

Delaware Supreme Court Rules Creditors May Not Bring Direct Actions Against Directors of Insolvent or Nearly Insolvent Corporations

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On May 18, 2007, the Supreme Court of Delaware, in *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*,¹ ruled for the first time that creditors do not have a right to assert “direct” claims for breaches of fiduciary duty against a corporation’s directors, notwithstanding that the corporation is insolvent or nearly insolvent. The court, however, declared that when a corporation is actually insolvent, although creditors cannot bring direct claims against directors for breaches of fiduciary duty, creditors may nevertheless bring claims derivative of the corporation itself. With this new significant decision, the Delaware Supreme Court took the opportunity to clarify questions raised by several recent Chancery Court decisions on the increasingly contentious matter of directors’ fiduciary duties where the corporation becomes insolvent or nearly insolvent.

Typically, creditors of a solvent company may not bring fiduciary duty claims against corporate directors, rather such claims are strictly reserved for shareholders. However, when a corporation has become insolvent or is in the “zone of insolvency” previous decisions of the Delaware Chancery Court have held that the directors then owe fiduciary duties to the corporation as a whole, which include the company’s creditors.² Thus, the shift in directors’ duties raises questions of whether creditors of such troubled companies have similar rights as those of shareholders. The recent Delaware Supreme Court decision makes clear that in contrast to the rights of shareholders, creditors may not bring “direct” actions for breaches of fiduciary duty by directors of an insolvent corporation or a corporation in the zone of insolvency, but rather may bring “derivative” suits where the corporation is clearly insolvent. The decision also calls into question whether directors of Delaware corporations owe any fiduciary duties to creditors prior to the corporation becoming insolvent.

In determining whether a claim is direct or derivative, the relevant inquiry is based on the following questions: who suffered the alleged harm — the corporation or the suing stockholder individually — and who would receive the benefit of the recovery or other remedy?³ In other

1 1. ___A.2d___, 2007 WL 1453705 (Del. May 18, 2007).

2. See *Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc’ns Corp.*, 1991 WL 277613 (Del. Ch. 1991).

3. *Tooley v. Donaldson, Lufkin & Jenrette, Inc* 845 A.2d 1031 (Del. 2004).

words, a direct claim is a claim on which a plaintiff may prevail without showing injury to the corporation, and importantly, is also a claim in which no relief flows to the corporation. Moreover, procedurally, a plaintiff who wishes to commence a derivative action must either make a demand on the company's board of directors to bring the action or demonstrate that demand was excused. In practice, however, this procedural requirement is a substantial impediment for a suit against directors as directors will rarely acquiesce to suits against themselves. Conversely, direct actions require no such procedural predicates.

The Facts

As the demand for wireless communication was increasing in 2000, North American Catholic Educational Programming Foundation, Inc. ("NACEPF") joined forces with several other networks holding licenses to a certain radio wave spectrum, known as "ITFS spectrum," to form the ITFS Spectrum Development Alliance, Inc. (the "Alliance"). Collectively, the Alliance owned a significant percentage of federally approved licenses for microwave signal transmissions used for educational programs. In late 2000, Goldman Sachs formed Clearwire Holdings, Inc. ("Clearwire"), a Delaware corporation, and initiated negotiations with the Alliance to obtain rights to the ITFS spectrum. The directors of Clearwire (the "Defendants") were all employees of Goldman Sachs and served on Clearwire's board of directors at the behest of Goldman Sachs. In March of 2001, Clearwire entered into a master use and royalty agreement (the "Master Agreement") with the Alliance, to acquire the Alliance members' spectrum licenses, as they became available, for an amount in excess of \$24.3 million.

When in June 2002, WorldCom revealed its accounting and financial problems, it appeared to industry experts that there would soon be a surplus of ITFS spectrum available from WorldCom. Thereafter, Clearwire began negotiations with members of the Alliance to terminate Clearwire's obligations under the Master Agreement. Eventually, Clearwire paid over \$2 million to the other members of the Alliance to settle all claims in connection with breaches under the Master Agreement. As a result, NACEPF was left as the sole remaining member of the Alliance. By October of 2003, Clearwire had been unable to obtain any further financing for its planned operations and effectively liquidated, leaving NACEPF with substantial unsatisfied claims.

