DELAWARE SUPREME COURT CLARIFIES DIRECTORS' FIDUCIARY DUTIES

Although numerous scholarly articles and practical advisories have been written regarding a director's fiduciary duty to creditors once a company becomes insolvent or enters the "zone of insolvency," until now, the Delaware Supreme Court has never addressed the issue. As a result, the Delaware Supreme Court's recent decision in North American Catholic Educational Programming Foundation, Inc. v. Gheewalla will provide much needed guidance for Boards of Directors to consider as they shepherd corporations through challenging financial circumstances.

In its decision, the Delaware Supreme Court determined whether a creditor may maintain a direct cause of action alleging particularized harm, rather than an action alleging more general harm to the corporation at two distinct periods in time – when a corporation is insolvent and when a corporation is not insolvent, but has entered the "zone of insolvency." The Supreme Court unambiguously held that as a matter of law a creditor cannot bring a direct claim in either situation. The Supreme Court also reaffirmed existing law in holding that when a corporation is insolvent, a creditor can bring a derivative claim for breach of fiduciary duty against the directors of a corporation.

A strong theme of the opinion is the need for absolute clarity in this area of the law. In particular, the Supreme Court wrote: "Individual creditors of an insolvent corporation have *no right to assert direct* claims for breach of fiduciary duty against corporate directors." Slip op. at 23 (emphasis in original). The Supreme Court went on to say 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 the business judgment in the best interest of the corporation for the benefit of its shareholder owners.

North American Catholic, slip op. at 19. Given the specific focus of the language on shareholders, the Supreme Court appears to have reaffirmed insolvency as the line when creditor standing for derivative claims arises and strongly suggests that the Supreme Court does not view creditors as having standing to assert derivative claims while in the "zone of insolvency." Giving further weight to this view is a footnote in the opinion in which the Supreme Court provides that based on its holding, it is "unnecessary to precisely define the 'zone of insolvency.'" Obviously, in the Supreme Court's view, it is unnecessary to define the "zone of insolvency" because creditors have no standings to assert derivative claims against directors of a corporation merely in the "zone of insolvency" as opposed to a corporation that is actually insolvent.

This ruling eliminates another avenue creditors had begun to pursue in applying pressure against the Board of Directors of a struggling corporation. Based upon this decision, directors can take comfort that they cannot be sued for exercising appropriate business judgment when a corporation may be facing serious financial difficulties. Moreover, the Supreme Court has reaffirmed the standard that directors should act in the best interest of the corporation as a whole without regard to the impact on a particular class of creditors. In this way, directors will not be forced to make decisions merely because no one will be harmed (even when such decisions benefit no one), but rather can pursue a path that will return the corporation to viability and profitability. In turn, this means that directors of an insolvent entity can appropriately consider the interests of various constituencies in addition to creditors, including employees and shareholders, and make business judgments that are in the best interests of the corporation as a whole. As a result of the Supreme Court's ruling, it will prove difficult for creditors to challenge the judgments of a well-advised, nonconflicted board, even when the corporation is insolvent.

* * * * * * * * * * * * * * *

If you have any questions regarding this memorandum, please contact Matthew A. Feldman (212-728-8651, mfeldman@willkie.com), or the Willkie attorney with whom you regularly work.

Willkie Farr & Gallagher LLP is headquartered at 787 Seventh Avenue, New York, NY 10019-6099. Our telephone number is (212) 728-8000 and our facsimile number is (212) 728-8111. Our website is located at www.willkie.com.

May 22, 2007

Copyright © 2007 by Willkie Farr & Gallagher LLP.

All Rights Reserved. This memorandum may not be reproduced or disseminated in any form without the express permission of Willkie Farr & Gallagher LLP. This memorandum is provided for news and information purposes only and does not constitute legal advice or an invitation to an attorney-client relationship. While every effort has been made to ensure the accuracy of the information contained herein, Willkie Farr & Gallagher LLP does not guarantee such accuracy and cannot be held liable for any errors in or any reliance upon this information. Under New York's Code of Professional Responsibility, this material may constitute attorney advertising. Prior results do not guarantee a similar outcome.