



# Business Reorganization Committee

## ABI Committee News

In This Issue:

Volume 6, Number 2 / July 2007

- New Delaware Supreme Court Opinion Limits D&O Claims of Insolvent Companies
- Delaware Supreme Court's Decision in *Gheewalla* Returns Clarity and Consistency to Creditors' Rights
- Hedge Funds: The New Players at the Chapter 11 Table
- Hedge Funds: Lessons Learned from the *Radnor* Decision

### Delaware Supreme Court's Decision in *Gheewalla* Returns Clarity and Consistency to Creditors' Rights

by **James Gadsden**  
Carter Ledyard & Milburn LLP; New York

Creditors finally have a definitive answer. The Delaware Supreme Court has now held in *North American Catholic Educational Programming Foundation Inc v. Gheewalla*<sup>1</sup> that creditors cannot directly sue directors of an insolvent debtor corporation for breach of fiduciary duty. There is no dispute that once a corporation is insolvent, creditors, not shareholders, are the parties entitled to a corporation's assets. As a result, creditors are empowered by law to enforce compliance with the duties of care and loyalty the directors owe to the corporation. However, since the Delaware Chancery Court's decision in *Credit Lyonnais Bank Nederland N.V. v. Pathe Communications Corp.*<sup>2</sup> there has been a vigorous debate concerning the nature and potential extent of a director's fiduciary duty to a creditor.<sup>3</sup> The *Gheewalla* decision clarifies that directors of insolvent corporations owe no direct duty to creditors. Instead, the court reaffirmed that creditors simply replace shareholders as the class of interested parties entitled to enforce the fiduciary duties directors owe the insolvent corporation through a derivative action.<sup>4</sup> According to the court, holding otherwise would be inconsistent with the other protections available to creditors<sup>5</sup> and undermine the deference afforded the business judgment of directors.<sup>6</sup> This article explores the court's reasoning in *Gheewalla* and discusses the practical implications of this important decision.

#### Fiduciary Duties and Derivative Actions

It has long been recognized that the law imposes fiduciary duties of care and loyalty

[Committee Officers](#)

[Upcoming Events](#)

[Contribute to the Newsletter](#)

[ABI World](#)

and good faith on directors.<sup>7</sup> The duty of care requires directors to take measures to inform themselves of the issues facing the corporation and to solicit the advice of experts, when necessary, to address these issues.<sup>8</sup> In assessing whether a director breached the duty of care, courts look to determine whether the decision was an informed decision, the directors reasonably relied on the information before them, and that the directors did not neglect their duties.<sup>9</sup> As for the duty of loyalty, this duty prohibits directors from placing personal gain before that of the corporation.<sup>10</sup> For example, under the umbrella of the duty of loyalty, directors are prevented from taking advantage of corporate opportunities that would benefit corporation or entering into self-interested contracts with terms and conditions that are detrimental to the corporation.<sup>11</sup>

While these duties appear to create broad liability for the actions of directors, courts have created standards to cabin this liability. In particular, the business-judgment rule affords great deference to the decision-making powers of directors, thus providing the necessary leeway to carry out these fiduciary duties in an uncertain world.<sup>12</sup> Deferring to their business judgment gives directors the ability to perform their duties without worrying about litigation at every turn. It does so by placing the burden of proof on the complaining party to demonstrate the directors' actions constituted a breach of fiduciary duty.<sup>13</sup> Another important feature of the rule is that "[i]f a board selected one of several reasonable alternatives, a court should not second-guess that choice even though it might have been decided otherwise or subsequent event may have cast doubt on the board's determination."<sup>14</sup>

Recognizing that directors that breached their duties would not readily authorize the corporation to pursue them to recover the resulting damages, legislatures and courts developed the concept of derivative actions. These actions allow shareholders or creditors, depending on the solvency of the corporation, to bring actions on behalf of the corporation against the breaching directors.<sup>15</sup> The procedural requirements reflect that such an action is brought on behalf of the corporation.<sup>16</sup> Most notably, in order to bring a derivative action, the shareholder or creditor must first demand that the current board of directors bring the action.<sup>17</sup> Absent improper dismissal of the demand or proof that the demand would be futile, courts will not allow the derivative action to proceed.<sup>18</sup> Additionally, the damages recovered as a result of the action go to the corporation, not the party that brought the derivative action.<sup>19</sup> Once a court has determined that a director breached this fiduciary duty, the director is barred from being indemnified by the corporation.<sup>20</sup>

As is evident from the court's decision in *Gheewalla*, prohibiting creditors from bringing direct actions against directors for breaches of these fiduciary duties to the

corporation is consistent with the theoretical underpinnings of corporate law.

