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CORPORATE ADVISOR

Delaware Supreme Court Ruling: Creditors Do Not Have Standing to Bring Direct Claims Against Directors of Insolvent Corporations for Breach of their Fiduciary Duties

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On May 18, 2007, the Delaware Supreme Court ruled for the first time in *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*¹ that, under Delaware law, creditors never have standing to bring a direct action against directors of insolvent or nearly insolvent corporations. Although previous Chancery Court decisions² have suggested a director of a Delaware corporation approaching the "zone of insolvency" may owe fiduciary duties directly to creditors, no Delaware court had previously ruled on this issue.

The Court's ruling establishes that directors' duties of care and loyalty are owed to the corporation and its shareholders and endure whether the corporation is solvent, insolvent or simply in the "zone of insolvency." Accordingly, creditors do not have standing to bring direct claims against directors of insolvent or nearly insolvent corporations. Creditors can, however, pursue derivative claims against directors for breach of fiduciary duty but the procedural hurdles to a successful claim may be a barrier.

Facts

In 2000, North American Catholic Educational Programming Foundation, Inc. (NACEPF) joined with several other networks holding licenses to a radio wave spectrum called "ITFS spectrum" to form the Spectrum Development Alliance, Inc. The Alliance owned a significant percentage of federally approved licenses for microwave signal transmissions used for educational programming. Later that same year, Goldman Sachs formed Clearwire Holdings, Inc., with a board of directors exclusively comprised of its own employees. Clearwire subsequently entered into a master use and royalty agreement entitling it to acquire members' ITFS spectrum licenses as they became available.

In 2002, following WorldCom's revelations of financial and accounting scandals, industry experts speculated that an abundance of ITFS spectrum licenses would flow to the market following WorldCom's collapse. Clearwire subsequently negotiated with the Alliance members to terminate its obligations under the master use and royalty agreement. NACEPF remained the sole member of the Alliance and, when Clearwire subsequently liquidated, NACEPF brought a direct claim against the directors of Clearwire for breach of their fiduciary duties to creditors.

¹ 2006 WL 2588971 (Del. Ch. Sept. 1, 2006).

² See *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.* 1991 WL 277613 (Del. Ch. 1991).

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Chancery Court Ruling

In March 2006, NACEPF filed a complaint in the Delaware Chancery Court against the defendant directors asserting three primary claims:

1. Defendants fraudulently induced NACEPF to enter into the master use and royalty agreement
2. Defendants owed fiduciary duties to NACEPF as a substantial creditor of Clearwire because Clearwire was insolvent or operating in the zone of insolvency throughout negotiations with the Alliance. Defendants therefore breached their fiduciary duties by failing to preserve the assets of Clearwire for the benefit of the company and its creditors.
3. Defendants tortiously interfered with a prospective business opportunity belonging to NACEPF by causing Clearwire to acquire NACEPF's ITFS spectrum without payment which resulted in NACEPF forfeiting the opportunity to convey its licenses to other prospective buyers.

The Delaware Chancery Court, ruling on a motion to dismiss, considered whether as a matter of law creditors should have standing to initiate direct claims against directors for breach of fiduciary duties when the corporation is insolvent or merely operating within the "zone of insolvency." The Court reiterated that, generally, directors of solvent corporations owe fiduciary duties to the corporation and its shareholders exclusively and, therefore, only shareholders of a solvent corporation have standing to bring a claim against a director for breach of fiduciary duty. However, in contrast to a solvent corporation where it is the shareholders who benefit from a company's increased value, in insolvency, it is the creditors who are the residual beneficiaries of any increase in value.

The Chancery Court held that directors' fiduciary duties of care and loyalty are owed to the corporation and its shareholders and persist regardless of whether the corporation is solvent, insolvent or merely in the zone of insolvency. The Court did not believe those duties should change merely because the corporation was approaching insolvency. Further, the Court noted that creditors have other protective measures at their disposal including contractual agreements, implied covenants, or actions under bankruptcy and general commercial law.

The Chancery Court was not prepared to extend an additional layer of protection to creditors through a direct claim against directors for breach of fiduciary duty. Further, the Court noted that directors facing insolvency need to be able to work pro-actively and negotiate in good faith with creditors, activities which would be significantly undermined if directors faced liability arising from direct claims from creditors for breach of their fiduciary duties.

Delaware Supreme Court Ruling

On Appeal, the Delaware Supreme Court considered whether creditors, as residual beneficiaries, should have standing to bring a direct suit against directors of insolvent or nearly insolvent corporations. Affirming the Chancery Court's decision, the Delaware Supreme Court held that creditors never have standing to bring direct actions against directors for breach of their fiduciary duties, regardless of whether the corporation is solvent, insolvent or in the zone of insolvency.

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The Court confirmed that creditors of an insolvent corporation, as residual beneficiaries, do have standing to pursue derivative claims against directors on behalf of the corporation for breach of fiduciary duty. A company's insolvency makes its creditors the primary constituency injured by a breach that has decreased the company's value, thus warranting standing for derivative action. However, procedural impediments to a successful derivative claim are substantial.

In a derivative suit the plaintiff shareholders sue on behalf of the corporation itself rather than in an individual capacity. Procedurally, the plaintiff in a derivative suit is required to demand that the board of directors pursue the action on the corporation's behalf or demonstrate that making such a demand would be futile. The demand requirement cannot be circumvented with unsubstantiated claims of futility; the plaintiff must demonstrate that a majority of the board lacks the requisite disinterest to adequately address the demand. In addition, many corporations also appoint a litigation committee from the board of directors to review shareholder demands. If the committee finds no merit in the demand it can recommend that the suit not be pursued and the court will dismiss the case.

Directors, understandably reluctant to pursue an action against themselves, coupled with the procedural demand requirement and the presence of litigation committee "gate-keepers" create an often insurmountable barrier to successful creditor derivative claims.

Conclusion

The implications of the Court's ruling are significant. First, directors can not be held personally liable as a result of a claim by creditors for breach of their fiduciary duty in the event of insolvency. Second, the interests of creditors may be subordinated to those of the shareholders upon insolvency and may even prompt directors to consider higher-risk business strategies while on the brink of insolvency. Creditors do, however, have standing to bring derivative actions against directors of insolvent or nearly insolvent companies.

A case pending before the Delaware Supreme Court³ should further refine the scope of director duties owed to creditors in insolvency or the trajectory thereto. The case will decide whether a director who pursues a business strategy, acting with due diligence and in good faith, which results in an even more insolvent entity will give rise to an independent cause of action for "deepening insolvency".

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³ *Trenwick American Litigation Trust v. Ernst & Young LLP* 906 A.2d 168 (Del. Ch. 2006).