The Chancery Court Decision

In March 2006, NACEPF filed a complaint in Chancery Court of Delaware against the Defendants asserting three claims. First, the Defendants fraudulently induced NACEPF to enter into the Master Agreement. Second, because at all relevant times, Clearwire was either insolvent or in the "zone of insolvency," the Defendants owed fiduciary duties to NACEPF as a substantial creditor of Clearwire, and that the Defendants breached those duties by, among other things, not preserving the assets of Clearwire for Clearwire's benefit and that of its creditors when it became apparent that Clearwire would not be able to continue as a going concern and cease operations. Third, the Defendants tortiously interfered with a prospective business opportunity belonging to NACEPF in that they caused Clearwire to acquire NACEPF's ITFS spectrum without

payment, which resulted in NACEPF losing the opportunity to convey its licenses for spectrum to other buyers.

In ruling on a motion to dismiss the complaint, the Court of Chancery was confronted with several threshold issues, including whether, as a matter of law, a corporation's creditors may assert direct claims against directors for breach of fiduciary duties when (i) the corporation is insolvent and (ii) the corporation is not insolvent, but is in the "zone of insolvency." First, the Court of Chancery addressed the scenario when the corporation is in the zone of insolvency, and observed that it is well established under Delaware law that directors owe their fiduciary obligations to the corporation and its shareholders, and creditors are afforded protection through contractual agreements and other actions under fraud and conveyance law, bankruptcy law and general commercial law. The Chancery Court reasoned that the imposition of an additional, unique layer of protection through direct claims for breaches of fiduciary duty would be unnecessary, and stated that "an otherwise solvent corporation operating in the zone of insolvency is one in most need of effective and proactive leadership — as well as the ability to negotiate in good faith with its creditors — goals which would likely be significantly undermined by the prospect of individual liability arising from the pursuit of direct claims by creditors."⁴ Consequently, the court ruled that where the corporation is in the zone of insolvency, creditors may not bring direct actions against directors for breaches of fiduciary duty.

Addressing the scenario where the corporation is insolvent, the Court of Chancery remarked that when the corporation is solvent the fiduciary duties of the directors may be enforced by its shareholders, who have standing to bring derivative actions on behalf of the corporation because they are the ultimate beneficiaries of the corporation's growth and increased value. When a corporation is insolvent, however, its creditors take the place of the shareholders as the residual beneficiaries of any increase in value. Therefore, equitable considerations give the creditors of an insolvent corporation the standing to pursue derivative claims against the directors of the insolvent corporation. The Chancery Court, while relying on another Chancery Court decision in *Production Res. Group v. NCT Group, Inc.*,⁵ stated that the fact that the corporation has become insolvent does not turn derivative claims into direct claims, it simply provides creditors with standing to assert those claims. At all times, claims of this kind belong to the corporation itself because bad acts by directors operate to injure the company in the first instance by reducing its value, and injuring creditors only indirectly, by diminishing the value of the company and its assets from which the creditors may ultimately satisfy claims. Thus, the Court of Chancery concluded that in either scenario NACEPF may not bring direct claims against the directors of Clearwire and granted the Defendants' motion to dismiss the complaint.

4. *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 2006 WL 2588971, at * 13 (Del. Ch. Sept. 1, 2006).

5. 863 A.2d 772 (Del. Ch. 2004).

The Delaware Supreme Court Affirms

On appeal, the Delaware Supreme Court affirmed the final judgment of the Court of Chancery and made the following key rulings: (i) when a corporation is in the zone of insolvency, but not yet insolvent, creditors are barred from bringing direct actions against directors for breaches of fiduciary duty; and (ii) when a corporation is insolvent, creditors may not assert direct claims for breaches of fiduciary duty against the directors, but may only assert claims derivative of the corporation itself.

