. Form 8-K for the period Sept. 25, 2006 (filed Sept. 26, 2006)).
[397] JX 42 (article from the Anderson Independent-Mail, "Hampshire Group Fires Top Execs" (Sept. 27, 2006)).
[398] JX 256 (Hampshire Group, Ltd. press release (May 31, 2007)) ("May Press Release") (emphasis added).

> On September 25, 2006, [Hampshire] announced that it had *terminated the employment of Mr. Kuttner as a result of findings indicating that Mr. Kuttner had submitted expense reports to [Hampshire] for approximately $1,450,000 covering approximately 10 years, a substantial portion of which were fraudulent or not substantiated in accordance with Company policy among other reasons. The Board of Directors also terminated the employment of Mr. Clayton on that date.*
>
> As part of the Audit Committee investigation, [Hampshire] also undertook a review of its accounting and disclosure policies and internal controls. On December 13, 2006, [Hampshire] announced that it would restate its financial statements for the years 2003 through 2005 as well as the fiscal quarter ended April 1, 2006, and advised that all financial statements and related reports of [Hampshire's] independent registered public accounting firm for such periods should no longer be relied upon. *[Hampshire] terminated the employment of Mr. Clark on December 31, 2006*.[399]

Therefore, the May Press Release explained that Kuttner was terminated because of misconduct, and noted, without explaining why, that Clayton and Clark were also terminated.

The Company's Form 10-K/A, filed with the SEC on May 31, 2007, contains language that is nearly identical to the May Press Release.[400] That 10-K/A also discussed the measures Hampshire took to remedy its inadequate internal control system, and in that discussion noted that "[w]ith respect to the control environment material weaknesses, the Company terminated the employment of three members of former senior management, who were also responsible for the preparation of financial statements."[401] That is, the 10-K/A did not disparage Clayton and Clark, but did suggest that Kuttner,

[399] *Id*.
[400] JX 1 (Hampshire Group, Ltd. Form 10-K/A for the period ending December 31, 2005 (May 31, 2007)) at 13.
[401] *Id*. at 62.

Clayton, and Clark were terminated in part because they were in charge of Hampshire's financial reporting and internal control functions — functions that had failed.

b. Clayton And Clark Do Not Succeed On Their Defamation Counterclaims

Clayton and Clark claim that they have been defamed by Hampshire's September and May Press Releases. Under South Carolina law,[402] the tort of defamation, which allows a plaintiff to recover damages for injury to her reputation resulting from the defendant's communication of a false message about the plaintiff to others,[403] requires a plaintiff to show that: (1) a false and defamatory statement was made; (2) the unprivileged publication was made to a third party; (3) the publisher was at fault; and (4) either the statement caused special harm, or the statement was actionable irrespective of special harm.[404]

Both Clayton and Clark's defamation claims founder on the first requirement that they show that a false and defamatory statement was made.[405] With the benefit of the full factual context provided at trial, it is clear that the somewhat unflattering statements made in the Press Releases cannot be the basis for Clayton and Clark's libel claims for one simple reason: the statements made in those Press Releases were not false. Under

[402] None of the parties dispute that the law of South Carolina applies to Clayton and Clark's defamation claims. *See* Clark Op. Post-Trial Br. 47; Clayton Op. Post-Trial Br. 49; Hampshire's Opening Post-Trial Brief at 46.

[403] *Erickson v. Jones Street Publishers, LLC*, 629 S.E.2d 653, 664 (S.C. 2006) ("The tort of defamation allows a plaintiff to recover for injury to his or her reputation as the result of the defendant's communications to others of a false message about the plaintiff." (citing *Holtzscheiter v. Thomson Newspapers, Inc*., 506 S.E.2d 497, 506 (S.C. 1998)).

[404] *Id*. (citing *Fleming v. Rose*, 567 S.E.2d 857, 860 (S.C. 2002); *Holtzscheiter*, 506 S.E.2d at 518).

[405] Under South Carolina law, defamatory statements are those that "tend[] to harm the reputation of another as to lower him in the estimation of the community or to deter third persons from associating with him." *Id*. (citing *Holtzscheiter*, 506 S.E.2d at 513).

