

Client Alert

A report
for clients
and friends
of the Firm June 2007

DISMISS THAT LAWSUIT! Recent Delaware Governance Decisions Restrict Creditor Litigation Against Boards of Troubled Companies and Distressed Debt Investors

A series of recent corporate governance decisions by the Delaware state courts—the *NACEPF, Production Resources and Trenwick cases*—read in conjunction with last November’s Delaware bankruptcy court decision, *In re Radnor Holdings Corp.*,¹ which rejected equitable subordination and recharacterization claims against an investor/lender that held board seats and permitted such lender’s credit bid for the company’s assets, provides investors, officers and directors with guidance and comfort as they navigate the waters of corporate restructurings, allowing them to take significant and active roles in the reorganization of troubled companies with greater certainty of successfully defending potential lawsuits by disgruntled creditors.

Creditors Have No Direct Cause of Action for Breach of Fiduciary Duties

In the most recent of these state court decisions, *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla* (the “*NACEPF case*”),² Delaware’s highest court held that creditors of a Delaware corporation have no right, as a matter of law, to assert *direct* claims for breach of fiduciary duty against the corporation’s directors, notwithstanding

that the corporation is either insolvent or in the so-called “zone of insolvency.”

In March 2001, NACEPF, which held certain radio wave spectrum licenses regulated by the FCC, entered into a master use and royalty agreement with Clearwire Holdings, Inc. (“*Clearwire*”), a Delaware corporation. After Clearwire filed for bankruptcy, NACEPF filed a complaint, as a putative *creditor* of Clearwire, alleging, among other things, *direct*, not derivative, fiduciary duty claims against certain directors of Clearwire that were appointed to the board at the behest of a large investor. The complaint alleged that the defendants were able to control Clearwire even though they comprised less than a majority of the board because Clearwire’s only source of funding was from the investor; that the director-defendants served on the board while Clearwire was either insolvent or in the “zone of insolvency”; and that the directors improperly used their power to favor the investor’s agenda. As such, NACEPF alleged that the directors owed (and breached) a *direct* fiduciary duty to NACEPF, as a creditor of Clearwire, when the company entered the zone of insolvency.

The Chancery Court dismissed the lawsuit, and the Delaware Supreme Court affirmed, holding 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 the corporation’s directors.” (*emphasis added*). The court observed that it was “well established” that directors owed fiduciary obligations to the corporation and its shareholders, but that the general rule was that directors did not owe creditors duties beyond the relevant contractual terms. Although fiduciary duties shift to take into account creditor interests upon a company’s insolvency or entry into the zone of insolvency, the Court held that the fact that a corporation has become insolvent or is

¹ 335 B.R. 820 (Bankr. D.Del. 2006). For a more complete discussion of the *Radnor Holdings* decision, see our December 2006 client alert entitled “*Radnor Holdings: Delaware Bankruptcy Court Validates Secured Creditors’ Workout Strategies And Credit Bid Over Unsecured Creditors’ Objections*.” The *Radnor Holdings* client alert is available on the Proskauer Rose LLP website or upon request.

² No. 521, 2006 (Del. May 18, 2007).

approaching insolvency does not vest in creditors a direct right to sue officers and directors for alleged breaches of fiduciary duty. Rather, such claims can only be brought derivatively on behalf of the corporation. The court emphasized that permitting direct creditor actions for breach of fiduciary duty could hamper a troubled company's ability to obtain effective leadership at a time when it was most in need by creating "uncertainty for directors who have a fiduciary duty to exercise their business judgment in the best interest of the insolvent corporation." Accordingly, the court held that individual creditors of an insolvent or near insolvent corporation have no right to assert direct claims for breach of fiduciary duty against corporate directors.³

Added Protection Through Exculpation Clauses

In 2004, the Delaware Chancery Court issued a decision in *Production Resources*⁴ rejecting claims that a board and a non-director executive officer had committed various breaches of fiduciary duty and finding instead that such claims alleged, at most, duty of care claims which belong to the corporation. Moreover, the court determined that such claims were exculpated by a statutorily authorized provision within the company's certificate of incorporation notwithstanding the fact that the Delaware statute authorizing exculpatory charter provisions does not specifically address claims by creditors.

The *Production Resources* Court stated that fiduciary duty claims, which alleged that the board and officers had mismanaged the company, were "classically derivative" in the sense that they involved an injury to the corporation as an entity and any harm to creditors was purely derivative of the direct financial harm to the corporation itself. The fact that the corporation had become insolvent did not transform such claims into direct creditor claims, it simply provided creditors with standing to assert derivative claims on behalf of the corporation. Thus, in Delaware, as of result of *Production Resources*, such creditor derivative claims, like shareholders derivative claims, can be exculpated in the charter of a Delaware corporation.

Rejection of Deepening Insolvency

In addition to the governance decisions discussed above, the Delaware Chancery Court in *Trenwick*⁵ recently found that Delaware law does not recognize a cause of action for "deepening insolvency" because it does not express a coherent legal concept. The court emphasized that even when a company is insolvent, its directors may, in the appropriate exercise of their business judgment, take action that might, if it did not pan out, result in the worsening of the company's financial position. Put simply, the Chancery Court ruled that, under Delaware law, "deepening insolvency" was no more of a cause of action when a company was insolvent than a cause of action for "shallowing profitability" would be when a company was solvent.⁶

Looking Forward

As these rulings demonstrate, Delaware courts have refused to carve out the distressed debt arena from the general rule historically embraced by such courts: that directors and officers should be free to pursue good faith value maximizing business strategies (even if they are unsuccessful), and investors should be able to exercise their bargained for rights and remedies, without the threat of judicial second guessing. The mere fact of a business failure does not mean that a creditor-plaintiff can state claims against the directors and officers (or advisors) on the scene, and, as the decisions discussed above show, investors have flexibility in realizing value from distressed situations. Nonetheless, officers, directors and investors of troubled companies would be well-advised to continue to tread carefully when managing the interests of an insolvent or near insolvent entity to be sure that their actions (even if well-intended) steer clear of other areas of potential liability.

If you would like more information about these decisions or the steps you can take to structure and protect your distressed investments, please contact one of the attorneys in our Bankruptcy and Reorganization Practice Group.

³ The Court found that expanding the rights of creditors to permit direct suits for breach of fiduciary duty was unnecessary because creditors of an insolvent entity have a host of other remedies available to protect their interests including the implied covenant of good faith and fair dealing, state fraudulent conveyance law, and bankruptcy law.

⁴ 863 A.2d 772 (Del.Ch. 2004)

⁵ 906 A.2d 168 (Del. Ch. 2006).

⁶ The *Trenwick* decision was appealed and argued before the Delaware Supreme Court in March. A decision is expected soon.

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