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CLIENT MEMORANDUM

Zone of Insolvency: Where We Are Today

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EXECUTIVE SUMMARY

It is well established that directors owe fiduciary duties to the corporation and its stockholders. The controversial issue has been whether and to what extent these duties are owed to creditors when the corporation is insolvent or in the "zone of insolvency." The Supreme Court of Delaware brought substantial clarity to this issue in 2007, holding that, regardless of the corporation's solvency, directors must continue to act in the best interest of the corporation and its owners, so that creditors have no direct claim for breach of fiduciary duty against directors of a Delaware corporation.[1] The court also held that creditors have standing to bring derivative claims against directors for breach of fiduciary duty when the corporation is insolvent. In the event of insolvency, the business judgment rule continues to protect directors against breach of fiduciary duty claims as long as the directors act on an informed basis, in good faith and in the best interests of the corporation for the benefit of its owners.[2] Notwithstanding this, because creditors can bring derivative actions for breach of duty in the event of insolvency, directors of a distressed company should be aware that their actions, even though protected by the business judgment rule, could be subject to creditor scrutiny and second guessing. Therefore, directors should take special care in distress situations to build a record of staying informed and taking actions that best serve the entire corporate enterprise rather than any single group interested in the corporation.

INSOLVENCY-BASED CREDITOR RIGHTS

Directors of a corporation ordinarily do not owe fiduciary duties to creditors. The law assumes that creditors can adequately protect their interests "through contractual agreements … and other sources of creditor rights."[3] Once a corporation becomes

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1 *N. Am. Cath. Ed. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 101-03 (Del. 2007).

2 *See Aronson v. Lewis*, 473 A. 2d 805, 812 (Del. 1984) ("[p]resumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company").

3 *Production Resources Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772, 790 (Del. Ch. 2004).

insolvent[4], the corporation's creditors have standing to bring derivative actions on behalf of the corporation for breach of fiduciary duties by directors because in that circumstance the creditors are the ultimate beneficiaries of the directors' decisions. However, "the fact of insolvency does not change the primary object of the directors' duties, which is the firm itself."[5] The Delaware Court of Chancery recently reinforced this view in *Nelson v. Emerson*, stating that "[i]t is settled Delaware law that an insolvent company is not required to turn off the lights and liquidate when that company's directors believe that continuing operations will maximize the value of the company."[6]

GHEEWALLA: LIMITATIONS ON CREDITOR RIGHTS

Chancellor Allen had suggested in 1991 in *Credit Lyonnais Bank v. Pathe Comm.* that fiduciary duties to creditors arose at an earlier time: when the corporation entered the "zone of insolvency."[7] Considerable uncertainty followed until 2007, when the Supreme Court of Delaware in *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla* expressly limited the ability of creditors to bring claims against directors for breach of fiduciary duty. In *Gheewalla*, the plaintiff-creditor of the corporation sued the directors for breach of fiduciary duty under a theory that the directors improperly favored the stockholders' agenda while the corporation was insolvent or in the "zone of insolvency." The suit alleged a direct claim, asserting particularized harm suffered by the creditor individually, rather than a derivative claim on behalf of the corporation.[8]

Direct Claims

Gheewalla expressly held that creditors have no direct claim for breach of fiduciary duty against directors of a Delaware corporation, regardless of whether the corporation is insolvent or in the "zone of insolvency." That is, creditors seeking to assert individual claims are limited to statutory, contractual, and other non-fiduciary claims potentially available to creditors, irrespective of the financial condition of the corporation. The *Gheewalla* court held that creditors may not bring a direct claim for breach of fiduciary duty of a corporation that is insolvent, expressing concern that creating a fiduciary duty to individual creditors "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."[9]

The court also held that creditors may not bring a direct claim for breach of fiduciary duty of a solvent corporation that is in the "zone of insolvency," taking the view that "[w]hen a solvent corporation is navigating 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."

Derivative Claims

The *Gheewalla* court reasoned that creditors may protect their interests by bringing derivative claims when the corporation is insolvent. When a corporation is solvent, of course, shareholders have standing to assert derivative claims on behalf of the corporation because they are the ultimate beneficiaries of the corporation's growth and increased value. When a corporation is insolvent, however, "its creditors take the place of the shareholders as the residual beneficiaries of any increase in value" and can assert derivative claims.[10] Delaware law, of course, permits a corporation to include an exculpatory provision in its

4 *See Geyer v. Ingersoll Publications Co.*, 621 A.2d 784, 787-90 (Del. Ch. 1992) (Courts generally have held that "insolvency" means insolvency in fact rather than insolvency based on institution of bankruptcy proceedings. A company is insolvent if it is (i) "unable to pay its debt as they fall due in the usual course of business," or (ii) "it has liabilities in excess of a reasonable market value of assets held.").

5 *Production Resources*, 863 A.2d at 792.

6 *Nelson v. Emerson*, C.A. No. 2937-VCS, 2008 WL 1961150, at *2 (Del. Ch. May 6, 2008).

7 *Credit Lyonnais Bank v. Pathe Comm.*, 1991 WL 277613 (Del. Ch. Dec. 30, 1991) ("[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, but owes its duty to the corporate enterprise... [I]n 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.").

8 *Gheewalla*, 930 A.2d 92.

9 *Id.* at 103.

10 *Id.* at 101.

charter insulating directors from claims for money damages arising out of breaches of the duty of care, even when creditors or a trustee, rather than shareholders, are suing derivatively.[11]

Gheewalla brought much needed clarity to the issue of directors' fiduciary duties in distress situations. Its holding establishes that even when a corporation is in the "zone of insolvency" or is insolvent, directors owe no direct duties to creditors. Notwithstanding this, because creditors of an insolvent corporation gain standing to bring derivative actions against directors, directors in corporate distress situations should be sensitive to the possibility that if insolvency occurs, their past actions could be subject to creditor scrutiny. Thus in distress circumstances, directors should build a record of staying informed and taking actions that clearly advance the interest of the corporation as a whole, and not the interests of any particular group.

CONCLUSION

The Delaware Supreme Court's rejection of direct creditor claims against directors for breach of fiduciary duty reinforces the principle that creditor rights are limited to rights bargained for in contracts and any additional protections provided in other traditional sources of creditor rights. Regardless of the financial state of the corporation, directors' duties run to the corporation and its owners.[12] The business judgment rule should protect directors against claims of breach of fiduciary duty as long as they act in good faith and by a process that focuses on maximizing the value of the corporation for the benefit of the beneficiaries of its residual value. In distress situations, directors should, nonetheless, take pains to build a record of acting in the corporation's best interest.

This memorandum is for general information purposes and should not be regarded as legal advice. Please contact your relationship partner if we can be of assistance regarding these important developments. The names and office locations of all of our partners, as well as memoranda regarding recent corporate reporting and governance developments, can be obtained from our website, www.simpsonthacher.com.

11 *See In re Radnor Holdings Corp.*, 353 B.R. 820, 842 (Bankr. D. Del. 2006); *Production Resources*, 863 A.2d at 793 ("Although §102(b)(7) itself does not mention creditors specifically, its plain terms apply to all claims belonging to the corporation itself, regardless of whether those claims are asserted derivatively by stockholders or by creditors.").

12 *See Nelson*, C.A. No. 2937-VCS, 2008 WL 1961150.