South Carolina law, a “defamatory communication [is] presumed to be false, but truth can be asserted as an affirmative defense.”[406] The only thing the September and May Press Releases suggest was that an accounting scandal occurred during Clayton and Clark’s watches, and that they were terminated when they failed in their responsibilities to prevent that scandal. The Press Releases did not launch an adjectival attack on either Clayton or Clark’s competence or integrity; rather, they simply noted that both officers were fired as a result of the investigation. The somewhat strong language about “wrongful” and “improper” conduct in the September Press Release only described Kuttner’s behavior, not Clayton’s;[407] and, even if the “wrongful” and “improper” language applied to Clayton, the fact is that Clayton knowingly breached his fiduciary duties and engaged in deceptive behavior, thereby engaging in “wrongful” and “improper” conduct. Indeed, after reviewing the results of the internal investigation, the board approved Clayton’s termination and prepared a draft termination letter indicating that he had been fired for cause. Testimony that the board eventually chose to terminate Clayton without cause does not bear on the matter because the evidence shows that that decision was made out of magnanimity, and not due to a reconsideration of Clayton’s

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[406] *Parrish v. Allison*, 565 S.E.2d 382, 391-92 (S.C. 2007); *see also WeSav Fin. Corp. v. Lingefelt*, 450 S.E.2d 580, 582 (S.C. 1994) (“The truth of the matter is a complete defense to an action based on defamation.”) (citation omitted). Hampshire asserted the truth of the statements made in the September Press Release as an affirmative defense in its Answer to Clayton and Clark’s Counterclaims. *See* Hampshire’s Answer to Counterclaims ¶¶ 146-47.

[407] The September Press Release quotes Michael Jackson as saying that the “wrongful conduct brought to the attention of the Audit Committee *as part of this investigation*” would not be tolerated, but the only behavior cited by the Press Release as being brought to light by the investigation was Kuttner’s: “the Audit Committee’s findings indicate that, among other issues still being reviewed, *Mr. Kuttner* submitted expense reports for approximately $1.45 million over a period of approximately 10 years, a substantial portion of which were fraudulent or not substantiated in accordance with Company policy.” *See* September Press Release.

culpability. In short, the September and May Press Releases were accurate to the extent they suggested that Clayton and Clark helped lead a financial management team that approached legal and accounting compliance in a loose fashion.

It is also important to consider the broader context to Clayton and Clark's terminations.[408] By accepting high-ranking positions at a public company, both Clayton and Clark were choosing to accept the kind of accountability that would allow — nay, require — Hampshire to inform the investing public that they had been terminated in the wake of an internal investigation. However uncomfortable it is, corporate officers in public companies cannot avoid public scrutiny. It comes with the job. When a corporation suffers the need for a restatement of earnings, the corporation's CFO and Principal Accounting Officer should expect to endure publicity. Although they may not have committed a breach of fiduciary duty exposing themselves to responsibility in damages, they cannot escape responsibility in the more colloquial sense for presiding in important ways over functions of the corporation that were not carried out properly.

To this point, as a public company, Hampshire has a duty to inform its shareholders of the Audit Committee investigation and the resulting terminations, which shields the Press Releases from Clayton and Clark's defamation claims through a qualified privilege. Under South Carolina law, communications made between

[408] *See Parrish,* 656 S.E.2d at 389 ("In making the determination of whether [a statement is defamatory per se], the trial court may consider not only the statement on its face, but also evidence of any extrinsic facts and circumstances.").

constituencies with a common interest are protected by a qualified privilege.[409] Other courts have persuasively reasoned that this privilege extends to SEC filings, such as those accompanying the September and May Press Releases, because they are mandated by federal law, and are intended "to provide investors with the information necessary to make informed decisions, and . . . the SEC with a basis to police the actions of companies subject to the requirement."[410] Hampshire was required to make periodic disclosures to the public on Form 10-K, and the circumstances surrounding the termination of two executive officers is something in which the public would have had an interest.[411] And, under Item 5.02(b) of Form 8-K, Hampshire was required to disclose that two of its named officers had been terminated.[412] Thus, Hampshire had a qualified privilege to make statements about the circumstances of Clayton and Clark's terminations, and neither Clayton nor Clark has presented any evidence rebutting that qualified privilege.[413]

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[409] *See Bell v. Evening Post Publ'g Co.*, 459 S.E.2d 315, 317 (S.C. 1995); *Murray v. Holnam, Inc.*, 542 S.E.2d 743, 748 (S.C. App. 2001).

[410] *Abella v. Barringer Res., Inc.*, 615 A.2d 288, 293 (N.J. Super. Ch. 1992) (finding that allegedly defamatory statements in an SEC filing were protected by qualified privilege as furthering a legitimate public interest); *see also Carnegie Intern. Corp. v. Grant Thornton, LLP*, 2006 WL 990960, at *7 (Md. Cir. Ct. Mar. 30, 2006) (explaining that absolute privilege protected statements in a Form 8-K and attached press release because, among other things, the publication was required by law).

