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Delaware Supreme Court Rules That Creditors Of A Delaware Corporation Cannot Bring Direct Claims Against Directors For Breach Of Fiduciary Duty – *But Questions Remain*

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In *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 2007 WL 1453705 (Del. May 18, 2007), the Delaware Supreme Court, in a case of first impression, provided some clarity on the controversial issue of whether and to what extent creditors have the ability to assert fiduciary duty claims against directors. The Supreme Court held, unequivocally, that "creditors of a Delaware corporation that is either insolvent or in the zone of insolvency have no right, as a matter of law, to assert direct claims for breach of fiduciary duty against [a] corporation's directors." Rather, the Court noted, creditors can protect their interests by asserting derivative fiduciary duty claims on behalf of an insolvent corporation or by asserting any applicable direct non-fiduciary duty-based claims. In the opinion, the Court pointed out that the plaintiff asserted only a direct claim for breach of fiduciary duty and waived any basis to pursue such a claim derivatively.

While the *Gheewalla* decision put to rest the issue of a creditor's ability to pursue direct claims for breach of fiduciary duty, there remain unresolved questions about the "insolvency" standard and the rights and roles of creditors under Delaware's corporate law.

The Facts and Holding of *Gheewalla*

The Delaware Supreme Court's decision in *Gheewalla* affirmed the Court of Chancery's dismissal of a claim by plaintiff North American Catholic Educational Programming Foundation, Inc. ("NACEPF") — a putative creditor of Clearwire Holdings, Inc. ("Clearwire") — that directors of Clearwire, while the company was insolvent or in the "zone of insolvency," breached their fiduciary duties by:

(1) not preserving the assets of Clearwire for its benefit and that of its creditors when it became apparent that Clearwire would not be able to continue as a going concern and would need to be liquidated and (2) holding on to NACEPF's ITFS license rights when Clearwire would not use them, solely to keep Goldman Sachs's investment "in play."

The director-defendants were directors of Clearwire (the "Defendants") serving at the behest of their employer, Goldman Sachs. NACEPF alleged that the Defendants effectively controlled Clearwire through the influence (financial and otherwise) that Goldman Sachs had over Clearwire.

NACEPF was a member of an alliance of FCC license holders, which included Hispanic Information and Telecommunications Network, Inc. ("HITN"), Instructional Telecommunications Foundation, Inc. ("ITF"), and various affiliates of ITF (collectively, the "Alliance"). The Alliance collectively owned a significant percentage of FCC-approved licenses for microwave signal transmissions ("spectrum") used for educational programs.

At some time between 2000 and 2001, Clearwire negotiated an agreement with the Alliance under which Clearwire was to acquire the licenses of the Alliance members when such licenses became available. In return, Clearwire was to pay the members of the Alliance more than $24.3 million. According to NACEPF's allegations, the Defendants represented that Clearwire's stated business purpose was to create a national system of wireless connections to the internet. NACEPF also alleged that the Defendants knew, but did not inform NACEPF that Goldman Sachs did not intend to fund Clearwire, and thus, Clearwire did not have the funds to pay to the Alliance, which included NACEPF, under the terms of the agreement.

A little over one year later, the market for wireless spectrum collapsed when WorldCom announced its accounting problems. Consequently, it appeared that a surplus of spectrum was to become available from WorldCom. Therefore, Clearwire began negotiation with the members of the Alliance to end Clearwire's obligations pursuant to the agreement. Ultimately, Clearwire paid over $2 million to HITN and ITF to settle their claims. The settlements left NACEPF as the sole remaining member of the Alliance. According to the complaint, by October 2003, Clearwire "had been unable to obtain any further financing and effectively went out of business."

