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# CORPORATE ALERT

## DELAWARE SUPREME COURT LIMITS CREDITOR CLAIMS AGAINST DIRECTORS

The Delaware Supreme Court recently held that creditors of an insolvent or near-insolvent Delaware corporation may not assert direct claims against the corporation's directors for breach of fiduciary duty. *North American Catholic Educational Foundation, Inc. v. Gheewalla*, No. 521-2006, slip op. (Del. May 18, 2007). Of perhaps equal significance, the decision also suggests that creditors may not be able to assert *derivative* claims for breach of fiduciary duty against directors of a corporation that is operating in the "zone of insolvency" but is not yet insolvent. Prior case law and commentary had supported the view that once a corporation is operating in the zone of insolvency, the constituencies to whom directors owe fiduciary duties are expanded to include creditors.

The Delaware Supreme Court's decision affirmed the Chancery Court's dismissal of a claim for breach of fiduciary duty brought by a creditor of Clearwire Holdings, Inc. against three directors of Clearwire who allegedly served on the Clearwire board at the behest of Goldman Sachs & Co. and who allegedly used their positions to favor Goldman Sachs to the detriment of the plaintiff at a time when Clearwire was either insolvent or near insolvency. The creditor had brought its suit as a *direct* claim alleging particularized harm suffered by the plaintiff individually, rather than as a *derivative* claim in which the harm is suffered by the corporation and for which any recovery would belong to the corporation.

### ZONE OF INSOLVENCY: NO DIRECT FIDUCIARY CLAIMS BY CREDITORS ALLOWED

Emphasizing the need for "providing directors with definitive guidance in this area,"[1] the Delaware Supreme Court first unequivocally held that no direct claim for breach of fiduciary duty may be asserted by creditors of a solvent corporation that is operating in the "zone of insolvency." In declining to recognize a direct cause of action, the court noted the general reluctance of Delaware courts to expand fiduciary duties and also explained that creditors have a plethora of legal protections available to them, including "contractual agreements, fraud and

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[1] *North American Catholic Educational Foundation, Inc. v. Gheewalla*, No. 521-2006, slip op. (Del. May 18, 2007) at 19.

fraudulent conveyance law, implied covenants of good faith and fair dealing, bankruptcy law, general commercial law and other sources of creditor rights."[2] The court also agreed with the Chancery Court's view that recognition of a direct claim would result in economic inefficiency since "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."[3]

**INSOLVENCY: NO DIRECT FIDUCIARY CLAIMS BY CREDITORS ALLOWED (BUT CREDITORS MAY BRING DERIVATIVE FIDUCIARY CLAIMS)**

The Delaware Supreme Court also held in *Gheewalla* that creditors of an insolvent corporation may not bring direct claims against directors for breach of fiduciary duty. In reaching its decision, the court emphasized that "directors owe fiduciary duties to the corporation. 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."[4] Consequently, the court stated, creditors of an insolvent corporation have standing to maintain derivative claims against directors on behalf of the corporation for breach of fiduciary duty. However, creditors do not have standing to bring direct claims against directors in such situations.[5] In the court's view, granting creditors the right to bring direct fiduciary claims against directors of insolvent corporations "would create a conflict between those directors' duty to maximize the value of the insolvent corporation for the benefit of all those having an interest in it, and the newly recognized direct fiduciary duty to individual creditors."[6]

**ZONE OF INSOLVENCY: NO DERIVATIVE FIDUCIARY CLAIMS BY CREDITORS ALLOWED?**

Although the court in *Gheewalla* was not presented with the question of whether a creditor of a solvent corporation operating in the zone of insolvency may bring a derivative claim against directors for breach of fiduciary duty, the *Gheewalla* decision suggests that creditors lack standing to assert such claims. In reaching its decision that creditors may not bring direct fiduciary claims against directors of a corporation operating in the zone of insolvency, the court stated:

> When a solvent corporation enters 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*.[7]

The court's emphasis on the duty of directors of a solvent corporation that is approaching insolvency to continue to advance the interests of shareholders (and the concomitant lack of any mention of the interests of creditors) indicates that the Delaware Supreme Court would use the bright line of insolvency to determine when creditors have standing to bring derivative fiduciary claims. Prior to actual insolvency, it appears that only shareholders may enforce director fiduciary duties.

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[2] *Id.* at 15.
[3] *Id.* at 18.
[4] *Id.* at 20 (emphasis in original).
[5] *Id.* at 20, 23.
[6] *Id.* at 23.
[7] *Id.* at 20 (emphasis added).

## CONCLUSION

The *Gheewalla* decision provides some much-needed guidance to those advising directors of financially troubled companies. It is now clear that directors of insolvent and near-insolvent Delaware corporations are shielded from liability for direct fiduciary claims by creditors. While a creditor may still theoretically bring a derivative claim against directors for breach of fiduciary duty occurring while the corporation is insolvent, from a practical point of view, only a creditor with a substantial claim would have the incentive to bring such a claim since the proceeds of any recovery would belong to the insolvent corporation. Furthermore, once the insolvent corporation is in bankruptcy, any such action is constrained by the automatic stay provisions of the Bankruptcy Code and typically such breach of fiduciary duty claims may be asserted only by the debtor or a trustee or by a creditors' committee if the debtor declines to bring such an action and the court finds that there is a colorable claim. Finally, the *Gheewalla* decision suggests that creditors do not have the right to bring derivative suits for breach of fiduciary duties occurring while a corporation is in the zone of insolvency, but not yet actually insolvent.

## CONTACT INFORMATION

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