[411] *See* 15 U.S.C. § 78(m) and 17 C.F.R. § 249.30, which govern filing requirements for public companies.

[412] *See* SEC Form 8-K at page 15, Item 5.02(b), *available at* http://www.sec.gov/about/forms/form8-k.pdf (last visited June 20, 2010) ("If the registrant's principal executive officer, president, principal financial officer, principal accounting officer . . . or any person performing similar functions, or any named executive officer retires, resigns or is terminated from that position . . . disclose the fact that the event has occurred and the date of the event.").

[413] To rebut the qualified privilege, Clayton and Clark would have to prove that Hampshire acted with common law malice when issuing the Press Releases. *See Swinton Creek Nursery v. Edisto Farm Credit, ACA*, 334 S.C. 469, 485 (S.C. 1999) ("When the occasion gives rise to a qualified

Finally, neither Clayton nor Clark has proven any actual damages arising from the September or May Press Releases. Clark does not even attempt to quantify his damages, explaining only that he has suffered "injury to his reputation, mental suffering, and emotional distress."[414] Clark cannot show damages from lost salary, because he was employed by HIL just after being terminated by Hampshire, and makes the same salary.[415] Clayton presented no evidence that he even looked for a job, much less that he could not get one due to the Press Releases. Indeed, he also became employed at HIL after leaving Hampshire. If Clayton's future job prospects were in fact hampered by his time at Hampshire, that would not be because of the public disclosures, but because of the reality of the serious issues with his job performance there.

privilege, there is a prima facie presumption to rebut the inference of malice, and the burden is on the plaintiff to show actual malice or that the scope of the privilege has been exceeded.") (citations omitted). Malice is proven by showing that the defendant was motivated by ill will seeking to injure the plaintiff, or that the defendant acted in reckless disregard of the plaintiff's rights. *Id.*; *see also* DAN B. DOBBS, THE LAW OF TORTS, vol. 2 § 416 ("Malice . . . could be shown by evidence that the defendant's chief motivation in publishing the defamation was based upon ill will, hostility, threats, rivalry, a direct intent to injure, or a reckless disregard of the reputational consequences.") (internal quotations omitted). As noted before, the disclosures made in the Press Releases and the accompanying SEC filings were factually accurate, and Clayton and Clark have not presented any evidence showing that Hampshire acted with malice. The absence of adjectival embellishment or negative characterization of Clark and Clayton also suggests an absence of malice.

[414] Clark's Opening Post-Trial Brief at 49. Instead, Clark asks that he be given his attorneys' fees and costs as his "actual" damages. But, both Delaware and South Carolina follow the American Rule that a party to litigation bears her own costs. *See In re 14 Realty Corp.*, 2009 WL 2490902, at *9 (Del. Ch. Aug. 4, 2009); *Layman v. State*, 658 S.E.2d 320, 329 (S.C. 2008). Clark has cited no precedent for support, and I found no South Carolina law supporting Clark's argument through the means available to me. Therefore, I find no reason to depart from the long-standing American Rule.

[415] Tr. at 7-8 (Clark).

V. The Remedial Picture

A. Hampshire Has Proven Damages For Clayton And Clark's Breaches Of Fiduciary Duty

Hampshire has succeeded in proving that Clayton and Clark have breached their duty of loyalty by allowing tuition payments for Kuttner's assistant to be recorded as charitable donations. Hampshire has also shown that Clayton has breached his duty of loyalty by giving the Item-Eyes Executives tax-free compensation for their personal expenses, and by participating in and facilitating the sweater donation program after the Audit Committee had asked him to stop. Damages resulting from breaches of fiduciary duty are to be liberally calculated,[416] and will be awarded as long as there is a basis for estimating damages.[417] Also, a duty of loyalty breach "loosen[s] the stringent requirements of causation and damages."[418] Any uncertainty in awarding damages is resolved against the wrongdoer.[419]

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[416] DONALD J. WOLFE, JR. & MICHAEL A. PITTENGER, CORPORATE AND COMMERCIAL PRACTICE IN THE DELAWARE COURT OF CHANCERY (July 2009) § 12.10[b][3] at 12-188; *see also Thorpe v. CERBCO, Inc*, 1993 WL 443406, at *12 (Del. Ch. Oct. 29, 1993) ("It is, of course, fundamental that a fiduciary who breaches his duty is liable for any loss suffered by the beneficiary of his trust.").

