ALM LAW JOURNAL NEWSLETTERS
The Bankruptcy Strategist®
Volume 24, Number 10 • August 2007

Did the Delaware Supreme Court Break the 'Directors' Shield'?

August 2007
By Russell E. Silberglied and Jonathan P. Friedland

Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp., C.A. No. 12150, 1991 WL 277613 (Del. Ch. Dec. 30, 1991), stands for the proposition that directors and officers of a Delaware corporation that is either insolvent or in the “zone” of insolvency owe fiduciary duties to creditors as well as stockholders. In essence, *Credit Lyonnais* provided a “shield” to directors against shareholder suits alleging that directors breached their duties to shareholders by acting to protect creditors. Courts around the country have adopted this view, and attorneys around the country have become accustomed advising boards of directors based on the assumption that this is indeed the law.

The Delaware Supreme Court, in *North American Catholic Educational Programming Foundation Inc. v. Gheewalla*, 2007 Del. LEXIS 227 (Del. Supr. May 18, 2007), might have “broken the shield.”

Background

North American Catholic Educational Programming Foundation, Inc. (“NACEPF”), a purported creditor, sued the board of its alleged debtor, Clearwire Holdings, Inc. (“Clearwire”). NACEPF’s complaint alleged direct claims against the directors for breaches of fiduciary duties while Clearwire was insolvent or in the zone of insolvency. For strategic reasons, NACEPF expressly disavowed any derivative claims it could have pursued.

In order for NACEPF to state a claim, the court had to find: 1) that NACEPF had pleaded sufficient facts that Clearwire was insolvent or in the zone of insolvency; and 2) that as a matter of law, a creditor has standing to sue directly (as opposed to derivatively) for breach of fiduciary duty. The Supreme Court first noted (and did not overrule) the Court of Chancery’s finding that NACEPF had satisfactorily alleged facts that permitted a reasonable inference for purposes of Defendants’ motion to dismiss that Clearwire operated in the zone of insolvency during at least a substantial port of the relevant period. The Supreme Court also left undisturbed the Court of Chancery’s holding that insolvency had been adequately alleged for at least a portion of the relevant period following execution of the Master Agreement.

The Zone of Insolvency

After it was found that the complaint’s allegations of insolvency and/or the zone passed muster for the purposes of a motion to dismiss, the relevant inquiry became whether the allegations of insolvency and/or the zone of insolvency gave NACEPF standing to sue for breach of fiduciary duty owed to it in its role as creditor. The court first addressed the zone of insolvency. It held “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.” *North American Catholic*, 2007 Del. LEXIS at *24-25.

However, the court went further than limiting its discussion to the distinction of direct versus derivative claims. It stated that if 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*." (Emphasis added.) *Id.* at *25.

The Supreme Court also analyzed whether creditors can bring direct claims against directors for breach of fiduciary duties if the corporation is insolvent in fact. Again, the court held that creditors cannot state a direct claim. However, unlike with respect to the zone, where the court did not mention derivative claims but its rationale implies that derivative claims also may not be stated by creditors, it stated that creditors of an insolvent company may obtain standing to sue derivatively. Citing liberally to the Court of Chancery's 2004 opinion in *Production Resources Group, LLC v. NCT Group, Inc*., 863 A.2d 772 (Del. Ch. 2004), the court stated that when a corporation is insolvent, its creditors become the residual beneficiaries of any increase in value, and therefore "equitable considerations give creditors standing to pursue derivative claims against the directors of an insolvent corporation." *Id.* at *26. To recognize a right of creditors to bring a direct fiduciary duty claim against directors, however, 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." *Id.* at *31.

In other words, the Delaware Supreme Court stated that directors of a solvent company that is in the zone do *not* owe fiduciary duties to creditors; their "focus … does not change" and they continue to only owe fiduciary duties to stockholders.

This development was unforeseen by most insolvency attorneys, and it seemingly reverses *Credit Lyonnais* and its progeny. The court emphasized that its decision was guided by the need to provide clear guidance to directors regarding their fiduciary duties and specifically to whom they are owed. However, the decision is such a stark reversal of prior precedent (most of which was developed by bankruptcy courts and other courts outside of Delaware purporting to apply Delaware law), that it is not clear to many practitioners what this change means and how to advise directors of troubled companies.

Reversal of *Credit Lyonnais*?

