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Private Equity Bulletin

DELAWARE SUPREME COURT SAYS – DIRECTORS CANNOT BE SUED DIRECTLY BY CREDITORS FOR BREACHES OF FIDUCIARY DUTY CLAIMS

Creditors of Delaware corporations that are either insolvent or in the zone of insolvency have no right, as a matter of law, to assert direct claims for breach of fiduciary duties against the corporation's directors. In a recent decision of the Delaware Supreme Court in *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 2007 Del. LEXIS 227 (Del. May 18, 2007), the Delaware Supreme Court extinguished any ongoing questions previously raised by the judiciary in Delaware that any individual creditor of a Delaware corporation has the right to assert a direct claim for breach of fiduciary duty against the directors of an insolvent corporation.

The complaint filed by North American Catholic Educational Programming Foundation, Inc. ("North American"), a creditor and not a shareholder of Clearwire Holdings, Inc. ("Clearwire") alleged that the directors of Clearwire (i) fraudulently induced North American to enter into, and perform a contract with Clearwire; (ii) breached their fiduciary duties to the creditors of Clearwire; and (iii) tortuously interfered with the creditor's business opportunities. The complaint alleged direct, rather than derivative fiduciary duty claims against the directors of Clearwire resulting from the directors', while less than a majority of the board, ability to control Clearwire and use this power in derogation of their fiduciary duties to North America by not preserving the assets of Clearwire for its benefit when it became apparent that Clearwire would not be able to continue as a going concern and would need to be liquidated.

North American held radio wave spectrum licenses for educational programs that were known as "Instruction Television Fixed Service" spectrum licenses. North American entered into a Master Use and Royalty Agreement with Clearwire whereby Clearwire obtained rights to purchase those licenses. To do so, Clearwire was obligated to pay North American more than $24.3 million for such licenses. The complaint alleged that the defendants, the directors of Clearwire, knew but did not tell North American that Clearwire did not intend to carry out their obligations set forth under the Master Agreement. North American asserted in its complaint that because, at all relevant times, Clearwire was either insolvent or in the "zone of insolvency," the defendants owed fiduciary duties to North American as a creditor of Clearwire.

Insolvency under Delaware law is determined using the "Balance Sheet" test or the "Equity" test. The Court in *North American*, applying the "Balance Sheet" test, which provides as follows: "(1) a deficiency of assets below liabilities with no reasonable prospect that the business can be successfully continued in the face hereof, or (2) an inability to meet maturing obligations as they fall due in the ordinary course of business" found that Clearwire operated in the zone of insolvency. The Court has long since held that in insolvency situations creditors may protect their interest by bringing derivative claims on behalf of the insolvent corporation or any other direct non-fiduciary claim it may have by law or contract. North American had asked the Delaware Supreme Court to recognize a new direct right for individual creditors to challenge directors' exercise of business judgment as breaches of the fiduciary duties owed to them when a corporation is insolvent or in the zone of insolvency.

It has been well established under Delaware law that the law limits creditors' ability to assert fiduciary claims against directors of solvent corporations because creditors are protected by their contractual agreements and a well-established body of fraudulent transfer law. That said, as long as the director complies with the business judgment rule and observes their legal obligations to a solvent corporation's creditors in good faith, they are entitled as fiduciaries to pursue the course of action that they believe is best for the corporation and its shareholders. The Delaware Supreme Court in *North American* used the same reasoning and found that the creditors in this case have existing protections, including protections negotiated by contract, implied covenant of good faith and fair dealing and fraudulent conveyance laws and the need for added protection through direct claims for

breach of fiduciary duties are unnecessary and are outweighed by the need to protect directors and their ability to negotiate in good faith with creditors. Thus, the Court's ruling was necessary, in its view, to encourage capable persons to serve as directors of corporations by providing them with freedom to make risky, good faith business decisions without fear of personal liability.

When a solvent corporation is in the zone of insolvency, the focus for Delaware directors does not change, directors have fiduciary duties to maximize value for the shareholders by exercising their business judgment in the best interest of the corporation for the benefit of its shareholders. The Delaware Chancery Court in 1991 in *Credit Lyonnais Bank Nederland v. Pathe Communications Corporation*, found that "where a corporation is operating in the vicinity of insolvency, the board of directors is not merely the agent of the stockholders, but owes its duty to the corporate enterprise." In Credit Lyonnais, "in the 'zone of insolvency' a director's duty was to the corporate enterprise itself and to maximize its value in the order to serve all the entities' constituencies". The law in Credit Lyonnais is still good law today and serves to protect the actions of directors and officers of solvent corporations navigating through murky waters of the "zone of insolvency." Directors and officers continue to be protected by the business judgment rule if they can prove their actions were pursued in good faith

However, in an insolvency situation, caution must be maintained by directors as the focus of the directors does shift from the primary focus on shareholders to maximizing payment to creditors. Directors of insolvent corporations do have fiduciary duties to the corporation's creditors and such fiduciary duties gives creditors standing to pursue derivative actions for the benefit of all creditors.

While the Delaware Supreme Court has taken this leap with its holding in *North American*, the Court has still left many questions unanswered. Notably, the distinction between insolvency and the zone of insolvency and the exact differences between the two as it relates to creditors' ability to gain standing to maintain a derivative action. When a corporation is solvent, director's fiduciary duties are enforced by shareholders, and the shareholders have the ability to bring derivative actions on behalf of the corporation. As noted by the Court in *North American*, when a corporation is insolvent, the creditors take the place of shareholders as the residual beneficiaries of any value that may exist. Upon insolvency, the creditors have an interest in any increase or decrease in value of the corporation and a creditor may have standing to assert a derivative claim based on fiduciary duty against an insolvent corporation. These claims are derivative as they involve an injury to the corporation as an entity and any harm to the creditors is purely derivative of the direct financial harm to the corporation itself. But what must be remembered is the fact that the corporation has become insolvent does not turn such claims into direct claims against the directors, but merely provides creditors with standing to assert those claims in a derivative action.

While the holding of the Delaware Supreme Court in *North American* may to some be characterized as "groundbreaking," we must not loose sight of the existing law that remains unchanged in Delaware, which includes the protections provided to directors under the business judgment rule that absolve directors and officers of personal liability for good faith business decisions. While the focus of directors in an insolvency situation does switch to the creditors, based on the decision in *North American*, this does not open the directors up to personal liability for direct claims by individual creditors. Creditors still have the ability to seek recourse against directors of insolvent corporations through derivative actions if no direct non-fiduciary action may be maintained under breach of contract or fraudulent transfer law theories. The Court in *North American* reasoned that allowing maintenance of direct claims by individual creditors would create uncertainty for directors because the duty to creditors would conflict with the directors' duties to shareholders to maximize value. In short, the Court stated in reaching its holding, "directors of solvent corporations operating in the zone of insolvency must retain the freedom to engage in vigorous, good faith negotiations with individual creditors for the benefit of the corporation."

Additional Information

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