[417] *See Thorpe*, 1993 WL 443406, at *12 ("While courts will not award damages which require speculation . . . so long as the court has a basis for a responsible estimate of damages, and plaintiff has suffered some harm, mathematical certainty is not required.") (citations omitted).

[418] *Thorpe v. CERBCO, Inc.*, 676 A.2d 436, 445 (Del. 1996); *see also Gotham Partners, L.P. v. Hallwood Realty Partners, L.P.*, 817 A.2d 160, 176 (Del. 2002) ("[T]he scope of recovery for a breach of the duty of loyalty is not to be determined narrowly.").

[419] *See Thorpe*, 1993 WL 443406, at *12 ("[O]nce a breach of [fiduciary] duty is established, uncertainties in awarding damages are generally resolved against the wrongdoer." (citing *Donovan v. Bierwirth*, 754 F.2d 1049, 1056 (3d Cir. 1985))).

Hampshire originally hoped to recover from Clayton and Clark the total amount that it spent on its investigation, totaling a robust $5,540,739.00.[420] But Hampshire concedes that these investigation costs were for multiple issues — for example, the Navigant and Paul Weiss investigations, which account for most of Hampshire's costs,[421] looked into the 23 issues that were raised in the Internal Review Memorandum.[422] Because Hampshire has only succeeded in more limited ways than it hoped, it is only entitled to a small fraction of its total costs of investigating.

As to that point, Hampshire also acknowledges that many of the invoices that it received do not contain sufficient detail to allow Hampshire to attribute its fees and expenses to particular instances of misconduct.[423] Hampshire spent a total of $2,235,847.00 to have Navigant conduct an investigation into many of the issues raised in the Internal Review Memorandum, and $2,819,148.00 for the time that Paul Weiss spent

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[420] Hampshire's Post-Trial Opening Brief at Ex. 1. More astonishing is the fact that Hampshire's damages claim has been drastically reduced. Until September 2009, Hampshire was seeking approximately $25 million in damages, which it reduced after this court instructed Hampshire to refine its damages request to the issues in this litigation only. *See Hampshire Group Ltd. v. Kuttner*, C.A. No. 3607-VCS (Sept. 2, 2009) (TRANSCRIPT) at 7-8, 128. These damages included the following: (1) $13.6 million related to the Audit Committee investigation; (2) $863,000 for restatement and delisting costs; (3) $1.447 million for Kuttner's expenses; (4) $2.25 million in taxes, penalties and interest due to Clayton's misconduct; (5) $7.2 million in bonuses paid by Hampshire to Kuttner, Clayton, and Clark during the time of their alleged wrongful conduct; and (6) $36,000 that Hampshire paid for Linck's tuition, even though the board later approved it. *See* Hampshire Group, Limited Amended and Supplemented Responses and Objections to the First Set of Interrogatories of Charles Clayton (Feb. 27, 2009) at Response No. 6.

[421] Navigant charged Hampshire $2,235,847.00 for its time, and Paul Weiss charged $2,719,148.00. Hampshire's Opening Post-Trial Brief Ex. 1 (Hampshire Group, Limited Summary of Damages).

[422] Navigant/ Paul Weiss Findings at DT 762-769.

[423] Hampshire's Opening Post-Trial Brief at 42.

investigating those issues.[424] Hampshire has not even attempted to explain what portions of its Paul Weiss bills are attributable to each of the discrete issues investigated or made any other reasonable proposal as to allocation.[425] But, as to Navigant and other advisors, Hampshire has provided some plausible estimates of how much of its investigation costs are attributable to the particular instances of wrongdoing, which I use as a starting point for an award.

First, on the tuition payments for Linck, Hampshire seeks $223,584.70 in damages from Clayton and Clark. At his deposition and at trial, William Jennings of Navigant testified that approximately 10% of Navigant's time was spent on investigating the tuition matter,[426] which amounts to $223,584.70. I find that amount unreasonable given the prior board examination of the issue and the discrete number of persons involved in this small dollar issue. I award $75,000 as a reasonable figure.

