

### **DELAWARE SUPREME COURT RULES DIRECTORS OF A CORPORATION IN THE ZONE OF INSOLVENCY OWE NO FIDUCIARY DUTIES TO CREDITORS**

#### **COURT ALSO RULES CREDITORS HAVE NO DIRECT ACTION AGAINST DIRECTORS OF AN INSOLVENT CORPORATION**

After years of uncertainty, the Delaware Supreme Court has finally spoken on the issue of fiduciary duties owed to creditors by directors of corporations approaching insolvency and those that are in fact insolvent. In *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, the Delaware Supreme Court ruled that directors of corporations “in the zone of insolvency”<sup>1</sup> do not owe fiduciary duties to creditors and that, even as to insolvent corporations, a creditor may not assert direct claims for breach of fiduciary duty against the directors but must proceed on a derivative basis.

It is black letter law that directors owe fiduciary obligations to the corporation and its shareholders but “do not owe creditors duties beyond the relevant contractual terms.”<sup>2</sup> Two Delaware Court of Chancery cases, decided over 15 years ago, opened the door to the possibility that the relationship between directors and creditors might be different in the context of insolvency. In *Geyer v. Ingersoll Publications Co.*, 621 A.2d 784 (Del. Ch. 1992), the Court recognized that this general rule was subject to an exception for special circumstances, including “fraud, insolvency or a violation of statute.” In holding that a creditor had stated a claim against the directors of an insolvent corporation, the Court for the first time used the language “fiduciary duty” to describe the obligation owed to creditors by the directors of an insolvent corporation. However, neither *Geyer*, or the authority upon which it relied, delineated in any way the contours of this duty. In *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communication Corporation*, 1991 Del. Ch. LEXIS 215 (Dec. 30 1991), the Court of Chancery held that the duty owed by directors of an insolvent corporation is to the “enterprise,” which includes the creditors. In addition, for the first time, the Court of Chancery discussed the concept of the “vicinity of insolvency.” Although the Court of Chancery’s long footnote in *Pathe* was no more than a discussion of the difficult choices confronting a board of directors in such circumstances, the decision was widely interpreted as supporting the notion that directors of a corporation approaching insolvency owed fiduciary duties to creditors.

In recent years, the Court of Chancery has openly questioned this interpretation of *Pathe*. See, *Production Resources Group, L.L.C. v. NCT Group, Inc.* 863 A.2d 772 (Del. Ch. 2004); *Trenwick America Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168 (Del. Ch. 2006). Until now, however, the Delaware Supreme Court has not spoken on whether directors of a corporation

<sup>1</sup> While there is no standard definition for the “zone of insolvency,” the Court notes that such a definition is unnecessary as a result of its holding in this opinion. *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 2007 WL 1453705, at \*5, n. 20 (Del. May 18, 2007).

<sup>2</sup> *Id.* at \*6.

in the zone of insolvency owe fiduciary duties to creditors, or on the nature of the duties owed by directors when a corporation is in fact insolvent.

In *Gheewalla*, the plaintiff NACEPF entered into an agreement with Clearwire Holdings, Inc. (“Clearwire”) for the development of a wireless internet network. NACEPF held licenses and rights to certain wireless spectrum, and, under its agreement with Clearwire, the licenses were to be sold to Clearwire when they became available. The defendants were members of the Clearwire board of directors who had been designated by Goldman Sachs & Co., Inc. (“Goldman Sachs”). Goldman Sachs owned a large stake in Clearwire, and was the sole source of financing for the venture. The complaint alleged that Goldman Sachs determined not to pursue the company’s business plan due to a collapse in the wireless spectrum market, and thus favored its own interests over those of the plaintiff. NACEPF suing as a creditor, claimed that the three Goldman Sachs board designees owed it fiduciary duties because Clearwire was in the zone of insolvency, and in fact became insolvent.

The *Gheewalla* Court affirmed the decision of the Court of Chancery that Clearwire did not owe fiduciary duties to the plaintiff-creditor. According to the Court, even when a solvent corporation enters the zone of insolvency, “directors must continue to discharge their fiduciary duties to the corporation *and its shareholders* by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners.”<sup>3</sup> Citing the Court of Chancery’s opinion with approval, the Court catalogued the protections available to creditors, including “their negotiated agreements, their security instruments, the implied covenant of good faith and fair dealing, fraudulent conveyance law, and bankruptcy law,” and concluded that the additional protection provided by fiduciary duties is unnecessary. The Court, again citing the Court of Chancery, also reasoned that directors of corporations in the vicinity of insolvency would be unwilling to provide the leadership needed were they to face personal liability from creditors for their decisions.

The *Gheewalla* Court also clarified the question left open by *Geyer*. Although the creditors of insolvent corporations become the residual risk holders, the *Gheewalla* Court held that directors have the “duty to maximize the value of the insolvent corporation for the benefit of all those having an interest in it.”<sup>4</sup> The Court refused to permit a direct fiduciary claim by creditors against directors of an insolvent corporation because any duty to creditors alone would be in conflict with the directors’ duty to the corporation and all other interest holders. Specifically, “[d]irectors of insolvent corporations must retain the freedom to engage in vigorous, good faith negotiations with individual creditors for the benefit of the corporation.”<sup>5</sup> On the other hand, the Court recognized that any increase in value of an insolvent corporation should inure first to the benefit of creditors, and therefore creditors may, as residual beneficiaries, protect their interest by bringing derivative claims.<sup>6</sup>

The *Gheewalla* decision represents a substantial clarification of the law relating to the debtor/creditor relationship. From the corporate director’s standpoint, it provides significant comfort that decisions made in the critical and difficult environment that exists when a corporation is approaching insolvency will not be subject to second-guessing by creditors. From the lender and creditor standpoint, it punctuates the importance of building into agreements appropriate ratios and other metrics, as well as enforcement mechanisms that will protect the creditors’ interests both before and in the event of insolvency. However, the *Gheewalla* court also

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<sup>3</sup> *Id.* at \*7.

<sup>4</sup> *Id.* at \*8.

<sup>5</sup> *Id.*

<sup>6</sup> *Id.*

appears to clarify certain creditor protections by recognizing that a board's attempt to increase the value of an insolvent corporation should inure first to the benefit of creditors, and that if the board acts to the contrary, there may be a corporate claim against directors that creditors can bring derivatively.

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