Credit Lyonnais Bank Nederland N.V. v. Pathe Communications Corp. is the progenitor, and perhaps the most famous opinion addressing directors' fiduciary duty in the "vicinity of insolvency." In this unpublished opinion, the Delaware Chancery Court stated that "[a]t least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers [*i.e.,* shareholders], but owes its duty to the corporate enterprise." The corporation's "board or its executive committee ha[ve] an obligation to the community of interests that sustained the corporation, to exercise judgment in an informed, good faith effort to maximize the corporation's long-term wealth creating capacity." *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*, 17 Del. J. Corp. L. 1099, 1991 WL 277613 at *34 (Del. Ch. 1991).

Sixteen years later, the Delaware Supreme Court appears to have disagreed, stating that directors of solvent companies operating in the zone owe fiduciary duties "to the corporation and its shareholders" and should use their "business judgment in the best interest of the corporation for the benefit of its shareholder owners." *NACEPF,* 2007 Del. LEXIS 227 at *25. That statement seems to overrule *Credit Lyonnais* and its progeny.

The Future of Zone of Insolvency Litigation

If directors of a solvent company operating in the zone of insolvency owe fiduciary duties only to stockholders, there does not appear to be a cogent reason to permit creditors to sue derivatively for breach of those duties to stockholders. Increasingly, these types of suits are filed in bankruptcy cases, either by debtors or trustees suing directly or by a creditors committee suing derivatively. Nothing in *North American Catholic* prevents such a suit from being filed. However, under the *North American Catholic* rationale, such suits would rise or fall on whether the plaintiff can show a breach of fiduciary duty to *stockholders*. Not only will this change the nature of such suits, but it largely makes the zone of insolvency a meaningless concept; a plaintiff need not plead the zone to invoke fiduciary duties to stockholders, which is the normal state for solvent companies.

Potential Problems in Advising Boards After NACEPF

'Definitive Guidance' or Merely Moving an Imprecise Line?

The very concept of the "zone of insolvency" has often been criticized, among other reasons, because it is imprecise and hard to define. [*See, e.g., Production Resources Group, LLC v. NCT Group, Inc.* 863 A.2d at 789 n.56; *People's Department Stores, Inc. (Trustee of) v. Wise,* [2004] 3 S.C.R. 461 (Canada Supr. Ct. 2004); Jonathan C. Lipson, *Directors' Duties to Creditors: Power Imbalance and the Financially Distressed Corporation*, 50 UCLA L. Rev. 1189, 1208 (2003)]. The Delaware Supreme Court's view that "the 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" is quite understandable and commendable. Incepting fiduciary duties to creditors upon actual insolvency, rather than movement into the zone of insolvency, however, does not — in our view at least — provide "definitive guidance to directors."

"Actual insolvency" certainly sounds like a much more precise concept than the "zone of insolvency," but is it? Under Delaware law, a corporation is insolvent: 1) if "it is unable to pay its debts as they become due in the ordinary course of business" (the "unable to pay debts test"); *or* 2) "'when it has liabilities in excess of a reasonable market value of assets held'" (the "balance sheet test"). [*LaSalle Nat'l Bank v. Perelman*, 82 F. Supp.2d 279, 290 (D. Del. 2000) (internal citations and quotations omitted); *see also Geyer v. Ingersoll Publ'n Co.*, 621 A.2d 784, 789 (Del. Ch. 1992) ("an entity is insolvent when it is unable to pay its debts as they fall due in the usual course of business … That is, an entity is insolvent when it has liabilities in excess of a reasonable market value of assets held."). *See also Angelo, Gordon & Co. v. Allied Riser Comm. Corp.*, 805 A. 2d 221, 224 (Del. Ch. 2002) (finding that fiduciary duties were owed to creditors because defendant corporation was balance sheet insolvent, even though note payments were not yet due)].