Second, Clayton is liable to Hampshire in the amount of $111,792.35 for the sweater caper. Although this was another small dollar issue, it is more factually complex than the tuition issue. I find persuasive the testimony of Jennings that Navigant spent 5% of its time investigating the sweater donation issue.[427]

Third, as to the Item-Eyes Executives' expenses, Clayton is liable to Hampshire for the following reasonable investigation and remediation costs: $56,621.00 to have

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[424] *Id*. at Ex. 1 (Hampshire Group, Limited Summary of Damages).
[425] William Jennings of Navigant testified at trial that he had no idea what percentage of time Paul Weiss spent on particular items, and that Paul Weiss reviewed issues in the Internal Review Memorandum that Navigant did not. Tr. at 313-14 (Jennings). I therefore cannot reliably use Jennings' estimates of the time that Navigant spent investigating particular issues as a basis for Paul Weiss' time.
[426] *Id*. at 311 (Jennings); Jennings Dep. at 26.
[427] Tr. at 311-12 (Jennings); Jennings Dep. at 27.

Ernst & Young investigate and to restate the Item-Eyes payroll for 2003 to 2005;[428] $5,074.00 to have Dixon Hughes analyze any restatement issues related to the Item-Eyes expenses;[429] and $30,282.03 in past-due Medicare taxes that Hampshire paid after the Executives' W-2s for 2003 to 2005 were corrected.[430] There is no evidence that the Item-Eyes matter was investigated by Navigant and, thus, none of the Navigant investigation costs are properly recoverable for this issue.[431] Thus, Hampshire can recover a total of $91,977.03 related to its investigation of the Item-Eyes matter.

In addition, Hampshire also seeks from Clayton and Clark the costs that it incurred in restating its financial statements. Specifically, Hampshire requests a total of $839,664.00 for the total costs of Deloitte's services in restating Hampshire's financial statements for 2003 to 2005, and restating Hampshire's retained earnings for years before 2003 and after the fiscal quarter ending April 1, 2006. Hampshire argues that if the full cost of the Restatement investigation is not awarded, it should receive 77.5% of the total amount of its Restatement costs, which is the amount that it believes is directly attributable to Clayton and Clark's conduct.[432] Hampshire bases this argument on its estimate that $2.4 million of Hampshire's tax reserves were caused by Clayton and

[428] JX 567 (Enrst & Young invoices) at HAMPDE 144260, 144265, 144319.
[429] JX 568 (Dixon Hughes invoices) at HAMPDE 146242.
[430] JX 634 (payment reconciliations for Item-Eyes wages, and amended W-2s).
[431] *See* Navigant/ Paul Weiss Findings (listing the issues that Navigant and Paul Weiss investigated, which does not include the Item-Eyes matter); Tr. at 876 (Norwood) (stating that Ernst & Young had been engaged to remedy the Item-Eyes issue).
[432] Hampshire is not requesting that Clayton and Clark pay it for the $7.7 million in tax reserves that it set aside due to the restatement.

Clark's alleged misconduct, and that $3.5 million of those reserves was caused by the § 162(m) issue — which combined account for 77.5% of Hampshire's tax reserves.[433]

But, as discussed earlier in this opinion, I find that Clayton and Clark were not responsible for the §162(m) issue. Hampshire cannot recover any of the Restatement investigation costs attributable to the §162(m) issue.

For the additional $2.4 million of the Restatement that Hampshire claims was caused by directly Clayton and Clark, Hampshire can only cover for the investigation and remediation of those costs that are attributed to issues for which I have found liability — the sweater donation program, Linck's tuition, and the Item-Eyes issue. Among those three issues, only the Item-Eyes matter contributed to the Restatement.[434] Specifically, according to Hampshire's own calculations $259,575 of the Restatement was directly attributable to the Item-Eyes issue.[435] Subtracting out the tax benefit of $89,788 that Hampshire received, the Item-Eyes expense account matter caused $169,787 worth of exposure.[436] That is, the Item-Eyes issue accounted for 2.2% of the Restatement. I thus hold Clayton accountable for 2.2% of the $839,664.00 investigation and remediation

[433] Tr. at 871-873 (Norwood).

[434] According to Hampshire's internal documents, which attribute the restatement costs to individual instances of misconduct, Hampshire claims that the following actions by Clayton and Clark let to the restatement: (1) New York state and city income taxes (for Hampshire's failure to be registered in New York; (2) deferred compensation issues for both Kuttner and Clayton; (3) income tax exposure for improper T&E given to Kuttner; (4) state and federal income tax exposure from reimbursements given to the Item-Eyes executives; and (5) tax exposure due to failure to comply with § 162(m). *See* JX 837 (illustrating the tax issues in the restatement that Hampshire attributes to Clayton and Clark); *see also* JX 794 (listing all of the restatement costs and attributing them to specific issues, most of which are not related to Clayton and Clark).

