

U.S. Restructuring & Insolvency Briefing.

Trend of Increased Protection for Directors and Officers of Corporations in the Zone of Insolvency

The Delaware Supreme Court, in *North American Catholic Educational Programming Foundation (NACEPF) v. Gheewalla, et al.*,¹ recently clarified that shareholders have standing to assert derivative fiduciary duty claims when the corporation is solvent and creditors have standing to assert derivative fiduciary duty claims when the corporation is insolvent. More importantly, the decision can be read to afford directors and officers with further protections when the corporation is in the zone of insolvency.

This decision reflects the growing trend of the Delaware courts to protect directors and officers of distressed corporations that make good-faith, informed and reasoned decisions to maximize the value of the corporate enterprise regardless of whether the actions taken by the corporation are ultimately proven successful.² As a result of these recent decisions, creditors should be aware that their leverage at the negotiating table may be reduced. Likewise, boards of directors should be more comfortable making informed decisions to maximize the value of the corporate enterprise, even where the corporation is insolvent or in the zone of insolvency.

¹ 2007 WL 1453705, at 7 (May. 18. 2007)

² See *id.*; *Production Resources Group v. NCT Group, Inc.*, 863 A.2d 772 (Del.Ch.2004); *Trenwick America Litigation Trust v. Ernst & Young, LLP, et al.* 906 A.2d 168 (Del.Ch.2006).

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Fiduciary Duties in the Zone of Insolvency

The Delaware Supreme Court stated that “[w]hen 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 interest of the corporation for the benefit of its shareholder owners.” This statement is in sharp contrast to the previous view of many scholars and practitioners that directors and officers of a corporation owe their fiduciary duty to the corporation and primarily (if not solely) to the corporation’s *creditors* while the corporation is in the zone of insolvency.

In reaching its decision, the Delaware Supreme Court emphasized the adverse effect that direct claims by creditors would have on the corporation while the corporation was on the verge of insolvency. In doing so, the court approved the Court of Chancery’s reasoning that the prospect of individual liability arising from direct claims by creditors would hinder a director’s ability to lead the corporation effectively and proactively when the corporation is most in need of such leadership (i.e., when the corporation is in financial distress).

In addition, the court adopted a key component of the reasoning espoused by the Delaware Chancery Court in *Trenwick* (a case currently on appeal to the Delaware Supreme Court), namely that state law provides creditors with appropriate statutory and common law remedies for their protection, separate and apart from claims for breach of fiduciary duties by directors. Specifically, the court stated: “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.”³

The Growing Trend

The *Gheewalla* decision comes on the heels of other recent Delaware cases that encourage directors to pursue value-maximizing strategies for the

³ *Gheewalla* at 6.

benefit of the corporation, even when the corporation is in financial distress. In *Production Resources*, the Delaware Court of Chancery suggested that although creditors may have standing to pursue breach of fiduciary duty claims against directors when the corporation is in the zone of insolvency, directors may fulfill their duties by maximizing the value of the corporate enterprise. Subsequently in *Trenwick*, the Delaware Court of Chancery reconfirmed that the business judgment rule applies while a corporation is in the zone of insolvency and rejected “deepening insolvency” as an independent cause of action under Delaware law.⁴

When these cases are read together with *Gheewalla*, it is clear that the Delaware courts are affording more deference to a corporation’s directors under the business judgment rule when the corporation is in financial distress. Furthermore, the Delaware Supreme Court’s decision in *Gheewalla* might indicate the court’s inclination to affirm the Chancery Court’s holding in *Trenwick*, which is currently on appeal.

⁴ For an additional discussion of fiduciary duties when the corporation is in the zone of insolvency following the *Trenwick* decision, see Brian E. Greer, *Fiduciary Duties When the Corporation is in the Zone of Insolvency*, Am. Bankr. Inst. J., Nov. 2006.

State of Delaware Law

- Only shareholders may assert breach of fiduciary duty claims against the directors and officers of a solvent corporation. However, such claims must be asserted derivatively on behalf of the corporation.
- Creditors have standing to assert breach of fiduciary duty claims against the directors and officers of an insolvent corporation. However, such claims must be asserted derivatively on behalf of the corporation.
- It is still an open question as to whether the Delaware Supreme Court will afford creditors standing to assert derivative breach of fiduciary duty claims against the directors and officers of a corporation in the zone of insolvency.
- *Gheewalla* suggests that the Delaware Supreme Court will affirm the *Trenwick* decision and hold that:
 - Directors and officers owe their fiduciary duties to the corporation when the corporation is in the zone of insolvency;
 - Directors and officers may cause the near-insolvent corporation to take action that could reasonably preserve value for shareholders, so long as directors and officers (a) are mindful of the context of insolvency and that the corporation's creditors may be the ultimate stakeholders of the corporation, (b) make good-faith, informed and reasoned decisions and (c) make decisions that do not result in corporate waste; and
 - There is no independent cause of action for deepening insolvency under Delaware state law.

Conclusion

This decision, when read with *Production Resources* and *Trenwick*, should give boards of directors of corporations in the zone of insolvency added comfort that good-faith, informed and reasoned decisions intended to maximize the value of the enterprise will withstand scrutiny when viewed with 20/20

hindsight. However, when making such decisions, directors should be mindful of the context of insolvency and that creditors are the corporation's ultimate stakeholders upon insolvency. This decision also may correspondingly reduce the leverage of creditors in challenging decisions by boards of directors of near-insolvent corporations.

This publication is intended merely to highlight issues and not to be comprehensive, nor to provide legal advice. Should you have any questions on issues reported here or on other areas of law, please contact one of your regular contacts, or contact the editors.

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