

**THE DELAWARE SUPREME COURT PROVIDES
“CLEAR SIGNAL BEACONS AND BRIGHTLY LINED CHANNEL MARKERS”
FOR DIRECTORS OF FINANCIALLY TROUBLED DELAWARE CORPORATIONS**

The Delaware Supreme Court recently held, in a case of first impression for that court, that creditors of insolvent and nearly-insolvent Delaware corporations may not assert *direct* claims against directors for breaches of fiduciary duties. *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, No. 521, 2006 slip op. (Del. May 18, 2007). The Delaware Supreme Court also made clear that creditors of insolvent corporations may, under certain circumstances, have standing to assert derivative claims for injury caused to the corporation. In doing so, the court affirmed the Court of Chancery’s dismissal of a direct claim for breach of fiduciary duty based on allegations that the three director-defendants, who were appointed to the board of directors of Clearwire Holdings, Inc. by Goldman Sachs & Co., used their positions to favor the interests of Goldman Sachs to the detriment of plaintiff at a time when Clearwire had been unable to obtain financing and did not have the ability to pay its debts as they became due. In short, the court’s decision will make it substantially more difficult for creditors to hold directors personally liable as fiduciaries for actions or inactions when the corporation was insolvent or close to insolvency.

In analyzing the question of whether creditors should have a right to bring a direct claim for breach of fiduciary duty, the court noted a reluctance to expand fiduciaries duties and observed that creditors have historically had a variety of legal protections available to them to protect their rights:

. . . creditors are afforded protection through contractual agreements, fraud and fraudulent conveyance law, implied covenants of good faith and fair dealing, bankruptcy law, general commercial law and other sources of creditor rights.¹

The court also endorsed the Court of Chancery’s reasoning 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.”²

Given the importance of providing “definitive guidance” to directors, the Delaware Supreme Court ruled it was compelled “to hold that no direct claim for breach of fiduciary duties may be asserted by the creditors of a solvent corporation that is operating in the zone of insolvency.”³ The next statement in the court’s opinion may have an even more significant impact on creditor claims, whether direct or derivative, for breach of fiduciary duty: “When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware

¹ Slip op. at 15. See also *Malone v. Brincat*, 722 A.2d 5 (Del. 1998) (noting interplay between federal securities laws claims and the fiduciary duty of disclosure).

² Slip op. at 18 (internal quotation omitted).

³ Slip op. at 19.

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.*”⁴ That the court has *excluded* creditors as a constituency to whom duties are owed before insolvency, but within the zone of insolvency, suggests directors may be able to defeat creditor claims, even if brought derivatively, by defending that the corporation was not, in fact, insolvent.

Noting the “well settled” law that shareholders of solvent corporations have standing in certain circumstances to bring derivative claims on behalf of the corporation by virtue of their status as its ultimate beneficiaries, the Supreme Court observed that once the corporation is insolvent, “*creditors take the place of the shareholders* as the residual beneficiaries of any increase in value”⁵ and, for that reason, creditors “of an *insolvent* corporation have standing to maintain derivative claims against directors on behalf of the corporation for breaches of fiduciary duties.”⁶ Here too, the court’s reference to the interests of creditors as *replacing* those of shareholders is significant as it makes clear that directors are not required to take the shareholders interests into consideration when evaluating options for an insolvent corporation and that, in fact, shareholders no longer have standing to assert claims against the directors, whether directly or derivatively. The Delaware Supreme Court may have another opportunity to revisit some of these issues when it decides the appeal presently before it of the Court of Chancery’s ruling in *Trenwick America Litigation Trust v. Ernst & Young, L.L.P.* that there is no cause of action for “deepening insolvency” under Delaware law.

⁴ *Id.* (emphasis added).

⁵ *Id.* at 20 (emphasis added).

⁶ *Id.* (emphasis in original).

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