[435] JX 794 (Hampshire Group, Limited Potential Prior Period Adjustments); Tr. at 869 (Norwood).

[436] JX 837 (Hampshire Group, Limited Summary of Non-Income Tax Exposure Adjustments in Hampshire Group's 2005 10-K/A Restatement Due to Clayton and Clark's Actions) at 2.

costs that Hampshire incurred in restating its financial statements, which is equivalent to $18,472.61.

This yields a total of $259,742.26 against Clayton, and $37,500 against Clark.

B. Clark And Clayton Are Required To Pay Back Prorated Portions Of Their Incentive Bonuses

I have also found that Clayton and Clark are required, under the Clawback Memorandum, to pay back prorated portions of the Incentive Bonuses they received between November 23, 2005, and April 1, 2006. Clayton was paid $231,821 out of his $281,821 2005 Incentive Bonus.[437] Clark was paid in full for his 2005 Bonus which, judging by his 2006 Incentive Bonus, totaled around $30,000.[438] The parties shall submit supplemental briefing as to whether Clark and Clayton received any of their 2005 Incentive Bonus checks after the November 23, 2005 Clawback Memorandum. If they did, those amounts shall be returned to Hampshire.

C. Clayton And Clark's Damages

For Clayton and Clark's counterclaims against Hampshire, I find the following. First, on the vacation days that Clayton is owed, I find that Clayton began 2006 with only 25 vacation days as provided in Hampshire's Personnel Policy.[439] Clayton admits that he used 6.5 of those days,[440] leaving him with 18.5 vacation days for 2006. Because Clayton was placed on administrative leave halfway through the year on June 12, 2006, I

[437] Tr. at 761-62 (Clayton).
[438] JX 291 (Hampshire Group, Limited Incentive Bonus Program).
[439] Personnel Policy at 6 (explaining that employees with 25 or more years of service time had annual vacation eligibility of 25 days).
[440] Tr. at 768 (Clayton).

find that he is only entitled to payment for half of the 18.5 days that he otherwise would have been entitled to in 2006 — that is, 9.25 days.

Second, I find that Clark and Clayton are entitled to Link Bonuses if and when Hampshire's reserves associated with liability for Link's alleged fraud are reversed. Clark argues that he was promised a Link Bonus of $24,000, and Clayton claims entitlement to a Link Bonus of $89,000. But Hampshire disputes these estimates, claiming that Clayton is entitled to one quarter of that amount, and Clark entitled to half of the amount that he claims.[441] Given the limited evidence that was submitted on the amount of the Link Bonuses promised to Clayton and Clark, the parties shall submit citations to the existing record that support their competing arguments. Following a determination of how the amount of Link Bonuses that Clayton and Clark were promised, I will enter an order such that Clayton and Clark are paid those amounts upon the reversal of the Link reserves.

D. Clayton And Clark's Requests For Indemnification Are Not Ripe

Clayton and Clark both seek indemnification for the attorneys' fees they have incurred and for any damages award against them. They urge me to address their indemnification claim now.

But indemnification claims do not typically ripen until *after* the merits of an action have been decided, and all appeals have been resolved.[442] It would be inefficient for me

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[441] Hampshire's Answering Post-Trial Brief at 42 n.40.

[442] *See Paolino v. Mace Sec. Intern., Inc.*, 2009 WL 4652894, at *4 (Del. Ch. Dec. 8, 2009) ("It is generally premature to consider indemnification prior to the final disposition of the underlying action."); *Simon v. Navellier Series Fund*, 2000 WL 1597890, at *9 (Del. Ch. Oct. 19, 2000)

to predict the final outcome of this litigation, given the potential for appeal. Moreover, the question of indemnification will be complicated by the admixture of actual success by Clayton and Clark in defending some claims and the findings that they have breached their duty of loyalty as to some other issues.[443] The parties have not addressed the precise outcome I reach, and it would be imprudent for me to address the question of indemnification without input from the parties.

In this respect, I also note that with the receipt of this decision, the parties have yet another chance to sensibly resolve their differences. Rather than violate settled principles that dictate that indemnification claims be addressed when the underlying matter for which indemnification is sought is final, I prefer to follow the proper order and address indemnification in a later proceeding, if the parties still cannot settle.