### **The Nature of Derivative VS. Direct Actions**

The Delaware courts have struggled to demarcate the boundaries between derivative and direct actions, which lead to a surprising level of confusion and inconsistency.<sup>21</sup> In 2004, the Delaware Supreme Court revisited the test for distinguishing these types of actions. After finding that prior formulations of this test were not useful, the court returned to a two-part analysis, holding that the determination “must turn *solely* on the following questions: (1) who suffered the alleged harm (the corporation or the suing stockholders, individually); and (2) who would receive the benefit of any recovery or other remedy (the corporation or the stockholders, individually)[.]”<sup>22</sup> Therefore, typical examples of shareholder direct actions are claims for breach of contract and breach of the implied covenant of good faith and fair dealing,<sup>23</sup> and deprivation of a shareholder’s right to vote.<sup>24</sup> Unlike shareholders, creditors do not have any claims or injuries resulting from the actions of directors acting as such that are distinct from those of the corporation which are not protected by other bodies of law.

### **Impact of *Credit Lyonnais***

The debate regarding the ability of creditors to maintain direct actions against directors for breaches of fiduciary duties began with Chancellor Allen’s opinion in *Credit Lyonnais*. This case involved the leveraged buy-out of MGM by Pathe Communications Corp. (PCC), which ultimately resulted in financial fallout. Credit Lyonnais, provided a loan for the buy-out that was secured by a controlling interest in MGM. When PCC defaulted on the loan, the bank sought to enforce the voting rights on the controlling stock interest. Credit Lyonnais instituted the action for a declaratory judgment validating its removal of the sitting board of directors and an injunction enforcing the contractual agreement of the parties.

In his opinion, Chancellor Allen discussed the impact of potential insolvency on the interests of those involved with the corporation. More specifically, Chancellor Allen noted that “[t]he possibility of insolvency can do curious things to incentives, exposing creditors to risks of opportunistic behavior and creating complexities for directors.” To illustrate his point, Chancellor Allen used a hypothetical corporation’s attempt to collect a judgment from a solvent corporation where the judgment is the corporation’s sole asset. Based on the likelihood of recovery, Chancellor Allen concluded that the corporation should settle with the debtor for an amount less than the judgment, but noted that this “result will not be reached by a director who thinks he owes duties directly to shareholders only.” Chancellor Allen then went on to state

that

in managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (*or the creditors*, or the employees, or any single group interested in the corporation) would make if given the opportunity to act.<sup>25</sup>

Although the opinion clearly stated that the board of a corporation operating in the vicinity of insolvency owed its duties to the corporate enterprise,<sup>26</sup> the opinion was read to suggest that the court might recognize a fiduciary duty running directly to the creditors.

The Delaware Chancery Court addressed this possibility in *Production Resources Group LLC v. NCT Group Inc.*<sup>27</sup> Production Resources Group (PRG) sought to have the court appoint a receiver for the insolvent NCT to protect PRG's interests as well as the interests of the other creditors. NCT Group moved to dismiss the complaint on the basis that PRG could not assert a direct claim against the directors. Although the holding was based on finding a sufficient basis for determining the action was a derivative suit brought by the creditors on behalf of the insolvent corporation, Vice Chancellor Strine noted that the opinion was not intended to rule out the possibility that creditors, in specific situations, could bring direct actions against the directors of a debtor corporation.<sup>28</sup>

Reading these cases as unequivocal support for the proposition that directors owe a fiduciary duty enforceable directly by creditors is untenable. Both opinions are replete with restatements of the general rules that directors owe fiduciary duties to the corporation and that it is the corporation that is harmed when a director's breach of fiduciary duty results in a decrease in the value of the corporation's assets.<sup>29</sup>

Moreover, the holding in *Production Resources* was based on these principles.<sup>30</sup> Therefore, the Delaware Supreme Court's decision in *Gheewalla* is simply a reiteration of the prevailing law.

### **The *Gheewalla* Case**

The defendants in *Gheewalla* were directors of Clearwire Holdings Inc., which acquired rights to radio wave spectrum licenses under agreements with parties holding licenses from the Federal Communications Commission, including plaintiff North America Catholic Educational Programming Foundation Inc. (NACEPF). NACEPF alleged that the director defendants served at the behest of Goldman Sachs & Co. and favored the interests of Goldman Sachs in breach of their fiduciary duties.<sup>31</sup> NACEPF also asserted

fraudulent inducement and tortious interference with contracts claims directly against the defendants, but the only basis of personal jurisdiction in Delaware was the Delaware Code §3114, which subjects the directors of Delaware corporation to the personal jurisdiction of the Delaware courts for all claims of duties in their capacities of directors.<sup>32</sup> Determining that the creditors may not assert direct claims for breach of fiduciary duties against directors, the Delaware Supreme Court affirmed the dismissal of the complaint.<sup>33</sup>

The Delaware Supreme Court provided a variety of reasons for deciding that directors do not owe any duty to creditors. The court conducted a separate analysis for corporations operating in the vicinity or zone of insolvency and insolvent corporations. However, both of these lines of analysis have a common thread — ensuring the directors of a corporation faithfully execute their duties to the corporation.