While neither test is precise, the second of these, the so-called "balance sheet" test, is particularly subjective because it requires a valuation of the corporation's assets. When the issue is litigated, dueling expert witnesses often disagree with one another as to valuation by tens or even hundreds of millions of dollars. [*See, e.g., Helig-Meyers Co. v. Wachovia Bank, N.A. (In re Helig-Meyers Co.)*, 328 B.R. 471, 477 (E.D. Va. 2005) ("Not surprisingly in this case, the two valuation experts reached vastly different conclusions regarding the value of the debtor's assets."); *Helig-Meyers Co. v. Wachovia Bank, N.A.* (*In re Helig-Meyers Co.*), 319 B.R. 447 (Bankr. E.D. Va. 2004), aff'd, 328 B.R. 471 (2005) ("the fact that two qualified appraisers … both applying sound appraisal methodologies to the same set of assets could reach such absurdly disparate conclusions gives the Court pause.")]. Not surprisingly, that large difference of opinion on valuation of the assets leads one expert to testify that the company was solvent on the valuation date, and the other to testify that the company was insolvent on the same date.

If the Delaware Supreme Court's goal was to "provid[e] directors with definitive guidance" as to when their duties expand to include creditors, shifting the "line" to a concept that itself is so subjective that qualified valuation experts can disagree by material percentages does not appear to meet the goal. We submit that it was easier for a practitioner to advise boards before *North American Catholic* than in its aftermath. Before *North American Catholic*, for example, if two reasonable experts could disagree on valuation such that one would opine that the company was solvent and the other would opine that it was insolvent, lawyers likely would have counseled the board that it should assume that the company was in the "zone of insolvency," and therefore that its members' fiduciary duties had expanded to include creditors. A plain reading of *North American Catholic* counsels that this may be bad advice today. In any event, boards will likely place increased reliance upon the company's financial adviser's opinion on solvency and valuation.

Does the 'Shield' Still Exist?

North American Catholic liberally cites to the Court of Chancery's 2004 opinion in *Production Resources*. Indeed, other than with respect to the "open question" left by *Production Resources* concerning direct claims, the Supreme Court appears to have gone out of its way to embrace and adopt portions of *Production Resources'* reasoning.

However, the Delaware Supreme Court did not mention, one way or the other, a key concept contained in *Production Resources*: the "shield to directors from stockholders who claimed that the directors had a duty to undertake extreme risk so long as the company would not breach any legal obligations". *Production Resources*, 863 A. 2d at 788. The Court of Chancery stated that "the *Credit Lyonnais* decision's holding and spirit clearly emphasized that directors would be protected by the business judgment rule if they, in good faith, pursued a less risky business strategy precisely because they feared that a more risky strategy might render the firm unable to meet its legal obligations to creditors and other constituencies." *Production Resources*, 863 A. 2d at 788.

As discussed above, *North American Catholic* specifically states that in the zone of insolvency, "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*." *NACEPF*, slip op. at 19 (emphasis added). This raises a significant question in advising boards of troubled companies: Did the Delaware Supreme Court mean to put an end to the *Credit Lyonnais/ Production Resources* "shield" for directors, or did the court simply not address the point (and not caveat its 'for the benefit of its shareholder owners" language) because it was not before the court? The question takes on increased significance, given older statements by the Delaware Supreme Court that favoring the interests of creditors over stockholders of a solvent company may well be a breach of fiduciary duty. *See, e.g., Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A 2d 173, 182-84 (Del. 1986).

This issue is not merely theoretical. Consider the following fact pattern, which occurs very frequently "in the real world." A company has $500 million of debt and its financial adviser has advised it that the fair market value of its assets is $500,010,000. The company has one million shares of common stock outstanding. The company has canvassed the market for years to determine if it could link up or be purchased by a strategic buyer, but none has emerged. Suddenly, a private equity firm makes an offer to purchase the company's assets for exactly what they are worth, $500,010,000 (or some small premium). Should the company accept the offer? The board, in the reasonable exercise of its business judgment, can conclude that this offer is the company's last, best hope; due to the slow deterioration of the company's business over the past few years, it is likely (but not certain) that if the company rejects the offer, it will be insolvent in six months. But if it accepts, the stockholders get only one penny.

North American Catholic, to say the least, is an interesting and challenging development. We look forward to future judicial clarification.

Russell C. Silberglied is a director in the Restructuring & Bankruptcy Group of Richards, Layton & Finger, P.A. in Wilmington, DE and a member of this Newsletter's Board of Editors. **Jonathan P. Friedland** is a partner at Schiff Hardin LLP in Chicago. The views expressed in this article are those of the authors only and not necessarily of their clients or law firms. The authors would like to thank Richards, Layton & Finger associate **Lee Kaufman** and summer associate **Lisa Goicuria** for their assistance in preparing this article.