As a result of Clearwire's rapid demise, NACEPF filed a complaint in the Court of Chancery, asserting three claims against the Defendants: (i) fraudulent inducement; (ii) breach of fiduciary duties; and (iii) tortious interference with prospective business opportunities. In response to the filing of the complaint, the Defendants filed a motion to dismiss based on lack of personal jurisdiction and failure to state a claim. NACEPF premised personal jurisdiction over the Defendants for the non-fiduciary duty-based claims on the Court of Chancery's first determining that the fiduciary duty claim was viable. The Delaware courts have personal jurisdiction over non-resident directors and officers of Delaware corporations pursuant to Title 10, Delaware Code § 3114. The statute

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provides that non-resident directors and officers of Delaware corporations are subject to personal jurisdiction in the Court of Chancery for claims relating to an individual's duty as a director or an officer of the corporation. The plaintiffs did not assert any other basis on which the Court of Chancery had jurisdiction over the director-defendants. The Court of Chancery proceeded on the basis that if it found that the fiduciary duty claim must be dismissed for failure to state a claim, then it would be without personal jurisdiction over other claims. The Court of Chancery then dismissed the complaint for failure to state a cognizable fiduciary duty claim.

On appeal, the Delaware Supreme Court concluded first that creditors of a Delaware corporation merely in the "zone of insolvency" at the time of an alleged breach of fiduciary duty may not bring direct breach of fiduciary duty claims against directors. The Court stated that, while directors owe fiduciary obligations to the corporation, generally they do not owe such duties to creditors. The Court reasoned that while stockholders rely on directors acting as fiduciaries to protect their interest, "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."

The Delaware Supreme Court very pointedly and unequivocally held:

> [T]he need for providing directors with definitive guidance compels us 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. 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.

The Court further concluded that, although creditors of a Delaware corporation that is actually insolvent "take the place of shareholders as the residual beneficiaries" of the company, and therefore, "have standing to maintain derivative claims against directors on behalf of the corporation for breaches of fiduciary duties," they may not assert direct claims for breach of fiduciary duty. The Court stated that permitting a corporation's creditors to bring such claims would:

> create uncertainty for directors who have a fiduciary duty to exercise their business judgment in the best interest of the insolvent corporation. To recognize a new right for creditors to bring direct fiduciary duty claims against those directors 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. Directors of insolvent corporations must retain the freedom to engage in vigorous, good faith negotiations with individual creditors for the benefit of the corporation.

On the other hand, the Court noted that permitting a corporation's creditors to bring a derivative claim does not benefit them directly but seeks recovery of value belonging to the company as a whole. The Court also indicated that creditors could bring whatever non-fiduciary duty-based direct claims that are available and identified some of these claims as breach of contract, fraud, fraudulent conveyance, etc.

Potential Issues and Implications of the *Gheewalla* Decision

Notwithstanding the clarity in the Delaware Supreme Court's ultimate ruling in *Gheewalla* on the issue of direct claims, with regard to derivative claims there are some unresolved questions about when such fiduciary duty-based claims can be brought by creditors. Some practitioners and scholars have asked whether the "zone of insolvency" has any remaining significance under Delaware law and whether a creditor can assert a derivative claim against directors of a Delaware corporation operating in the "zone of insolvency." While the Delaware Supreme Court did not expressly decide the issue, the answer would appear to be "no." In its discussion on the viability of fiduciary duty claims by creditors, the Delaware Supreme Court brushed aside the "zone of insolvency" analysis and limited its recognition of claims by creditors to actual insolvency: "Creditors may … protect their interest by bringing *derivative* claims on behalf of [an] *insolvent* corporation …." (Emphasis added). If this language restricts a creditor's ability to pursue derivative claims outside the context of insolvency, the "zone of insolvency" would have no remaining practical application in the world of fiduciary duty claims by creditors. The more significant questions relate to application and to practicality: When can creditors derivatively assert fiduciary duty claims?

What is the "Insolvency" Standard?