Addressing this issue in the context of a corporation in the vicinity of insolvency, the court noted several paramount considerations. First, creditors are able to protect their rights through a variety of other means such as contractual protections; implied covenant of good faith and fair dealing; the law of fraudulent conveyances; and bankruptcy law.<sup>34</sup> The court quoted with approval the observation by the Court of Chancery in *Production Resources* that allowing creditors to bring direct actions against the directors of a corporation in the vicinity of insolvency would involve “using the law of fiduciary duty to fill gaps that do not exist,”<sup>35</sup> obviating the need for “an additional, unique layer of protection through direct claims for breach of fiduciary duty.”<sup>36</sup> Moreover, in the interest of clarity, the court held that for “a solvent corporation . . . navigating in the zone of insolvency, the focus for the Delaware directors does not change.”<sup>37</sup> The directors must act “in the best interests of the corporation for the benefit of its shareholder owners.”<sup>38</sup> This rule provides directors clear and consistent guidance on the nature of their fiduciary duty. At the same time, this rule also grants directors the flexibility needed to ensure the continued existence of the corporation. As both the Supreme Court and Court of Chancery noted, to hold otherwise would allow creditors to significantly undermine this essential goal forcing the corporation to act in ways that are beneficial solely to the creditors and not the corporation itself.<sup>39</sup>

Once the corporation becomes insolvent this rule remains the same but its justification is slightly different. First and foremost, the court noted that to allow a direct cause of action would place directors in the impossible position of making decisions to the benefit of one creditor over another. Additionally, “[d]irectors of an insolvent corporation must retain the freedom to engage in vigorous, good faith negotiations with individual creditors *for the benefit of the corporation.*”<sup>40</sup>

## Do Creditors Have Breach of Fiduciary Claims Outside of Derivative Actions?

*Gheewalla* holds that the answer is no. This conclusion is consistent with the overall framework of corporate law on the roles and duties of corporate directors. As such, this decision provides the clarity and consistency needed in this area of the law, providing further guidance to directors on how to conform their conduct in order to comply with their duties of care and loyalty while eliminating claims of competing duties to creditors and to the corporation.

<sup>1</sup> No. 521,2006, 2007 WL 1453705 (Del. May 18, 2007)

<sup>2</sup> Civ. A. No. 12150, 1991 WL 277613, (Del. Ch. Dec. 30, 1991).

<sup>3</sup> See, e.g., Campbell, Rutherford B. & Frost, Christopher W., *Managers' Fiduciary Duties in Financially Distressed Corporations: Chaos in Delaware (and Elsewhere)*, 32 J. Corp. L. 491 (2007) (arguing that unless a corporation is in bankruptcy proceedings fiduciary duties should be enforceable by the shareholders); Jones, Patrick M. & Harris, Katherine Heid, *Chicken Little Was Wrong (Again): Perceived Trends in the Delaware Corporate Law of Fiduciary Duties and Standing in the Zone of Insolvency*, 16 J. Bankr. L. & Prac. 2 (2007) (arguing there is no trend to expand fiduciary duties to include duties to creditors); Sahyan, Robert K., Note, *The Myth of the Zone of Insolvency: Production Resources Group v. NCG Group*, 3 Hastings Bus. L.J. 181 (2006) (arguing that fiduciary duties should always run to the corporation regardless of the corporation's financial status); Lin, Laura, *Shift of Fiduciary Duty Upon Corporate Insolvency: Proper Scope of Directors' Duty to Creditors*, 46 Vand. L. Rev. 1485, 1487 (1993) (arguing lawmakers should require creditors to negotiate for director's duty to increase corporate value and enforce them through contracts); Jonathan C. Lipson, *Directors' Duties to Creditors: Power Imbalance and the Financially Distressed Corporation*, 50 UCLA L.Rev. 1189 (2003) (arguing that any duty to creditors should be based on the ability of the creditor to protect itself); Ramesh K.S. Rao, et al., *Fiduciary Duty a La Lyonnais: An Economic Perspective on Corporate Governance in a Financially-Distressed Firm*, 22 J. Corp. L. 53 (1996) (arguing that duties should shift to creditors as a corporation approaches insolvency).

<sup>4</sup> *Gheewalla*, 2007 WL 1453705, at \*7.

<sup>5</sup> *Id.* at \*6.

<sup>6</sup> *Id.* at \*8–9.

