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# Delaware Supreme Court Rules Directors Of Corporations That Are Insolvent Or In "Zone Of Insolvency" Do Not Owe Direct Fiduciary Duties To Creditors

On May 18, 2007, the Delaware Supreme Court issued an important ruling addressing the fiduciary duties owed by directors of a corporation that is insolvent or in the "zone of insolvency." *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla et al.* ("*Gheewalla*") (Appeal No. 521, 2006 from the Court of Chancery). The Court held 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 its directors."

Delaware courts have long held that directors owe their fiduciary obligations to the corporation and its stockholders. Delaware courts have traditionally been reluctant to expand existing fiduciary duties. "While shareholders rely on directors acting as fiduciaries to protect their interests, 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." *Gheewalla* (citing *Production Resources Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772 (Del. Ch. 2004)). Accordingly, "the general rule is that directors do not owe creditors duties beyond the relevant contractual terms." *Id.*

However, over the past 15 years several decisions of the Delaware Court of Chancery have suggested that creditors might have standing to assert claims for breach of fiduciary duty against a corporation's directors when the corporation is insolvent, or in the zone of insolvency. Indeed two of its recent decisions suggested the possibility that, in limited circumstances, a creditor of an insolvent corporation might have standing to assert *direct* breach of fiduciary duty claims against directors for breach of a fiduciary duty owed to the creditor.[1] With its opinion in *Gheewalla*, the Delaware Supreme Court has now rejected that possibility.

In *Gheewalla*, the plaintiff-appellant, North American Catholic Educational Programming Foundation, Inc. ("NACEPF"), a putative creditor of Clearwire Holdings, Inc. ("Clearwire"), had sought to bring direct breach of fiduciary duty claims against three of Clearwire's directors, alleging that Clearwire was either insolvent or in the zone of insolvency during the relevant periods.[2] The Court of Chancery dismissed the claims, holding that (i) creditors have no standing to assert direct fiduciary duty claims against directors of corporations operating in the "zone of

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1 *Production Resources Group*, 863 A.2d 772; *Big Lots Stores, Inc. v. Bain Capital Fund VII, LLC*, 2006 WL 846121 (Del. Ch. Mar. 28, 2006).

2 NACEPF's complaint was not limited to claims of breach of fiduciary duty, and included counts of fraudulent inducement and tortious interference. However, because the only basis asserted for personal jurisdiction over Clearwire's directors was Delaware's long arm director statute, 10 *Del.* C. § 3114, personal jurisdiction could be sustained only if the complaint successfully alleged a claim for breach of fiduciary duty. In addition, NACEPF had waived any basis for pursuing its breach of fiduciary claims derivatively.

insolvency" because "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 be significantly undermined by the prospect of individual liability [for directors] arising from the pursuit of direct claims by creditors" and (ii) assuming *arguendo* that a direct claim for a breach of fiduciary duty to a creditor is legally cognizable in the context of actual insolvency, NACEPF failed to state such a direct creditor claim because NACEPF did not allege Clearwire director animus against, or invidious conduct toward, NACEPF. On appeal, the Delaware Supreme Court affirmed the dismissal, but on a broader basis.

In *Gheewalla*, the Supreme Court agreed that the "zone of insolvency" does not impose upon directors any new direct fiduciary duties to creditors. "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 held as a matter of Delaware law 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."

The Court also held as a matter of law that "individual *creditors* of an *insolvent* corporation have *no right to assert direct* claims for breach of fiduciary duty against corporate directors." The Court reasoned that "[r]ecognizing that directors of an insolvent corporation owe direct fiduciary duties to creditors, 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 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 [hypothetical] 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."

The Court did confirm, however, that the creditors of an *insolvent* corporation do have standing to maintain *derivative* claims against directors on behalf of the corporation for breaches of fiduciary duties.[3] When a corporation is insolvent, "its creditors take the place of the shareholders as the residual beneficiaries of any increase in value [of the corporation]." Accordingly, "[t]he corporation's insolvency 'makes the creditors the principal constituency injured by any fiduciary breaches that diminish the firm's value.'" (quoting *Production Resources Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d at 794 n.67).

In sum, the Delaware Supreme Court has now made clear that although insolvency may give individual creditors standing to assert *derivative* fiduciary claims against directors on behalf of the corporation,[4] insolvency or the "zone of insolvency" does *not* impose on directors direct fiduciary duties to

3 A derivative claim is brought on behalf of the corporation to enforce a duty owed to the corporation and seeks a recovery or other benefit for the corporation. Ordinarily, only stockholders of a Delaware corporation have standing to bring derivative suits and creditors do not. In *Gheewalla*, the Supreme Court observed that when a corporation is *solvent*, fiduciary duties owed by directors to the corporation may be enforced by its stockholders, "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."

4 Derivative claims against corporate directors become property of the corporate debtor's bankruptcy estate upon commencement of a bankruptcy of the corporation — and therefore may be asserted by the corporation as a Chapter 11 debtor-in-possession, or by other estate representatives (*e.g.*, by a Chapter 11 or Chapter 7 bankruptcy trustee, or by a creditors' committee with bankruptcy court approval, or as otherwise provided under a confirmed Chapter 11 plan of reorganization).

creditors or give creditors standing to assert *direct* fiduciary claims against directors. Nevertheless, directors of insolvent Delaware corporations have fiduciary duties "to exercise their business judgment in the best interest of the insolvent corporation" and "to maximize the value of the insolvent corporation for the benefit of all those having an interest in it."