"Insolvency" for purposes of pursuing a derivative claim under Delaware's corporate law may be different from "insolvency" as generally understood by most practitioners. Historically, there have been two principle tests for insolvency: (i) inability to pay debts as they come due; and (ii) liabilities exceed the fair market value of assets. These are also the tests set forth in Delaware's Fraudulent Transfers Act, Title 6, Delaware Code §§ 1302(a)-(b). Although the Delaware Supreme Court clearly stated that "[c]reditors may … protect their interest by bringing *derivative* claims on behalf of [an] *insolvent* corporation …." (emphasis added), the standard articulated in *Gheewalla* appears to have added something to the historical insolvency test. The Court articulated the second test as follows: "A deficiency of assets below liabilities *with no reasonable prospect that the business can be successfully continued in the face thereof.*" (Emphasis added). The additional language was adopted from the Court of Chancery's decision below as well as the Court of Chancery's prior decision in *Production Resources Corp. v. NCT Group, Inc.* 863 A.2d 772, 782 (Del. Ch. 2004). This additional language makes the standard somewhat different from *some* earlier Delaware precedent and United States Supreme Court precedent, which follow the balance sheet

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approach. For example, in *Geyer v. Ingersoll Publ'ns Co.*, 621 A.2d 784, 789 (Del. Ch. 1992), the Delaware Court of Chancery explained that a corporation is insolvent if "it has liabilities in excess of a reasonable market value of assets held." Similarly, in *McDonald v. Williams*, 174 U.S. 397, 403 (1899), the United States Supreme Court defined an insolvent corporation as an entity with assets valued at less than its debts. In *Production Resources*, the Court was addressing a request for appointment of a receiver under Section 291 of the Delaware General Corporation Law, which may explain the additional language focusing on continuation of the business. Moreover, according to the *Gheewalla* opinion, Clearwire was insolvent *and*, while not in bankruptcy, was "out of business" at the time of the litigation, which may explain why the *Gheewalla* Court followed the Court of Chancery's expansive definition of insolvency. However, one could argue that regardless of whether a company is out of business or operating, *Gheewalla* has announced a rule of law that imposes an additional burden on creditors before they can pursue derivative claims.

The "insolvency" test employed has implications. Many companies, including many public companies with significant market caps and much long-term promise (in the view of their management), operate as viable entities even though a creditor could argue they are technically "insolvent" under a balance sheet test because of the inability to include future prospects as an intangible asset. Notably, the cost of litigation between management and creditors over what insolvency test applies and whether it has been satisfied could be just enough to ensure that a company on the fence will go out of business. That possibility, and the leverage to creditors that comes with that possibility, is at least one obvious consequence of creditors having standing to at least litigate the issue of a company's "reasonable prospect" of continuing the business at the same time the company is nonetheless attempting to operate while being balance sheet insolvent.

Is There Dual Standing?

If a company is paying its debts as they come due, is viable and somewhat promising (in management's view) notwithstanding a balance sheet analysis, and if creditors can bring a derivative fiduciary claim under such circumstances, then is there dual standing so that stockholders have a simultaneous right to bring a claim? If the answer is "yes," then can stockholders take a position contrary to that of the creditors in the litigation, or do stockholders lose standing to sue derivatively if the company is insolvent? No Delaware decision states that stockholders lose standing, and what would be the basis to deprive stockholders of standing when they remain invested with a possibility (though maybe remote) of a return on their investment over time. Nonetheless, it is noteworthy that the Delaware Supreme Court's opinion stated that the "creditors *take the place of* shareholders as the residual beneficiaries of any increase in value" resulting from a derivative claim. (Emphasis added). "Replacement" of an interest is inconsistent with dual standing. Furthermore, to take this a step further, what if the derivative claim exceeds the amount of the solvency deficiency so that the stockholders have a residual interest after the creditors? Do the creditors bring the claim for both or do both the creditors and stockholders have the right to bring the claims as their interests may appear?