<sup>7</sup> See, e.g., *McMullen v. Beran*, 765 A.2d 910, 918 (Del. 2000) (alleging that directors

permitted majority stockholder to negotiate merger without board oversight is sufficient to maintain a cause for breach of fiduciary duty); *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985) (holding directors failed to abide by duty of care in authorizing merger); *Guth v. Loft Inc.*, 5 A.2d 503, 510 (Del. 1939). See, also, Del. Code Ann. tit. 8, §141 (2007).

<sup>8</sup> See *Brehm v. Eisner*, 746 A.2d 244, 259–61 (Del. 2000) (reiterating that board need only consider material facts and can reasonably rely on experts for information and assistance)

<sup>9</sup> See, e.g., *Van Gorkom*, 488 A.2d at 874; *In re Caremark Int’l Inc. Derivative Litig.*, 698 A.2d 959, 967–70 (Del. Ch. 1996).

<sup>10</sup> See, e.g., *Broz v. Cellular Info. Sys. Inc.*, 673 A.2d 148, 154 (Del. 1996) (taking advantage of corporate opportunities is a breach of loyalty).

<sup>11</sup> *Id.*

<sup>12</sup> *Van Gorkom*, 488 A.2d at 872.

<sup>13</sup> *Id.*

<sup>14</sup> *Paramount Comm’cns Inc. v. QVC Network Inc.*, 637 A.2d 34, 45 (Del. 1994).

<sup>15</sup> Edward P. Welch et al., *Folk on the Delaware General Corporation Law* §327.2 (2007).

<sup>16</sup> David A. Dexler et al., *Delaware Corporate Law & Practice* §42.01 (2006).

<sup>17</sup> Del. Ch. Ct. Rule 23.1 (2007); *Grimes v. Donald*, 673 A.2d 1207, 1215 (Del. 1996); see also Welch et al., *supra* note 15, at §327.4.

<sup>18</sup> *Id.* at 1216; see, also, *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984).

<sup>19</sup> *Tooley v. Donaldson, Lufkin & Jenrette Inc.*, 845 A.2d 1031, 1036 (Del. 2004). There are rare instances where the damages are awarded directly to the shareholders as opposed to the corporation. *Kennan v. Eshleman*, 2 A.2d 904, 912–13 (Del. 1938); see, also, Welch et al., *supra* note 15, at §327.2.2.

<sup>20</sup> Del. Code Ann. tit. 8, §145 (2007).

<sup>21</sup> The Delaware Supreme Court created a variety of tests in hopes of finding the proper balance between the corporation’s rights and those rights that run to the shareholders. See, e.g., *Elster v. Am. Airlines Inc.*, 100 A.2d 219, 222 (Del. 1953)

(requiring plaintiff allege a “special injury” in order to maintain a direct action); *Bokat v. Getty Oil Co.*, 262 A.2d 246, 249 (Del. 1971) (defining derivative suits as seeking recovery for an injury that affects all shareholders equally); *Grimes*, 673 A.2d at 1213 (holding that the plaintiff could bring a direct action because he was not seeking to recover for an injury to the corporation).

<sup>22</sup> *Tooley*, 845 A.2d at 1033 (emphasis in original).

<sup>23</sup> *Blue Chip Capital II Fund Ltd. P’ship v. Tubergen*, 906 A.2d 827 (Del. Ch. 2006).

<sup>24</sup> *Lipton v. News Int’l, PLC*, 514 A.2d 1075, 1079 (Del. 1986). For other examples of types of direct actions, see R. Franklin Balotti & Jesse A. Finkelstein, *Delaware Law of Corporations and Business Organizations* §13.9 (2007).

<sup>25</sup> *Credit Lyonnais*, 1991 WL 277613 at \*34 n.55 (emphasis added).

<sup>26</sup> *Id.* at \*34.

<sup>27</sup> 863 A.2d 772 (Del. Ch. 2004).

<sup>28</sup> *Id.* at 798.

<sup>29</sup> See, e.g., *Production Resources*, 863 A.2d at 790–93; *Credit Lyonnais*, 1991 WL 277613 at \*34.

<sup>30</sup> *Production Resources*, 863 A.2d at 793. As noted above, Chancellor Allen’s discussion of this issue in *Credit Lyonnais* was tangential to the issues involved in the litigation, therefore there was no need to consider these principles in reaching the decision.

<sup>31</sup> *Gheewalla*, 2007 WL 1453705, at \*1.

<sup>32</sup> *Id.*

<sup>33</sup> *Id.* at \*2.

<sup>34</sup> *Id.* at \*6.

<sup>35</sup> *Production Resources*, 863 A.2d at 790.

<sup>36</sup> *Gheewalla*, 2007 WL 1453705, at \*6.

<sup>37</sup> *Id.* at \*7.

<sup>38</sup> *Id.*

<sup>39</sup> *Id.* at \*6.

<sup>40</sup> *Id.* at \*8 (emphasis added).