E. Clayton's Third Party Contribution Claims Are Moot Or Lack Merit

As noted, Clayton brought third party claims against various other directors and officers for contribution. Had Hampshire succeeded in holding Clayton responsible for the damages related to Kuttner's expense reports, these third party claims would have raised interesting issues. It is clear that the board bears substantial responsibility for any damages suffered as a result of that issue, but the outside directors are immunized by an

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("As a matter of litigative efficiency, it makes little sense for this court to decide claims for indemnification — as opposed to claims for advancement of litigation expenses — in advance of a non-appealable final judgment.").

[443] *Compare* 8 *Del. C.* § 145(c) ("To the extent that a present or former director or officer of a corporation *has been successful on the merits* or otherwise in defense of any action . . . such person shall be indemnified against expenses . . . .") (emphasis added) *with id.* § 145(a) ("A corporation shall have the power to indemnify . . . a director [or] officer . . . of the corporation . . . *if the person acted in good faith and in a manner the person reasonably believed to be in or not opposed to the best interests of the corporation* . . . .") (emphasis added).

exculpatory charter provision. Nonetheless, there is no need to examine those issues because Clayton has not been held liable on the expense report issue.

As to those claims on which Clayton has been held liable — those relating to Item-Eyes, the sweater and tuition capers,[444] and his certification of certain financial statements — Clayton has not shown that the directors and other officers he names as Third Party Defendants committed any breach of fiduciary duty. Only Kuttner emerges from the record as being a person to whom Clayton (and Clark) may look for contribution. I touch on the contribution issue as it relates to Kuttner's settlement with Hampshire in the following section.[445]

F. The Parties Shall Provide Further Briefing To Aid In Finalizing The Judgment

The final issue I touch upon is one that I will not resolve right now. As the bidding stands, Clayton owes Hampshire $259,742.26, and Hampshire owes Clayton for 9.25 vacation days, and for payment of his Link Bonus when the reserves associated with Link are reversed. Clark owes Hampshire $37,500, and Hampshire owes Clark payment of his Link Bonus upon the reversal of Hampshire's reserves. Clayton and Clark may also owe Hampshire a portion of their 2005 Incentive Bonuses under the policy established in the Clawback Memorandum. Clayton and Clark may also have certain indemnification rights.

But, as noted previously, the primary party Hampshire blamed for all of the claims in this case and for many other issues is its former CEO, Kuttner. Hampshire settled with

[444] Although Golden took sweater deductions, the record does not show that he was a moving force behind the sweater program. That is in sharp contrast to the role played by Clayton.
[445] *See infra* page X.

Kuttner for consideration that is valued at $16,469,721.60.[446] The parties have sparred in an unhelpful way about the extent to which this settlement ought to reduce any judgment against Clayton and Clark. For their part, Clayton and Clark claim that they should get a judgment credit under § 6304 of the Delaware Uniform Contribution Among Tortfeasors Act (the "Contribution Act").[447] Hampshire claims that no credit at all should be given.

As a preliminary matter, I believe that Hampshire's argument that § 3604 of the Contribution Act does not apply to cases involving fiduciary misconduct is wrong.[448] A breach of fiduciary duty is easy to conceive of as an equitable tort,[449] and equity courts would seem to be the last place where a plaintiff could receive a double recovery.[450]

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[446] Again, Kuttner paid Hampshire $1,554,000 and 2,390,340 of Hampshire common stock, which was valued at $6.24 per share. *See supra* note 66. Kuttner gave Hampshire a particularly good deal, as Sperry acknowledged, because he sold his family's 30% stake in Hampshire back to the company for just $5 per share. Tr. at 539 (Sperry).

[447] *See* 10 *Del. C.* § 3604(a) (providing that "[a] release by the injured person of one joint tortfeasor, whether before or after judgment, does not discharge the other tortfeasor unless the release so provides; but reduces the claim against the other tortfeasor in the amount of the consideration paid for the release").

[448] Hampshire also argues that, under § 3606 of the Contribution Act, Clayton and Clark cannot receive the benefit of its settlement with Kuttner because they did not name Kuttner as a crossclaim defendant. 10 *Del. C.* § 6063(b) (stating that "[a] pleader *may* either (1) state a cross-claim against a co-party any claim that the coparty is or may be liable to the cross-claimant for . . . or (2) move for judgment for contribution") (emphasis added). But the failure to name Kuttner as a crossclaim defendant does not preclude them from seeking a judgment credit against the damages that Clayton and Clark owe Hampshire. *See* 10 *Del. C.* § 3604(a); *In re Telecorp PCS, Inc*., 2003 WL 22901025, at *3, n.3 (Del. Ch. Nov. 19, 2003) ("The failure to assert cross-claims pursuant to § 6306(b)(1) before the entry of a joint judgment against co-parties at most precludes a party who satisfied the entire judgment from obtaining contribution from a co-party in excess of the latter's equal *pro rata* share, but does not extinguish the right to contribution altogether.").