As all of this plays out in future cases, arguments on both ends of the spectrum may emerge. Directors and corporations may seize upon the language in *Gheewalla* to argue for a rule that provides more clarity. For example, they may argue that until equity is wiped out (*i.e.*, out of the money) and the company is in bankruptcy, dissolution, or at least "out of business" and stockholders no longer have an interest in pursuing fiduciary duty claims, when it comes to the issue of compliance with their fiduciary duties, management should only answer to stockholders (the constituency who elected them to act as fiduciaries). Later, when creditors "take the place of" stockholders, creditors can bring derivative fiduciary duty claims that were available to the stockholders, but only as the residual beneficiaries of those claims — *i.e.*, claims that the company itself was harmed by a breach of fiduciary duty. On the other side, creditors may argue that dual standing is workable, and if the goal is to determine whether the company has been harmed by a breach of fiduciary duty, a court can simply hear from both stockholders and creditors (as it does when stockholders make competing arguments) and decide which constituency, if either, is correct. In any event, future cases may show that this is a small or non-issue and that stockholders and creditors are aligned most of the time.

Impact on Director Decision-Making

Importantly, the Delaware courts have made it clear that directors, in the exercise of their business judgment, are free to engage in entrepreneurial risk-taking. Thus, when fiduciary duty claims are asserted in the context of insolvency, such claims are likely to focus, to various degrees, on (i) whether a board's decision was outside the bounds of reasonable business judgment and placed too much risk on creditors, or (ii) whether the directors disregarded the stockholders' interests by foregoing business strategies, opting instead to preserve assets for creditors. The central question may well be whether the directors' fiduciary duties rest primarily (or exclusively) with the corporation *and its stockholders* or whether, when the company is insolvent, the directors' fiduciary duties rest *only* with the corporation (whatever the courts ultimately determine that to mean) and the directors cannot favor the interests of one corporate constituency (*e.g.*, stockholders) over another corporate constituency (*e.g.*, creditors).

While legal analyses are nice, directors want to avoid potential liability for their decision-making. This is an even greater concern if the breach of fiduciary duty claim is being pursued in a bankruptcy proceeding, where advancement of defense costs from the bankrupt company may not be available, leaving directors to rely on a fast-depleting directors' & officers' insurance policy. Clearly, a stockholder or creditor asserting a derivative claim will have to demonstrate that the directors breached either their duty of care or their duty of loyalty (as a consequence of a conflict of interest or bad faith action); but the analysis is not crystal clear. Cases where a board of a wholly-owned subsidiary harms the company (creditors and/

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or stockholders) by transferring assets to the parent or guaranteeing the debt of the parent for inadequate consideration may prove easy; but, consider a scenario where the company has never turned a profit and has used $35 million of a $50 million line of credit, and the board is faced with the following choice: cease doing business now with the bank trying to recover just $35 million or pursue another strategy with a very low probability of success (but a probability nevertheless) and utilize the remaining $15 million. When the company ultimately fails, imagine being a former director facing claims by creditors who have obtained leave from the bankruptcy court to bring the action in a non-Delaware court with a right to a jury trial and who are arguing that not enough weight was given to preserving assets (for the creditors) and that the low probability of success of the plan pursued (for the stockholders) was so low that it was not a valid business judgment or amounted to bad faith. When does a business plan get so risky (if ever) that the duty of the board shifts to preserving assets? Add to the aforementioned facts a board dominated by a private equity firm with preferred stock and a liquidation preference, and therefore a greater incentive to forego risk so as to benefit from the preference rather than having to line up with the unsecured creditors in bankruptcy if a last-ditch business strategy fails. Although the language of the rule of law may be clear that directors owe their fiduciary duties to the corporate enterprise, and there is a deference to business judgment absent disabling conflicts of interest, weighing the interests of stockholders and creditors may not be easy for directors sitting on the boards of distressed companies.

Conclusion

In the end, although it remains to be seen how the Delaware courts will deal with the foregoing issues, directors can take some comfort in the fact that the Delaware Supreme Court held that while in the "zone of insolvency" the company is to be managed for the benefit of stockholders (by negative implication, not creditors). Indeed, the precise language employed by the Court was quite clear: "[W]hen 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 stockholder owners."

If you have any questions regarding the matters discussed in this advisory, please contact the Edwards Angell Palmer & Dodge LLP attorney responsible for your affairs or:

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