In its decision, the Delaware Supreme Court initially commented that although the subject had been discussed in several Chancery Court decisions⁶ and in many scholarly articles,⁷ it had never addressed the issue of whether creditors have the right to sue directors of a Delaware corporation operating in the zone of insolvency. The Supreme Court began with rejecting NACEPF's argument that it should be permitted to bring a direct claim for breaches of fiduciary duty against the directors when the corporation was in the zone of insolvency. Agreeing with the Chancery Court, the Delaware Supreme Court observed that the general rule is that directors do not owe creditors duties beyond the relevant contractual terms and have the legal responsibility to manage the business of a corporation for the benefit of its shareholders. Importantly, the Delaware Supreme Court further reasoned that "When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: 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*."⁸ Therefore, the Court concluded that creditors do not have standing to bring direct actions for breaches of fiduciary duty against directors of corporations in the zone of insolvency and strongly implied that Delaware directors owe *no* fiduciary duties to creditors prior to actual insolvency.

The Delaware Supreme Court next addressed the issue of whether a derivative claim for breaches of fiduciary duty may be brought by creditors against directors when the corporation crossed from the zone of insolvency into actual insolvency. The Delaware Supreme Court reasoned that when a corporation is solvent, those duties may be enforced by its shareholders, who have standing to bring derivative actions on behalf of the corporation because they are the ultimate beneficiaries of the corporation's growth and increased value. When a corporation is insolvent, however, its creditors take the place of the shareholders as the residual beneficiaries of any increase in value. Consequently, the creditors of an insolvent corporation have standing

6. See *North American Catholic*, 2007 WL 1453705, at * 6 (citations omitted).

7. See *North American Catholic*, 2007 WL 1453705, at * 6 (citations omitted).

8. *Id.* at 19 (emphasis added).

to maintain derivative claims against directors on behalf of the corporation for breaches of fiduciary duties.

Finally, the Delaware Supreme Court focused on whether creditors have a right to bring direct claims against directors of an insolvent corporation. In ruling that creditors have no such right, the Court reasoned that to recognize such a new right for creditors to bring direct fiduciary claims against such directors would create confusion and conflict between the directors' duty to maximize the value of the insolvent corporation for the benefit of all constituencies, and the purported newly recognized direct fiduciary duty to individual creditors. Further, the court stated that directors of insolvent corporations must retain the freedom to engage in "vigorous, good faith negotiations with individual creditors for the benefit of the corporation." Accordingly, the court concluded that individual creditors of an insolvent corporation have no right to assert direct claims for breach of fiduciary duty against corporate directors.

Conclusion

The *North American Catholic* decision is significant on several fronts. First, it unambiguously sets forth the Delaware Supreme Court's view that under Delaware law creditors may not bring direct actions for alleged breaches of fiduciary duty against directors of insolvent corporations and corporations in the zone of insolvency. Second, the decision presents a handbook for creditor actions that may be brought against troubled companies such as derivative suits against directors for breaches of fiduciary duty where the corporation is actually insolvent coupled with the protections afforded creditors through contractual agreements, fraudulent conveyance law, implied covenants of good faith and fair dealing, bankruptcy law and general commercial law. Finally, in its discussion of insolvency and zone of insolvency, the Delaware Supreme Court provides clear guideposts of how it views directors' shifting fiduciary duties as a corporation slides from one troubled category to the next.

It is expected that the Delaware Supreme Court will expand on these holdings when it decides the appeal currently pending before it in *Trenwick American Litigation Trust v. Ernst & Young LLP*⁹ in which the Court of Chancery held that there is no cause of action under Delaware law for "deepening insolvency." Taken together, *North American Catholic* and *Trenwick* may conclusively define the extent of Delaware director fiduciary duties to creditors.

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9. *Trenwick American Litigation Trust v. Ernst & Young L.L.P.*, 1571-N, 2006 Del. Ch. LEXIS 139 (Del. Ch. Aug. 10, 2006)