[449] *See* RESTATEMENT (SECOND) OF TORTS § 874 (1979) (observing that "[a] fiduciary who commits a breach of his duty as a fiduciary is guilty of tortious conduct"); *see also Sloan v. Segal*, 2008 WL 81513, *9 (Del. Ch. Jan. 3, 2008) (explaining that a defendant "could be viewed as having committed actions in the nature of a tort — a breach of fiduciary duty, an equitable obligation — in Delaware" for purposes of applying Delaware's long arm statute).

[450] Equitable contribution was applied in this court and our Supreme Court long before the Contribution Act took effect. *See De Paris v. Wilmington Trust Co.*, 104 A. 691, 695 (Del.

Indeed, this court's historic refusal to indulge punitive damage claims would seem to make that point.[451] Moreover, there is no doubt here that Hampshire admits that Kuttner was jointly and severally liable on all the issues on which it has prevailed against Clayton and Clark. Hampshire's original complaint made clear that it viewed Kutter as the primary wrongdoer as to most of these issues and at least equally culpable with Clayton on the Item-Eyes issue.

But, because the parties did not know how the case would come out, they have understandably not focused on how principles of contribution — in particular, those involving the judgment credit that might be required — precisely apply to the outcome I now reach. Rather than reach a determination without the aid of reasoned commentary by the parties, I require them to provide supplemental briefs, with record citations, of no more than 15 pages by July 27, 2010, with simultaneous answers of 10 pages due on August 3, 2010. These page limits cover all the issues I have identified as requiring further briefing. No extensions will be granted. The briefing should focus not only on whether the Kuttner settlement should be credited against any judgment for Hampshire, but on the record evidence as to the economic value of that settlement.

1918) ("[Contribution] is an equitable principle based on natural justice, and was originally enforced in equity only . . . ."); *Eliason v. Eliason*, 1869 WL 1358, at *2 (Del. Ch. Feb. 1869) ("One shall not bear a common burden in ease of the rest. Hence, if as often as may be done, a lien, charge or burden of any kind, affecting several, is enforced at law against only one, he should receive from the rest what he has paid or discharged on their behalf. This is the doctrine of equitable contribution . . . .). The Contribution Act is likely best read as codifying a clear approach to contribution to applies to all torts, be they legal or equitable, absent another statute more clearly covering the subject.

[451] *See Cardone v. State Dept. of Corr.*, 2008 WL 2447440, at *11 (Del. Ch. June 4, 2008) ("[T]his court does not award punitive damages."); *Gesoff v. IIC Indus. Inc.*, 902 A.2d 1130, 1154 (Del. Ch. 2006) ("[O]bviously, the court cannot award punitive damages.").

Additionally, the parties shall, again with reference only to the existing record evidence, compare Kuttner's settlement value with the total harm suffered by Hampshire. This comparison shall include a discussion of what effect, if any, it should have on the extent of a credit if it turns out that Hampshire suffered injuries from multiple issues of misconduct by Kuttner that, when considered with the issues for which Clayton and Clark are held liable, resulted in more monetary harm than would be recovered if Hampshire received 1) a full judgment from Clayton and Clark and 2) the benefits of the settlement with Kuttner.

The parties shall also address the amount of pre-judgment interest that is due.

Finally, one hopes that the parties would take this opportunity to try to settle the case. To that end, the parties shall meet in person, with counsel present, within ten calendar days, in order to make a good faith effort to settle the case or to narrow the issues. Delaware counsel shall certify by July 27, 2010 that such an effort took place.

VI. Conclusion

For the foregoing reasons, I find that Clayton breached his fiduciary duty of loyalty as to the tuition, Item-Eyes, sweater donation, and certification issues. I also find that Clark has breached his duty of loyalty as to the tuition and certification issues. I conclude that Clayton and Clark are required to pay back any portion of their 2005 Incentive Bonuses received after the Clawback Memorandum was issued. I also find that Hampshire is liable to Clayton for unpaid vacation days, and to both Clayton and Clark for Link Bonuses. On all other claims, the party with the burden of persuasion has failed to prevail. But, a final order addressing the amount of damages that each of the parties is owed will not be entered until after the parties submit supplemental briefing. IT IS SO ORDERED.