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DELAWARE SUPREME COURT LIMITS CREDITOR CLAIMS AGAINST CORPORATE DIRECTORS

The Delaware Supreme Court has definitively decided that creditors of a Delaware corporation that is either insolvent or operating in the zone of insolvency do not have the right to assert direct claims for breach of fiduciary duty against the corporation's directors. The Court strongly implied, but did not expressly hold, that creditors do not have standing to assert derivative claims for breaches of fiduciary duty to the corporation when the corporation is operating in the zone of insolvency. The Court confirmed, however, that creditors of an insolvent Delaware corporation have standing to assert derivative claims against directors for breaches of fiduciary duty. The decision, *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla ("NACEPF")*, issued on May 18, 2007, is available by clicking here.

In the *NACEPF* decision, the Delaware Supreme Court resolved a previously unsettled area of Delaware corporation law — whether the fiduciary duties of directors of a corporation expand to include fiduciary duties to creditors in their individual capacities, thus supporting direct creditor claims, when that corporation is insolvent or operating in the zone of insolvency. (Under Delaware law, a direct claim is one that is not predicated on an injury caused to the corporation and for which the recovery flows solely to the plaintiff-creditor.) A recent decision of the Delaware Chancery Court questioned the propriety of affording creditors an equitable claim of breach of fiduciary duty but nevertheless left the door open for the possibility of direct creditor suits for breach of fiduciary duty under certain circumstances. *See Production Resources Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772, 787-95 (Del. Ch. 2004).

That door has now been firmly shut by the Delaware Supreme Court. In *NACEPF*, the Delaware Supreme Court refused to create what it characterized as a new right for creditors to challenge business judgment decisions of directors by asserting direct claims for breach of fiduciary duty. The Court stated that creditors were adequately protected by their contractual arrangements, the implied covenant of good faith and fair dealing, tort laws, fraudulent conveyance law and bankruptcy law. The Court further expressed concern that directors needed guidance when a corporation is in the zone of insolvency, instructing that the focus of directors prior to actual insolvency should remain on their duties to the corporation for the benefit of shareholders. The Court observed, however, that equitable considerations existed to give creditors standing to pursue derivative claims for breach of fiduciary duty on behalf of a corporation that is actually insolvent because at that juncture creditors become the ultimate stakeholders.

The Court did not expressly address whether creditors may bring derivative suits during the period when a corporation is in the zone of insolvency. Nevertheless, the Court's stated desire to create a bright line test to guide directors during the pre-insolvency period and the absence of any discussion regarding the right of creditors to assert derivative claims during this period appears to sound the death knell for creditor derivative claims short of actual insolvency.

By limiting creditors to derivative claims, and then only in cases of actual insolvency, *NACEPF* leaves creditors with little incentive to pursue breach of duty claims: any recovery flows to the corporation, not to the creditor; the creditor will likely need to establish that the board is conflicted from deciding for itself whether the corporation should bring the claim; and under the automatic stay provisions of the Bankruptcy Code, the claim is available only so long as the corporation is actually insolvent, but is not placed into bankruptcy.

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This information is not intended as legal advice, which may often turn on specific facts. Readers should seek specific legal advice before acting with regard to the subjects mentioned herein.

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